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Regulatory Policy

The Supreme Court in *Perez* recently reversed a prominent D.C. Circuit precedent and held that agencies can change the way they interpret one of their own regulations without going through notice-and-comment rulemaking. But authors Jonathan S. Martel and Jeremy Karpatkin of Arnold & Porter LLP suggest *Perez* is likely to lead to greater judicial scrutiny of the substance of agency interpretations of their regulations, especially changes to those interpretations. They even see signs that the justices may lower the degree of deference courts owe to agency interpretations.

Perez v. Mortgage Bankers: Win for Agencies On Interpretive Rules Could Lead to Loss of Agency Deference

BY JONATHAN S. MARTEL AND JEREMY KARPATKIN

An essential purpose of the federal Administrative Procedure Act ("APA") is to provide for "public participation in the rulemaking process"[1] and to ensure "fairness in administrative procedures."[2] The APA reflects a fundamental deal struck between the Legislative and Executive branches of government: in exchange for wide-ranging quasi-legislative rulemaking powers, federal agencies must adhere strictly to a procedural regime intended to protect the due process rights of regulated entities, and the general public.[3] The APA was established, in part, "as a check upon administrators whose zeal might otherwise have carried them to excesses not contemplated in legislation creating their offices." *United States* v. *Morton Salt Co.*, 338 U. S. 632, 644 (1950).

Against this backdrop of Constitutional due process and separation of powers concerns, the U.S. Supreme Court on March 9—in a decision with far-reaching implications for entities regulated by federal agencies—struck down a D.C. Circuit APA precedent that has for almost twenty years limited the ability of federal agencies to change their interpretations of federal regulations. In *Perez v. Mortgage Bankers Ass'n*, No. 13-1041, Slip Op., the Supreme Court considered a challenge to the D.C. Circuit's doctrine, first established in 1997, that a federal agency, once it interprets a regulation, "can only change that interpretation as it would formally modify the regulation itself: through the process of notice and comment rulemaking." *Paralyzed Veterans of*

[1] Attorney General's Manual on the Administrative Procedure Act, Prepared by the U.S. Department of Justice, Tom C. Clark Attorney General, 1947, at 5.

[2] *Id.* at 9.

[3] *See, e.g.,* Robert L. Rabin, Federal Regulation in Historical Perspective, 38 Stan. L. Rev. 1189, 1266 (1986). ("The [APA] was a formal articulation of agency due process in return for the newly recognized powers of wide-ranging administrative intervention in the economy.")

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Am. v. D.C. Arena L.P., 117 F.3d 579, 586 (D.C. Cir. 1997). The Supreme Court held in *Perez* that the *Paralyzed Veterans* doctrine is directly inconsistent with the rulemaking requirements of the APA and so cannot stand. *Perez,* Slip Op. at 6-7.

Federal regulatory agencies wield tremendous power over the regulated community. Agencies, delegated authority by Congress to implement federal statutory directives, have substantial discretion in interpreting those statutory directives, with discretion to adopt any reasonable interpretation of an ambiguous statute. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, 842-843 (1984). Their factual determinations and policy decisions in determining how best to implement those statutory directives may only be reversed if arbitrary or capricious. *See* 5 U.S.C. § 706(2)(a). And, under current Supreme Court case law, their interpretations of their own regulations control unless clearly erroneous. *See Auer* v. *Robbins*, 519 U. S. 452, 461 (1997); *see also Christopher* v. *SmithKline Beecham Corp.*,132 S. Ct. 2156, 2166 (2012).

Moreover, a highly regulated party reading often complex or confusing regulations must tread lightly to preserve relationships with regulators—such parties may have repeat interaction with the agency, or depend on the agency for permissions essential to their business. And the public and government relations risks of an enforcement action can be highly disruptive. Finally, the risks of shifting or inconsistent agency interpretations are surely significant. In particular, federal agencies are part of the Executive Branch, run by Presidential appointees, and thus respond to the policy preferences that may change, sometimes dramatically, with each Presidential Administration.

***Perez* lowers the bar to agency changes in regulatory interpretations.**

Against this backdrop, the *Perez* decision lowers the bar to agency changes in regulatory interpretations, thus adding to agency power and to uncertainty for the regulated community. At the same time, strong concurring opinions in *Perez* raised a question of the continued vitality of the Supreme Court's doctrine of deference under *Auer* to agency interpretations of their own regulations. There is much to be said for limiting such deference, but currently *Auer* remains binding on the lower federal courts.

As this plays out, the regulated community would do well to gird for a period of greater agency reliance on changes in regulatory interpretations without the protections of notice-and-comment rulemaking. At the same time, although *Perez* eased the procedural burden on agencies to make changes to their interpretive rules, *Perez* is likely to lead to greater judicial scrutiny of agency interpretations of their regulations, and particularly changes in those interpretations.

Background

According to the D.C. Circuit's doctrine, first established in 1997, an agency must use notice-and-comment rulemaking whenever an agency alters a ''definitive interpretation'' of a regulation. *See, e.g., Alaska Professional Hunters Ass'n Inc. v. F.A.A.,* 177 F.3d 1030, 1034 (D.C. Cir. 1999). Under this doctrine, when an agency revises a long-standing and established interpretation, ''the agency has in effect amended its rule, something it may not accomplish without notice and comment.'' *Id.* Allowing an agency to ''make a fundamental change in its interpretation of a substantive regulation without notice and comment,'' the D.C. Circuit held, ''obviously would undermine'' APA requirements for notice and comment before an agency may amend a regulation. *Paralyzed Veterans,* 117 F.3d at 586.

In *Perez,* the Supreme Court considered a Mortgage Bankers Association challenge to the Secretary of Labor's 2010 Administrative Interpretation that mortgage loan officers are not considered exempt employees—and therefore not eligible for overtime wages—under a 2004 regulation promulgated under the Fair Labor Standards Act (''FLSA''). *Perez,* Slip Op. at 4. The 2010 AI explicitly overruled a 2006 Department of Labor Opinion Letter on the same subject. *Id.* at 4-5. The Mortgage Bankers Association challenged the 2010 AI on numerous grounds, including that the 2010 AI was invalid under the *Paralyzed Veterans* doctrine, since it did not go through notice-and-comment rulemaking. *Id.* at 5-6. The District Court applied *Paralyzed Veterans*, but concluded that the Mortgage Bankers had failed to demonstrate reliance on the 2006 opinion, a necessary element for triggering notice-and-comment rulemaking requirements for a change in an agency interpretive rule. *Id.* at 6.

The D.C. Circuit considered the specific issue of whether reliance on a prior interpretation constituted an independent element to be satisfied under the *Paralyzed Veterans* doctrine, concluding that reliance was simply one element in assessing whether a pre-existing agency interpretation was definitive. *Id.* The court of appeals, applying *Paralyzed Veterans,* reversed the District Court. The Department of Labor, joined by three individual plaintiff mortgage loan officers, appealed to the Supreme Court to challenge the underlying doctrine of *Paralyzed Veterans. Id.*

The Perez Decision

The Supreme Court reversed, rejecting *Paralyzed Veterans* based on a straightforward application of the APA text addressing rulemaking requirements. The Court observed that, while the APA prescribes rulemaking requirements, these requirements do not apply to interpretive rules. Slip Op. at 7. The Court concluded that ''[t]his exemption of interpretive rules from the notice and comment process is categorical, and it is fatal to the rule announced in *Paralyzed Veterans*.'' *Id.*

While the courts have long grappled with the distinctions between interpretive rules and legislative rules, the D. C. Circuit has recently defined a legislative rule as ''[a]n agency action that purports to impose legally binding obligations or prohibitions on regulated parties'' and an interpretive rule as ''[a]n agency action that merely interprets a prior statute or regulation, and does not itself purport to impose new obligations or prohibitions or requirements on regulated parties.'' *National Mining Assn.* v. *McCarthy*, 758 F. 3d 243, 251–252 (2014). For agencies, the key administrative distinction between legislative and interpretive rules is that interpretive rules do not require notice and comment rulemaking, *see* 5 U.S.C. § 553(b)(A), and interpretive rules do not formally have the force and effect of law.

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Shalala v. *Guernsey Memorial Hospital*, 514 U. S. 87, 99 (1995).

Nevertheless, since the APA sets forth the full extent of procedural requirements for rulemaking authority, Supreme Court held that the courts lack the authority to impose an additional requirement on agency rulemaking. *Perez,* Slip Op. at 8. Although agencies are free to use their discretion to add ''additional procedural rights'' beyond those required by the APA, these discretionary steps are not enforceable by federal courts. *Id.* at 8-9, (*citing Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519, 524 (1978)). The *Paralyzed Veterans* doctrine of requiring notice-and-comment rulemaking when an agency alters an interpretation of a regulation, the Court concluded, is an impermissible judicially-created procedural requirement that goes beyond the APA. *Id.*

Scalia's Portentous Concurrence. In an important concurring opinion, Justice Scalia discussed the impact of the Court's decision in light of the judicial doctrine of deference to agency interpretations of their own rules. Under *Auer v. Robbins,* an agency's interpretation of its own regulation is ''controlling unless plainly erroneous or inconsistent with regulation.'' 519 U.S. 452, 461 (1997)(internal cites and quotes omitted). Such a plainly erroneous standard gives an agency enormously wide berth in interpreting its own rules. As a practical matter, an agency change in interpretation of a regulation, to the extent that a court later gives it controlling effect, surely will impact regulated parties just as an amendment to the rule would.

Justices Alito, Scalia and Thomas joined the majority but called on the Court to repeal the *Auer* doctrine of deference.

With the striking of *Paralyzed Veterans,* agencies may now effectuate what may practically amount in light of the breadth of *Auer* deference to an amendment to the rule without following APA notice and comment requirements. Justice Scalia thus observed that the *Perez* opinion, while correctly decided, failed to address *Auer* deference, thus enabling a federal agency seeking ''to expand its domain'' to ''write substantive rules more broadly and vaguely, leaving plenty of gaps to be filled in later, using interpretive rules unchecked by notice and comment.'' *Perez,* Slip Op. (Scalia, J. concurring), at 4. Significantly, three justices—Alito, Scalia and Thomas—while joining the majority opinion in *Perez*, filed individual concurring opinions calling upon the Court to revisit and repeal the doctrine of *Auer* deference.

Implications

The striking of the *Paralyzed Veterans* doctrine will have significant implications for federal agency rulemaking, and for anyone subject to agency regulation and enforcement. (While not all circuits previously followed the *Paralyzed Veterans* rule, its application in the District of Columbia rendered it broadly applicable to federal agencies.) At least initially, the *Perez* decision further shifts power to regulatory agencies. The decision is likely, however, to ripple through the regulatory process and over time may well lead to reconsideration of the deference accorded such interpretations in various contexts.

First, *Perez* may create fresh incentives regarding agency reliance on interpretive rules rather than legislative rules to effectuate policy. In addition to Justice Scalia's observation in his concurrence that agencies might have an incentive to write vague rules, the Court in *Perez* acknowledged that ''there may be times when an agency's decision to issue an interpretive rule, rather than a legislative rule, is driven by a desire to skirt notice and comment provisions.'' *Perez,* Slip Op. at 12. Under *Paralyzed Veterans*, agencies at least needed to maintain consistent interpretations in order to be spared notice and comment requirements that effectively amounted to the process required to amend the rule outright. Now, agencies will be able to revisit longstanding interpretations of regulations without such procedures.

In the not uncommon event of changes in agency policy derived—for example—from changes in Administration, agencies will be able to reject longstanding agency precedent simply by issuing a fresh interpretation. In view of that possibility, in the case of controversial rules agencies might be particularly wary to try to insulate those rules from a subsequent Administration's efforts to change policies and therefore seek to *avoid* ambiguity that could be later reinterpreted.

Even the majority opinion signaled a need to check agency whim in changing interpretations that could impact regulated parties without the protections of rulemaking.

Second, given the incentives of agencies, by promulgating vague rules or through shifting policy preferences, to announce changes in interpretations without notice-and-comment procedures, the spotlight on the standard of review of such interpretations is likely to increase. The *Perez* Court appeared satisfied that ''arbitrary and capricious'' review under the APA provides a sufficient check on agency action. *Id.* at 12-13. The remaining question is how far courts will go in revisiting doctrines of deference in applying the arbitrary and capricious standard. Although *Auer* deference remains binding on the lower federal courts, not only did the concurrences suggest it should be reversed outright, but even the majority signaled a need to check agency whim in changing interpretations that could, as a practical matter, impact regulated parties without the protections of rulemaking. For example, the majority in *Perez* reaffirmed its prior holding in *FCC v. Fox Television Stations, Inc.,* 556 U.S. 502, 515 (2009), that a change in agency position resting upon factual findings that contradict earlier findings, or that has ''engendered serious reliance interests'' must be considered as part of APA arbitrary and capricious review. *Id.* at 13. It is not clear, however, how much of a check this will be. Indeed, the central holding of *Fox Television*, was that,

even if there might be situations in which an agency must acknowledge and explain a change in position, ultimately the same standard of review applies to the initial action and a later action reversing the first action *Id.* at 516.

Degrees of Deference. Third, since agencies after *Perez* are clearly no longer required to undertake notice-and-comment rulemaking to change their regulatory interpretations, agencies are more likely to announce or defend changes in their regulatory interpretations made through processes short of such notice-and-comment rulemaking. This raises a question about whether the extent of process that the agency does undertake will affect the extent of deference that court will afford the resulting change in interpretation. In *U.S. v. Mead Corp.,* 533 U.S. 218, 227-228 (2001), the Supreme Court determined that the weight a court will accord an Agency's interpretation of a *statute* may depend on the degree of formality and process the Agency uses in reaching its decision, as well as the ''degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position.''

Although not entirely clear, the Court has also applied *Mead to* agency interpretations of regulations. *See Christopher,* 132 S. Ct. at 2168-2169 (finding a Department of Labor interpretation of a regulation under the Fair Labor Standards Act contained in amicus briefs to be unpersuasive, in part, due to absence of opportunity for public comment and inconsistent Agency justifications). Since notice-and-comment is not required to change agency interpretations of regulations, courts will have to grapple with the relevance of process in considering the validity of changed interpretations. For example, agencies often explain and interpret regulatory language in the preamble to proposed and final rules. It is unclear to what extent courts will weigh such process in evaluating a subsequent interpretation announced without notice-and-comment that might deviate from such a preamble interpretation.

Notice Issues. Indeed, *Perez* also raises the question of how the regulated community might be expected to know of changes in agency interpretations. While the Court in *Perez* noted that changes in agency position may ''upset settled reliance interests,'' *Perez,* Slip Op. at 13, the Court seemed to take some comfort that the FLSA at issue in that case contains a safe harbor provision that would protect regulated entities from liability based on conformance with a prior agency interpretation. *Id.*

But not every federal statute contains such a safe harbor provision. The court observed that the Government asserted at oral argument that principles of retroactivity may serve to protect regulated entities' compliance with an earlier agency interpretation prior to the effective date of the new interpretation, but the court did not resolve this issue. *Id.*, at fn 5. Even if reliance on an earlier agency interpretation provides a measure of protection against enforcement for actions taken *at that time* in conformance with the earlier interpretation, such reliance does not address a regulated entity's potential liability for failure to comply with the new interpretation after it is effective when the entity was unaware of the new interpretation. Courts have held that constitutional requirements of due process demand that regulated entities receive ''fair notice'' of an Agency's regulatory interpretation, especially in an enforcement context. *See General Electric Co. v. U.S.E.P.A.,*53 F.3d 1324, 1328-1329 (D.C. Cir. 1995). And even if we assume some protection under a constitutional doctrine of fair notice, the potential lead-time to conform to new and potentially sudden interpretations and the associated costs are issues that courts may need to resolve.

Conclusion

At bottom, the D.C. Circuit's impulse in *Paralyzed Veterans* was that agency authority suddenly to change interpretations of a rule is tantamount to amending the rule itself, and that the regulated community is entitled to the deliberation for such a change that notice-and-comment rulemaking affords. The essential purpose of *Paralyzed Veterans* was—as acknowledged by the Supreme Court—to curb Agency power to evade APA notice and comment requirements. Such evasion raises basic Constitutional concerns about fairness and public participation.

After *Perez*, even absent notice-and-comment rulemaking, it is likely that courts will feel that same impulse to ensure adequate deliberation on the part of agencies in changing interpretations of rules to protect against arbitrary and capricious agency action, to ensure adequate public involvement in the rulemaking process, and to remain sensitive about enabling agencies to overstep the APA's intended constraints on agency power to make law. Accordingly, courts are likely to find ways to ensure adequate Agency process, in order to vindicate the due process and separation of powers concerns that originally animated the APA.

For this reason, Agencies would do well not to overreach in changing interpretations and in providing adequate notice to the regulated community of policy changes. And the regulated community would do well to remain vigilant regarding shifting interpretations, and will surely hold agencies' feet to the fire as courts sort through policing agency interpretations of their own rules. In the wake of *Perez*, the deference to agency interpretations under *Auer* will at the very least be scrutinized, if not chipped away or ultimately reversed.

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