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TO: CLIENTS

FROM: SIVON, NATTER & WECHSLER, P.C.

DATE: NOVEMBER 9, 2022

RE: IMPLICATIONS OF THE FIFTH CIRCUIT'S DECISION IN COMMUNITY FINANCIAL ASSOCIATION OF AMERICA v. CFPB

In *Community Financial Association of America v. Consumer Financial Protection Bureau*, a panel of three judges in the U.S. Court of Appeals for the Fifth Circuit held that the funding mechanism used by the Consumer Financial Protection Bureau ("CFPB") violates the Appropriations Clause of the Constitution. While this decision is only applicable in the Fifth District (Texas, Louisiana, and Mississippi), it raises serious questions about the operations of the CFPB and the body of law issued by that agency. This memorandum discusses the implications of the Fifth Circuit's decision and concludes that the decision should not disrupt prior actions by the CFPB and that there are several significant bases upon which the decision could be reversed upon appeal.

I. The Establishment and Powers of the CFPB

The CFPB was established by Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.<sup>1</sup> The statute describes the agency as an "independent bureau" within the Federal Reserve System.<sup>2</sup> The CFPB is headed by a Director,<sup>3</sup> who is appointed by the President, and confirmed by the Senate. As originally passed, the Director could only be removed for cause, thus limiting the authority of the President to replace a Director before the expiration of his or her term.

The Dodd-Frank Act gave the CFPB broad authority to enforce 18 existing consumer protection laws, as well as a new authority to prohibit any "unfair, deceptive, or abusive act or practice" by consumer financial services providers, with only a few statutory exemptions.<sup>4</sup> The CFPB has rulemaking, supervision, and enforcement authority, may

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<sup>1</sup> Public Law 111-203 (2010) (hereinafter "Dodd-Frank Act").

<sup>2</sup> Dodd-Frank Act §1011, 12 U.S.C. § 5491.

<sup>3</sup> *Id.*

<sup>4</sup> Dodd-Frank Act §1031, 12 U.S.C. § 5511. For example, the CFPB has only limited authority over insurance, real estate agents, automobile sales, and timeshare sales.

conduct investigations, issue subpoenas and civil investigative demands, initiate administrative adjudications, and prosecute civil actions in federal court. The enforcement authority is coupled with extensive adjudicatory authority, and when acting in this capacity, the CFPB may grant any appropriate legal or equitable relief.

Unlike most other agencies, the CFPB does not rely on the annual appropriations process for funding. Instead, the CFPB receives funding directly from the Federal Reserve System, which is itself funded outside the appropriations process primarily through open market transactions in securities. Each year, the CFPB requests an amount that the Director deems “reasonably necessary to carry out” the agency’s duties, and the Federal Reserve System must grant that request so long as it does not exceed 12% of the total operating expenses of the Federal Reserve System (inflation-adjusted).<sup>5</sup>

## II. Seila Law Supreme Court Decision

In 2017, the Seila law firm (“Seila Law”) was served with a request for documents and other information in connection with a potential civil enforcement action by the CFPB. The law firm fought the information demand, arguing that the statutory limitation on the power of the President to remove the CFPB Director was unconstitutional. The case eventually went before the U.S. Supreme Court, which in 2020, agreed with Seila Law and struck the statutory language limiting the President’s removal authority.<sup>6</sup>

The Court based its decision on its analysis of Article II of the Constitution, which provides that “[t]he executive Power shall be vested in a President,” who must “take Care that the Laws be faithfully executed.”<sup>7</sup> The Court determined the unusual structure of the CFPB was violative of this provision, and therefore the limitation on the President’s removal power was constitutionally invalid when applied to the CFPB, a single Director agency with expansive power over a broad swath of the U.S. economy.

While the Court did not base its finding on the Appropriations Clause, it did note that the CFPB funding scheme “further aggravates” the agency’s insulation from Presidential control. The Supreme Court stated that CFPB funding authority “makes it even more likely that the agency will slip from the Executive’s control, and thus from that of the people.”<sup>8</sup>

As noted, the remedy chosen by the Supreme Court was to strike the provisions in the CFPB’s enabling statute that limited the President’s removal power. This allowed the agency to continue to operate because the Court found that “the *only* constitutional defect [the Court has] ... identified in the CFPB’s structure is the Director’s insulation from removal.”<sup>9</sup> In other words, the Supreme Court concluded that if the Director were removable at will by the President, all constitutional issues with the CFPB structure would be resolved.

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<sup>5</sup> 12 U.S.C. § 5497.

<sup>6</sup> Seila Law LLC. v CFPB, \_\_ U.S. \_\_, No. 1907 (June 29, 2020), 140 S.Ct. 2183 (2020) (hereinafter “Seila”)

<sup>7</sup> U.S. Const. Art. II, §1, cl. 1.

<sup>8</sup> Id. at 2204.

<sup>9</sup> Id. at 32-22. Emphasis added.

### III. CFSA v. CFPB

On October 19, 2022, a three-judge panel of the Court of Appeals for the Fifth Circuit held that the funding mechanism used by the CFPB, in which the agency obtains its funds from the Federal Reserve System rather than through the appropriations process, was unconstitutional.<sup>10</sup> The case arose when a trade association representing payday lenders challenged a CFPB rule that limits the ability of a creditor to obtain loan payments via preauthorized transfers after two transfer attempts were denied due to insufficient funds.

The Court of Appeals explained that the Appropriations Clause of the Constitution was designed to separate the three branches of Government, and thereby provide a system of checks and balances to prevent any one branch from assuming unbounded power. The Court of Appeals noted that the CFPB is funded through the Federal Reserve System, which itself is funded through its operations and not through appropriations (leading to what the court refers to as being “double-insulated”).

The Appropriations Clause only applies to money “drawn from the Treasury.”<sup>11</sup> Since CFPB’s funds are derived from the Federal Reserve System, it could be argued that technically the CFPB is not drawing money from the Treasury. However, the Federal Reserve System’s income that is not used for operations (and a statutory reserve) is remitted to the Treasury.<sup>12</sup> Therefore, as an *economic matter*, the CFPB is in fact using Treasury funds.

The court also mentioned other factors that limit the ability of Congress to use its constitutional “power of the purse.” The funds of the CFPB are not held in a Treasury account, but instead, the statute establishes the “CFPB Fund” independent of the Treasury and under the control of the Director. The Dodd-Frank Act specifies that the CFPB funds shall not be considered Government funds or appropriated money. The Court of Appeals argued that taken together, these provisions create an unprecedented insulation of the CFPB’s funding from Congress that is violative of the Appropriations Clause, which is designed to provide a check on Executive Department power. The Court of Appeals found that this problem was compounded by the fact that the Director, following the *Seila* case, could be removed by the President at will:<sup>13</sup>

An expansive executive agency insulated (no, double-insulated) from Congress’s purse strings, expressly exempt from budgetary review, and headed by a single Director removable at the President’s pleasure is the epitome of the unification of the purse and the sword in the executive – an abomination the Framers warned would destroy that division of powers on which political liberty is founded.

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<sup>10</sup> Community Fin. Services Ass’n. v. Consumer Fin. Protection Bureau, No. 21-50826 (Oct. 19, 2022) (hereinafter *CFSA v. CFPB*).

<sup>11</sup> U.S. Const. Art. I, §9, cl.7.

<sup>12</sup> 12 U.S.C. §289(a)(3)(B).

<sup>13</sup> *Id.* at 32.

The Court of Appeals recognized that other agencies are exempt from appropriations, including the Federal Reserve System, the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”), the National Credit Union Administration (“NCUA”), and the Federal Housing Finance Agency (“FHFA”). The Court of Appeals distinguished these agencies because, in the Court’s view, they do not have the CFPB’s broad scope of authority throughout the economy, and because the other agencies are not “double insulated” from appropriations.

The Court of Appeals discussed the *Seila* ruling but determined that the Supreme Court did not confront whether the Bureau’s unique funding also violates the Constitution. While it is correct that the Supreme Court did not *specifically* rule on the appropriations issue, the Fifth Circuit decision ignores the fact that the Supreme Court had discussed in detail CFPB’s funding scheme in *Seila*, but nevertheless stated that the *only* constitutional defect was the limitation on the President’s removal authority. This finding was key in fashioning the Court’s remedy in *Seila*, which was to remand the case for possible enforcement by the Bureau. This would not be an acceptable remedy if the Supreme Court felt there were other constitutional infirmities with the CFPB’s structure.

#### IV. Will Other Circuits or the Supreme Court Likely Follow the Fifth Circuit

Technically, the holding in *CFSA v. CFPB* was to declare invalid the CFPB’s rule limiting the number of preauthorized transfer requests that can be made by a creditor. No other rule or issue was before the court. However, at least in the Fifth Circuit (Texas, Louisiana, and Mississippi), the case may be raised to invalidate other CFPB regulations or enforcement actions if funds derived from the Federal Reserve System are utilized.

Currently, there is a split between the D.C. Court of Appeals, which previously upheld the CFPB’s funding mechanism,<sup>14</sup> and the Fifth Circuit. We do not know if the Fifth Circuit or the D.C. Circuit ruling will be followed in other jurisdictions, and it is possible that other appellate courts will reach different conclusions. Ultimately, a nationwide resolution will require either a Supreme Court decision or a statutory change in the Bureau’s funding provisions.

Assuming the Supreme Court does review the Fifth Circuit’s decision, there are several reasons why the Supreme Court may reach a different conclusion. First, as mentioned above, the Court of Appeals did not take into account the conclusion reached by the Supreme Court that making the Director removable at will resolves *all* of the constitutional issues with the structure of the Bureau. As explained by Chief Justice Roberts:<sup>15</sup>

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<sup>14</sup> *PHH v. CFPB*, 881 F.3d 75 (D.C. Cir. 2018), overruled for other reasons by *Seila*. There are also a number of District Court cases that have upheld the constitutionality of the funding mechanism. See Footnote 15 in the Fifth Circuit’s decision.

<sup>15</sup> *Seila*, slip opinion at 32-33. This section of the plurality opinion represents the views of Chief Justice Roberts and Justices Alito and Kavanaugh. A separate opinion by Justices Thomas and Gorsuch does not discuss the Appropriations Clause issue and appears to agree with the conclusion that eliminating the restriction on the President’s removal authority fixes the constitutional problems. The minority opinion authored by Justices Kagan, Ginsburg, Breyer, and Sotomayor argues that the CFPB statute is constitutional, thereby implicitly finding that the Appropriations Clause was not violated by the CFPB’s funding mechanism.

The only constitutional defect we have identified in the CFPB's structure is the Director's insulation from removal. If the Director were removable at will by the President, the constitutional violation would disappear.

This determination was made by the Supreme Court after a discussion of the Bureau's funding. Further, it is not mere dicta, as the constitutional validity of the Bureau (after severing the limitation on the President's removal authority) was a necessary finding for the Supreme Court's ultimate remedy.

It is possible that the Supreme Court will agree to reconsider its finding in *Seila* that fixing the removal problem resolves all constitutional issues. However, since *Seila* was decided only two years ago, the Supreme Court may be very reluctant to reverse its decision allowing the CFPB to proceed with its enforcement proceeding if ratified by a CFPB Director removable at will.<sup>16</sup> Thus, there appears to be a significant likelihood that, if the Supreme Court agrees to review this case, it will not find the Fifth Circuit's reasoning on the Appropriations issue persuasive.<sup>17</sup>

The Fifth Circuit distinguishes the CFPB from other agencies that use non-appropriated funds, such as the FDIC, the OCC, and the Federal Reserve System, based on two arguments. First, the Court of Appeals argues that the CFPB is "double insulated" from Congressional appropriations since its funds come from an entity that is also not subject to appropriations. However, the Court of Appeals does not explain why this is constitutionally significant.

The second difference noted in the decision is the broad jurisdictional reach of the CFPB throughout the economy, which the Court of Appeals finds exceeds that of the other non-appropriated agencies. However, while the CFPB has broad power over most consumer financial institutions, it does not regulate non-consumer financial transactions, securities transactions, insurance, and commodities, among other carve-outs.<sup>18</sup> In contrast, the Federal Reserve System has power over the entire economy through interest rates regulation, payment system regulation, and financial stability regulation, as well as supervisory and regulatory authority over bank and savings and loan holding companies and state member banks. Thus, it is difficult to make the case that the CFPB has more influence or power over the Nation's economy than the Federal Reserve System.

In short, while the Fifth Circuit's decision makes a compelling case as to why the Appropriations Clause should apply to the CFPB, there are significant reasons to believe that a different Circuit Court of Appeals and the Supreme Court may not agree.

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<sup>16</sup> The discovery request was ratified and held to be valid in CFPB v. Seila Law, 997 F.3d 837 (9<sup>th</sup> Cir. 2021).

<sup>17</sup> Of course, the Supreme Court could also determine that the rule in question is invalid for other reasons, such as failure to fully comply with APA rulemaking procedures.

<sup>18</sup> There are a number of specific exemptions to the Bureau's authority, e.g., insurance, car dealerships, real estate agents, and to a limited extent, timeshare sales.

## V. Next Steps

The Fifth Circuit's decision is likely to be appealed, either to the full Circuit for an *en banc* review, or directly to the Supreme Court. Pending the review, the decision is binding in Texas, Louisiana, and Mississippi. The decision only invalidated the preauthorized payment rule. The Court of Appeals did not discuss the status of other rules or prospective CFPB enforcement actions. As will be discussed below, there is solid precedent for CFPB's existing rules to remain in effect. Yet, unless the Fifth Circuit's decision is overturned, or Congress modifies the funding mechanism for the CFPB, the ability of the CFPB to pursue its mission in the Fifth Circuit will be compromised. Thus, the CFPB likely will seek an expedited review of this decision, either by the entire Court of Appeals or the Supreme Court. Due to the importance of this decision, and the need for legal certainty for consumer financial services in the affected States, one would expect the Supreme Court to grant certiorari, unless the Fifth Circuit, sitting *en banc*, reverses the decision, or affirms it on other grounds, such as failure to comply with the APA. It would also be likely that a reviewing Court would stay the effectiveness of the Fifth Circuit panel's opinion pending any review.

## VI. Status of Existing CFPB Regulations and Orders

A review of past decisions in which an administrative agency or other governmental body has been declared to be violative of the Constitution indicates a general reluctance to upset prior reliance on agency rules or orders while giving Congress an opportunity to remedy the constitutional infirmity. In *Collins v. Yellen*,<sup>19</sup> the Supreme Court held that prior actions of the Director of the Federal Housing Finance Agency would remain in effect despite finding that limitations on the President's removal power over that officer were unconstitutional. In *Buckley v. Valeo*,<sup>20</sup> the Supreme Court held that the Congressional appointment of members of the Federal Election Commission was an unconstitutional intrusion on the Executive's power to appoint Executive Branch officers but went on to declare that past acts of the Commission would be afforded *de facto* validity. The Court also allowed the Commission to continue to exercise its powers going forward for a 30-day period, during which Congress could reform the statute to deal with the constitutional problems identified by the Court.

A similar result was reached by the D.C. Circuit Court of Appeals when it held that the D.C. Financial Control Board exceeded its authority when it transferred some of its authority to the School Board of Trustees. The Court of Appeals used its "judicial discretion" to provide that the past acts of the trustees would be accorded *de facto* validity.<sup>21</sup>

In another D.C. Circuit Court of Appeals case, the court found the structure of the Washington Metropolitan Airports Authority unconstitutional but accorded past acts taken by the agency "de facto validity."<sup>22</sup>

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<sup>19</sup> 141 S.Ct. 1769 (2021)

<sup>20</sup> 424 U.S. 1 (1976).

<sup>21</sup> *Shook v. D.C. Fin. Responsibility and Management Assistance Auth.*, 132 F.3d 775 (1998).

<sup>22</sup> *Hechinger v. Washington Metropolitan Airports Authority*, 36 F.3d 97 (D.C. Cir. 1994).

In an analogous situation, when a court determines that an official has not been validly appointed, the court will typically use the “de facto officer doctrine” to keep prior actions taken by the putative official in effect. The Supreme Court explained that the de facto officer doctrine was developed by the courts to deal with the chaos that could result from multiple and repetitious suits challenging every action taken by an agency official whose claim to office is open to question and to protect the public by ensuring the orderly functioning of the government despite technical defects in title to office.<sup>23</sup> The de facto officer doctrine is technically not applicable to the instant case, in which the legitimacy of the agency itself, rather than that of an official, is the issue. However, the same policy considerations are at play, and a court would have similar motivation to preserve prior agency actions to prevent chaos while Congress considers how it will address the constitutional problem.

## VII. Implications for Other Self-Funded Financial Agencies

The Fifth Circuit’s decision distinguishes the CFPB from other self-funded agencies, such as the OCC, FDIC, the Federal Reserve System, FHFA, and the NCUA Board (“self-funding agencies”) principally on two grounds. First, only the CFPB is “double insulated” by obtaining its funding from the Federal Reserve, which itself is not subject to the Appropriations Clause. Second, the Court of Appeals argues that the regulatory authority of the CFPB over segments of the economy is far greater than the other self-funded agencies. We have previously explained why these two factors may not provide a sufficient basis for differentiating these agencies from the CFPB.

On the other hand, there are some significant differences that could justify a differentiation between the CFPB and the other agencies. The self-funding agencies raise their entire operating budgets through fees, insurance premiums, and examination charges imposed on the entities they regulate, or in the case of the Federal Reserve System, from fees and earnings on their securities portfolio. Therefore, there is no draw on the Treasury. This does not apply to the CFPB, which does not raise funds from private entities outside of the Government but instead transfers funds from the Federal Reserve System. As a matter of economics, these transfers are equivalent to a draw on the Treasury. It is somewhat surprising that this essential difference between the CFPB and the other non-appropriated agencies was not more fully discussed in the Fifth Circuit’s decision.

## VIII. Conclusion

In *CFSA v. CFBP*, the Federal Court of Appeals for the Fifth Circuit Court held that the funding mechanism used by the CFPB was violative of the Appropriations Clause and therefore the regulation at issue in the case was invalid. The decision is only applicable in the Fifth District. While the Court of Appeals did not specify remedies, it is likely that if challenged, another court would allow other existing rules and orders of the CFPB to continue to be effective in order to avoid legal uncertainty for the public. It is also likely that the case will be appealed, and that a stay would be imposed pending review, and should final review affirm the Fifth Circuit, additional time may be afforded to allow for Congressional action.

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<sup>23</sup> Ryder v. United States, 515 U.S. 177 (1995).

Whether the Fifth Circuit's decision will be upheld on review is questionable. In 2020, the Supreme Court reviewed the structure of the CFPB and concluded that if the President had the power to remove the CFPB Director at will, *all* other constitutional issues with the CFPB structure would be resolved. The Fifth Circuit's decision does not address why this is not determinative over the funding issue, which was also discussed by the Supreme Court in its 2020 decision. While it is possible that the Supreme Court will agree to reconsider its decision, it is unlikely that it would reverse its own recent decision that effectively allowed a CFPB enforcement proceeding to continue.