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Fifth Circuit Holds That FHFA is Unconstitutionally Structured

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The decision by the United States Court of Appeals for the Fifth Circuit earlier this week in ***Collins v. Mnuchin*** holding that the structure of the Federal Housing Finance Agency (**FHFA**) is unconstitutional is an important development not only for the FHFA but also for the constitutionality of the CFPB. The *per curiam* opinion in *Collins* almost guarantees that the Supreme Court will grant cert in the near future on whether the FHFA, the CFPB and similarly structured agencies are unconstitutional.

In addition, a powerful dissent by Judge Don Willett, who is on President Trump's **published list** of potential Supreme Court candidates, also increases the possibility that the Supreme Court may grant cert on a separate issue: whether the FHFA exceeded its statutory authority as conservator of Fannie Mae and Freddie Mac when it agreed to the net worth sweep amendment without the consent of their non-government shareholders.

Under the Housing and Economic Recovery Act of 2008 (**HERA**), the two government-sponsored enterprises (**GSEs**), Fannie Mae and Freddie Mac, are regulated entities subject to the direct supervision of the FHFA. In *Collins*, the Fifth Circuit considered two arguments brought by the plaintiffs—three Fannie Mae and Freddie Mac shareholders. The shareholders first argued that the FHFA, as conservator of Fannie Mae and Freddie Mac, had exceeded its statutory authority by consenting to a 2012 amendment to the original 2008 terms of Fannie and Freddie's financial assistance agreements with the Treasury Department without the consent of their non-government shareholders. That amendment required Fannie Mae and Freddie Mac to pay to Treasury quarterly dividends equal to their entire net worth in perpetuity (the **net worth sweep amendment**), thereby discriminating in favor of the government and against their non-government shareholders. Second, the shareholders argued that a variety of factors that shelter

the FHFA from control by or accountability to the Executive Branch, taken in combination, render the FHFA's structure unconstitutional.

The Fifth Circuit granted the plaintiffs a partial victory, ruling against them on the net worth sweep claim while ruling in their favor of the constitutional claim. Both aspects of this decision may prove to be highly significant. We offer below some initial takeaways and key points to watch going forward.

Split *Per Curiam* Opinion. The *Collins* decision produced a splintered *per curiam* opinion, with two judges agreeing with the government that the FHFA did not exceed its statutory authority under HERA in consenting to the net worth sweep amendment, but a different set of two judges agreeing with the plaintiffs that the FHFA is unconstitutionally structured.

Net Worth Sweep Argument Rejected. By a 2-1 vote, the Fifth Circuit rejected the plaintiffs' net worth sweep argument based on the same reasoning as that used by the Sixth, Seventh and District of Columbia Circuits in previous decisions that rejected identical arguments.

Powerful Dissent to the Net Worth Sweep Decision by Judge Willett. In a well-reasoned, clearly written and highly persuasive dissent, Judge Willett calls into question the validity of the reasoning of the majority opinion on the net worth sweep claim and all other circuits that have previously addressed this issue. Judge Willett's dissent contains an analysis of the plain meaning of the statute governing the FHFA's statutory powers as conservator. It does so in the context of the statute as a whole and against the backdrop of the closely related powers of the Federal Deposit Insurance Corporation (**FDIC**) as conservator for insured depository institutions and the common law of conservatorships. According to Judge Willett, the FHFA, as conservator, has a statutory duty under HERA to "preserve and conserve the assets and property of" Fannie and Freddie and restore them to a "sound and solvent condition." The FHFA's consent to the net worth sweep amendment was inconsistent with that duty, and was not authorized by any other provision in HERA that applies to conservators, because it stripped Fannie and Freddie of their capital reserves and future income potential. It was also inconsistent with the caselaw construing the FDIC's closely related powers of the FDIC as conservator of insured depository institutions and with the common law of conservatorships. This latter point is significant since the conservatorship and receivership provisions in HERA are essentially a minor mark-up of the preexisting conservatorship and receivership provisions applicable to insured depository institutions. HERA's severe limit on

judicial review of the FHFA's actions as conservator, on which the majority opinion and the other circuits have relied to deny judicial review of challenges to the net worth sweep amendment in the past, does not apply since the limit only applies to actions taken by the FHFA within its statutory powers as conservator.

Judge Willett's dissent is consistent with the views of two former FDIC general counsels, including John Douglas who as FDIC general counsel from 1987 to 1989 was heavily involved in drafting the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (**FIRREA**), which contains the conservatorship and receivership provisions that apply to insured depository institutions and of which the conservatorship and receivership provisions in HERA were essentially a minor mark-up.[1] Though the Supreme Court has **declined** to hear previous appeals raising the net worth sweep issue, Judge Willett's dissent is likely to feature in an eventual cert petition by the *Collins* plaintiffs.

Unconstitutionally Excessive Insulation. Turning to the constitutional issue, the *Collins* court observed that though "agencies may be independent, they may not be isolated." The *per curiam* opinion then determined that the FHFA is so insulated by Congress from the Executive Branch that the Executive Branch can no longer control the FHFA or hold it accountable. The opinion reached this conclusion after considering the combined effect of the facts that (1): the FHFA's director may be removed only for cause; (2) the FHFA is headed by only a single director (3) the FHFA lacks bipartisan leadership; (4) the FHFA is funded outside the normal appropriations process; and (5) the FHFA is overseen by the Federal Housing Finance Oversight Board acting in a purely advisory role.

PHH* Distinguished?** For those who have followed the D.C. Circuit's opinions in ***PHH v. CFPB or **other challenges** to the CFPB's structure, the first four elements of what the Fifth Circuit considered to be excessive insulation of the FHFA will look highly familiar. And indeed the *per curiam* opinion cites repeatedly to the *PHH en banc* dissents of Judges Kavanaugh (eight times) and Henderson (ten times). In light of the fact that a case directly challenging the CFPB's structure is currently awaiting oral argument in the Fifth Circuit, and in light of the **recent decision** by the former Chief Judge of the United States District Court for the Southern District of New York adopting the Kavanaugh and Henderson dissents and declaring the CFPB's structure unconstitutional, the significance of these references will be lost on no one. At the same time, the *per curiam* opinion does not adopt the *PHH* dissents. Instead, *Collins* seeks to distinguish *PHH* based on "salient distinctions" between the FHFA and the CFPB.

The Role of FSOC. For the *per curiam* opinion, the most significant distinguishing factor between the FHFA and the CFPB is that "the Executive Branch can directly control the CFPB's actions" through the Financial Stability Oversight Council (**FSOC**). Here, as did the concurrence by Judge Wilkins in *PHH*, the Fifth Circuit found it significant that a "supermajority" of FSOC members are appointed by the President, thus giving the Executive Branch some measure of control over the CFPB, even if the Director is a not a Presidential appointee. Furthermore, the FSOC has a "powerful" veto mechanism whereby it may, with a two-thirds majority vote, set aside CFPB regulations that put the safety and soundness of the U.S. banking system or the U.S. financial system at risk. In contrast, the FHFA is overseen by a Federal Housing Finance Oversight Board that is "purely advisory" with no power to direct FHFA actions.

In our view, it is an open question just how powerful the FSOC's veto mechanism is and just how much control the FSOC exercises over the CFPB. The *per curiam* opinion itself appears to be reluctant to fully embrace its own distinction, quoting in a footnote a portion of Judge Henderson's *PHH* dissent that described the FSOC's veto power as so "narrow" that it in fact serves as "a testament to the CFPB's unaccountable policymaking power."

What's Next? The Fannie and Freddie conservatorships remain in place nearly ten years after the financial crisis. This lack of resolution, combined with the fact that the *per curiam* opinion unavoidably touches on many issues that overlap with those raised by the ongoing CFPB cases, makes the *Collins* case a strong candidate as an eventual Supreme Court vehicle. Should it reach the high court, it would present the Justices with an opportunity to resolve the thorny issues related to statutory interpretation and the separation of powers at the center of recent FHFA and CFPB litigation.

[1] *See* John Douglas and Randall Guynn, *Resolution of US Banks and Other Financial Institutions*, Part IV, Sections 8.209 to 8.215, in Debt Restructuring (Oxford University Press, 2d edition 2016); Michael Krimminger and Mark A. Calabria, *The Conservatorships of Fannie Mae and Freddie Mac: Actions Violate HERA and Established Insolvency Principles*, Cato Working Paper No. 26 (Cato Institute, February 2015) (**link**); Randall D Guynn, *Background and Perspectives on Fannie and Freddie Conservatorships*, The Future of Fannie and Freddie Conservatorship and the Takings Clause, Conference of The Classical Liberal Institute and NYU Journal of Law & Business (September 2013) (**link**).