THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 31 No. 10 October 2015

INCLUSIVE COMMUNITIES AND DISPARATE IMPACT UNDER THE FAIR HOUSING ACT

In its recent Inclusive Communities decision the Supreme Court held (5-4) that disparate impact claims are cognizable under the Fair Housing Act. The authors discuss disparate impact prior to the case, HUD's disparate impact rule, and the Inclusive Communities decision. They point out that, although ruling for plaintiff, the Court also tightened the requirements for plaintiff's prima facie case and loosened the requirements for defendant's business necessity rebuttal.

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On June 25, 2015, the Supreme Court announced its highly anticipated opinion in *Texas Dept. of Housing and Comm. Affairs v. Inclusive Comm. Project, Inc.*[1] The question presented to the Court was whether plaintiffs bringing suits under the Fair Housing Act (the "Act") would be permitted to continue relying on a disparate impact theory of liability, in lieu of a more widely recognized theory of intentional discrimination, to carry their burden in discrimination cases.

The Court held in a 5-4 decision that disparate impact is cognizable under the Act. While the outcome was a victory for the Inclusive Communities Project and proponents of disparate impact, the opinion provided much to detractors as well. Among other things, the Court clarified and stiffened the hurdles that plaintiffs must clear in order to establish a prima facie case of disparate impact discrimination. This article examines the legal landscape of disparate impact prior to *Inclusive Communities*, and explores how the Court's decision has changed — in several ways for the better — the application of, and risks posed by, the doctrine to financial institutions and other housing market participants.

OVERVIEW OF THE FAIR HOUSING ACT

Enactment and Enforcement

Congress enacted the Act in 1968 "to provide, within constitutional limitations, for fair housing throughout the United States."[2] The stated policy is to promote integrated residential housing patterns.[3] Protected

[1] 135 S.Ct. 2507 (2015).

[2] Fair Housing Act, 42 U.S.C. §§ 3601 *et seq*., enacted as Title VIII of the Civil Rights Act of 1968.

[3] *See, e.g., Lawrence v. Courtyards at Deerwood Ass'n, Inc.*, 318 F. Supp. 2d 1133, 1141 (S.D. Fla. 2004) (the purpose of the

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IN THIS ISSUE

RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (937) 387-0473 or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

classes under the Act initially included race, color, religion, and national origin at enactment; Congress subsequently added additional protected classes based on sex, disability, and familial status.[4]

The Act provides for various methods of enforcement by both government and private litigants, though limitations imposed by the Act on government action have made "complaints by private persons [ ] the primary method of obtaining compliance with the Act."[5] With respect to individual lawsuits, a party harmed by unlawful discrimination may bring suit in federal or state court within two years after the occurrence or termination of an alleged discriminatory housing practice.[6] Successful plaintiffs are entitled to actual and punitive damages, an injunction or other equitable relief, and, in the court's discretion, reasonable attorney's fees and costs.[7]

Private Litigation under the Act

Historically, the Supreme Court has construed the standing of private litigants as broadly "as is permitted by Article III of the Constitution."[8] This expansive view of standing has resulted in courts permitting suits under the Act by various parties in addition to individual victims of discrimination, including "fair housing organizations whose mission is being frustrated by the defendant's discrimination[.]"[9] Fair housing organizations have inserted themselves as sorts of private attorneys general, deploying substantial legal and statistical resources to promote policy and social initiatives through challenges to alleged discriminatory practices, including redlining, reverse redlining, and steering.

In developing their complaints, plaintiffs generally have relied on one or both of two theories of liability: (1) disparate treatment and (2) disparate impact. Allegations of disparate treatment are based on intentionally discriminatory policies,[10] while disparate impact-based claims arise out of neutral policies that, despite not being intentionally discriminatory, have a disproportionately negative effect on members of a protected class.[11] A prima facie case of disparate impact is most often established through reliance on data that demonstrates a statistically significant difference in the way an identified neutral practice is asserted to impact a protected class of individuals.[12]

DISPARATE IMPACT PRIOR TO *INCLUSIVE COMMUNITIES*

While the Act clearly prohibits intentional discrimination, the cognizability of the disparate impact theory of liability has long been subject to debate among legal scholars.[13] Nevertheless, all 11 federal circuit courts of appeals that have considered the issue have understood the Act to permit disparate impact cases.[14]

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FHA is to "promote open, integrated residential housing patterns and to prevent the increase of segregation, in ghettos, of racial groups….").

[4] 42 U.S.C. 3605(a).

[5] *Trafficante v. Met. Life Ins. Co.*, 409 U.S. 205, 209 (1972).

[6] 42 U.S.C. § 3613(a)(1)(A).

[7] 42 U.S.C. § 3613(c).

[8] *Trafficante*, 409 U.S. at 209.

[9] Robert G. Schwemm, *Private Enforcement and the Fair Housing Act*, 6 Yale L. & Pol'y Rev. 375, 382 (1988).

[10] *See, e.g., Batista v. Cooperativa de Vivienda Jardines de San Igancio*, 776 F.3d 38, 43 (1st Cir. 2015) (stating that under a disparate treatment theory, the plaintiff must show either direct or indirect evidence of "discriminatory intent").

[11] *See, e.g., Hallmark Developers, Inc. v Fulton Cty.*, 466 F.3d 1276, 1286 (11th Cir. 2006) (finding that under the disparate impact theory, "a showing of discriminatory effect suffices to demonstrate a prima facie violation of the Fair Housing Act").

[12] *Id.* ("Typically, a disparate impact is demonstrated by statistics.").

[13] Kirk D. Jensen & Jeffrey P. Naimon, *The Fair Housing Act, Disparate Impact Claims,* and *Magner v. Gallagher: An Opportunity to Return to the Primacy of the Statutory Text*, 129 BANKING L.J. 99, 125–26 (2012); Andrew L. Sandler & Kirk D. Jensen, *Disparate Impact in Fair Lending: A Theory Without a Basis & the Law of Unintended Consequences*, 33 BANKING & FIN. SERVICES POL'Y REP. 18, 18 (2014).

[14] Margaret Burgess, *American Insurance Association v. United States Department of Housing and Urban Development*:

Allowing plaintiffs to pursue fair housing claims against defendants without requiring a showing of discriminatory intent or purpose had the effect of lowering the barrier to suit, creating strong incentives to sue lenders and other participants in the housing market and housing finance industries — and to extract substantial payments through settlements or pre-filing resolutions.

Judicial Treatment of Disparate Impact Claims Pre-Inclusive Communities

While the federal circuits even prior to *Inclusive Communities* have unanimously agreed that the disparate impact theory of liability is cognizable under the Act, significant variability has existed among them as to the requirements for establishing a prima facie case. This issue was raised in a 2011 petition for certiorari in *Magner v. Gallagher*, where the petitioner asked the Supreme Court to clarify whether disparate impact claims should "be analyzed under the burden shifting approach used by three circuits, under the balancing test used by four circuits, under a hybrid approach used by two circuits, or by some other test."[15] However, despite the variance in prima facie requirements among the circuits, in practice, many courts appear to require only that plaintiffs present some level of statistical evidence of a disparity in order to satisfy the prima facie requirements and shift the burden of disproving discrimination to the defendant. As the Third Circuit noted in its decision in *Mt. Holly Gardens Citizens in Action v. Twp. of Mt. Holly*, "[t]ypically, a disparate impact is demonstrated by statistics, and a prima facie case may be established where gross statistical disparities can be shown."[16]

Indeed, even in the circuits purportedly requiring a showing of causation to establish a prima facie case,[17] the element often has appeared to be overlooked or deemed satisfied by the production of statistics showing a mere possibility of causation. For example, in the Sixth Circuit, a plaintiff may establish a prima facie case of disparate impact by "identifying and challenging a specific housing practice, and then showing an adverse effect by offering statistical evidence of a kind or degree sufficient to show that the practice in question has caused the adverse action in question."[18] Applying this rule, a federal district court in Tennessee considering a case brought against a financial institution under Sections 3604 and 3605 of the Act found that the plaintiff's statistical evidence of disparities in lending rates to minorities as compared to non-minorities was "sufficient to illustrate that [the institution's] policies had a disproportionate impact on the minorities in the total group to which the policies applied." The court reached this conclusion without engaging in analysis regarding the persuasiveness of the statistical data and/or how its nature or degree was sufficient to establish causation.[19]

In circuits that use a burden-shifting test, a defendant may rebut a prima facie showing of disparate impact — and shift the burden of proof back to the plaintiff — by showing that the challenged policy or practice was a "business necessity."[20] The business necessity test generally requires a defendant to show a "compelling business interest" justifying the practice in question.[21]

HUD Disparate Impact Rule

In 2013, HUD promulgated a disparate impact regulation that purports to set forth the requirements for plaintiffs to establish a disparate impact claim under the Act. As described in the preamble to the final rule, under the HUD test,

> the charging party or plaintiff first bears the burden of proving its prima facie case that a practice results in, or would predictably result in, a discriminatory effect on the basis of a protected characteristic. If the charging party or plaintiff proves a prima facie case, the burden of proof shifts to the respondent or

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Reframing Chevron to Achieve Partisan Goals, 6 CAL. L. R. CIR. 2, 13 (Apr. 2015).

[15] Petition for Writ of Certiorari at i, *Magner v. Gallagher*, 132 S. Ct. 1306 (2011) (No. 10-1032).

[16] 658 F.3d 375, 382 (3d Cir. 2011), cert granted, 133 S.Ct. 2824 (June 17, 2013).

[17] *See, e.g., Tsombanidis v. West Haven Fire Dep't*, 352 F.3d 565, 575 (2d Cir. 2003) (finding that disparate impact must be "produced by the defendant's facially neutral acts or practices"); *Gonzales v. City of New Braunfels*, 176 F3d 834, 839, n.26 (5th Cir. 1999) (plaintiff must "demonstrate a *causal relationship* between the identified practice and the disparate impact").

[18] *Graoch Assoc. #33, LP v. Louisville/Jefferson Cty. Metro Human Relations Comm'n*, 508 F.3d 366, 374 (6th Cir. 2007) (internal quotation omitted).

[19] *City of Memphis v. Wells Fargo Bank, N.A.*, 2011 U.S. Dist. LEXIS 48522, at *51 (W.D. Tenn. 2011).

[20] *Graoch Assoc. #33, LP*, 508 F.3d at 386.

[21] *Id*. at 387-388.

> defendant to prove that the challenged practice is necessary to achieve one or more of its substantial, legitimate, non-discriminatory interests. If the respondent or defendant satisfies this burden, then the charging party or plaintiff may still establish liability by proving that the substantial, legitimate, non-discriminatory interest could be served by a practice that has a less discriminatory effect.[22]

Under the rule, plaintiffs are not required to make an affirmative showing that neutral policies cause discriminatory impacts. Rather, they may use statistics to show that a neutral practice "would predictably result in" a discriminatory effect.[23] HUD noted that the new rule was "consistent with its longstanding interpretation of the Act," and pointed to two decades of administrative guidance articulating similar standards in disparate impact cases.[24] It now appears that the Supreme Court is suggesting a modified version of this standard. We now turn to the case.

THE *INCLUSIVE COMMUNITIES* DECISION.

In October 2014, the Supreme Court granted certiorari in *Inclusive Communities*, announcing for the third time that it would determine the validity of the disparate impact theory in cases brought under the Act.[25] In the case, the Inclusive Communities Project, a non-profit organization in Dallas, sued the Texas Department of Housing and Community Affairs over the way the department allocated housing tax credits. HUD's Low-Income-Housing Tax Credit, which is distributed by states, essentially empowers developers to build affordable housing without taking losses. In Texas and other states, the state housing agency chooses which projects will receive the credits through a formula called the Qualified Allocation Plan, which awards more points to some projects than it does to others. Projects with the most points receive the tax credits. The Inclusive Communities Project said that the way Texas distributed the points in Dallas over approximately 15 years resulted in the segregation of minorities in poor areas of Dallas. The reason for this, Inclusive Communities argued, is that Texas did not prioritize the goal of desegregation when it chose which projects would receive tax credits.

The question presented was whether disparate impact claims are cognizable under the Act, but the Court's decision would collaterally determine whether plaintiffs could continue to rely upon the recently promulgated HUD disparate impact rule. During oral argument, Texas Solicitor General Scott A. Keller, representing the Texas Department of Housing, focused on the absence of effects language in the statute and the near-paradoxical constitutional consequences imposed on potential defendants if the Court allowed cases to continue to be brought under the theory — specifically, that entities could face liability under the Act for failing to use a quota-type system, but using such a system could constitute a constitutional violation. The one wrinkle in Keller's argument — so significant that Justice Scalia focused on it during the argument — was the fact that Congress had amended the Act in 1988. While none of the amendments expressly mentioned disparate impact, at least three of the provisions seemed to indicate awareness of it. In the petitioners' view, the mere fact that Congress did not address disparate impact with any of its amendments, notwithstanding two decades of judicial recognition, was to be understood as a nod, if not an affirmation, of its continued application.

As the attorney for Inclusive Communities began his argument, discussion transitioned to the practical effects of the Court's decision. The conservative justices on the Court seemed sympathetic to the Texas Department of Housing's catch-22 defense: if disparate impact theory were to be allowed, then governmental and business entities would potentially be placed in the impossible position of either violating the Act or instituting a conceivably unconstitutional system of numerical racial quotas to avoid liability. This argument allowed the Texas Department of Housing to sidestep the harder (in light of the 1988 amendments) question of Congressional intent and instead place its focus on whether or not, regardless of intent, Congress was acting within the scope of its authority.

Finally, Solicitor General Donald B. Verrilli, Jr., presented the argument in support of the government's long-held view that the disparate impact theory is cognizable under the Act. Verrilli's primary strategy was to rely heavily on the passage of the 1988 amendments. At the very least, Verrilli argued, those amendments showed that disparate impact could permissibly be read into the Act, and that deference should thus be granted to HUD's codification of

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[22] Final Rule, Implementation of the Fair Housing Act's Discriminatory Effects Standard, 78 Fed.Reg. 11460 (Feb. 15, 2013).

[23] *Id.*

[24] *Id.* at 11462.

[25] *Texas Dep't of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project, Inc.*,135 S.Ct. 46 (October 2, 2014). The Court previously had granted certiorari in *Magner v. Gallagher*, 132 S.Ct. 548 (November 7, 2011), and *Mount Holly v. Mount Holly Gardens Citizens in Action*, 133 S.Ct. 2824 (June 17, 2013), but the cases settled prior to oral argument.

disparate impact. The Solicitor General sought to dismiss the suggestion that Congress had created an impossible situation for potential defendants with a few words about the ways in which a housing developer could adopt race-neutral practices without running afoul of Constitutional limitations.

Five months later, in a 5-4 decision, Inclusive Communities and the federal government prevailed.[26] In an opinion written by Justice Kennedy, the Court analogized disparate impact theory under the Act to disparate impact theories under Title VII of the Civil Rights Act and the Age Discrimination in Employment Act ("ADEA"). The Court also relied on the passage of the 1988 Congressional amendments, and in particular three provisions of the amendments that would have been superfluous in the absence of disparate impact theory. Finally, the Court focused on the important role played by disparate impact theory in cases where disguised motives and unconscious prejudices made disparate treatment impossible to prove. In navigating these aspects of the law, the Court changed in three substantive ways how disparate impact cases may be pled and proved going forward.

Contours of the Prima Facie Case

While the Court's decision affirmed the cognizability of disparate impact under the Act, it granted significant muscle to the defense of such claims. In fact, a large portion of Justice Kennedy's majority opinion limits the way in which plaintiffs can bring claims under the theory, truncating plaintiffs' ability to pursue discovery and thus dramatically diminishing the potency of claims driven by the hope of cost-of-discovery settlements.

For example, under the HUD rule, a plaintiff had to show that a challenged policy or practice "caused or predictably will cause a discriminatory effect" to carry the initial burden. As noted above, this first step of the disparate impact burden-shifting test had often been treated as little more than a notice pleading requirement, provided that the plaintiff was able to present a statistically significant disparity and allege that it was "likely" caused by a prohibited practice. The Court's opinion in *Inclusive Communities* made clear that this should no longer be the case. Indeed, the Court repeatedly focused on establishing standards for the plaintiff's prima facie case and emphasized the existence of a "robust causality requirement" that a plaintiff must satisfy in order to make out a cognizable claim of disparate impact. According to Justice Kennedy, "[a] plaintiff who fails to allege facts at the pleading stage or produce statistical evidence demonstrating a causal connection cannot make out a prima facie case of disparate impact."[27]

The Court's emphasis on requiring plaintiffs to show robust causality solved the Texas Department of Housing's objection that application of disparate impact could put potential defendants in a catch-22 situation in which they must either (i) comply with the Act and risk committing constitutional violations or (ii) avoid constitutionally problematic quotas and find themselves instead in violation of the Act. By strengthening the initial causality requirement and encouraging district courts to play a gatekeeping role to prevent "abusive disparate impact claims," the Court reasoned that it could avoid situations where defendants were "held liable for racial disparities [they] did not create." The Court admonished district courts to avoid perverting disparate impact to require racial considerations in housing decisions.[28]

Defendants' Obligations under the Burden-Shifting Test

The Court's decision also contains favorable language for housing market participants in cases where the plaintiff is able to make out a prima facie case of disparate impact. As noted above, once a plaintiff has established a prima facie case, under HUD's rule the burden of proof shifts back to the defendant to show that the challenged policy or practice was "necessary to achieve one or more substantial, legitimate, non-discriminatory interests." Under the *Inclusive Communities* decision, a defendant may rebut a showing that a policy was discriminatory by demonstrating that it is not "artificial, arbitrary, and unnecessary."[29] This modified standard prevents disparate impact liability from displacing "valid governmental and private priorities."[30] In other words, just as every housing decision need not consider race to avoid a prima facie case, every business decision also need not consider race to avoid carrying the burden of proof.

Treatment of the Business Justification

Prior to *Inclusive Communities*, the final step of the burden-shifting analysis required a plaintiff to show that

[26] *Inclusive Communities, supra* note 1.

[27] *Id.* at 2510, 2512-2525.

[28] *Id.* at 2512-2525.

[29] *Id.* at 2524.

[30] *Id.*

a demonstrated business necessity could have been achieved through an available alternative that serves the entity's legitimate interests with less discriminatory effect.[31] The Court did not directly modify this final step of the analysis, but it did approvingly cite to prior Supreme Court precedent, which requires the alternative to be "equally effective" in achieving the entity's legitimate interests.[32] Additionally, much of the opinion focused on the lack of alternatives available to those in the housing industry under a broader reading of disparate impact. Justice Kennedy's decision suggests that this looser standard will help to avoid a situation in which private developers "no longer construct or renovate housing units for low-income individuals" in an attempt to avoid FHA liability, undermining the purpose of the FHA and the free market system.[33]

BEST PRACTICES IN LIGHT OF THE COURT'S DECISION

While *Inclusive Communities* leaves ample room for work in implementing in the district courts, the decision reliably settles the issue of cognizability under the FHA for now. However, the outcome is reasonably positive for institutions serving the housing and housing finance industries. Entities looking to mitigate fair lending risk going forward should consider evaluating all policies to ensure that they do not cause disparate impacts on protected class consumers. They may also consider consulting their legal counsel regarding ways of distinguishing between the requirements articulated in the HUD rule and the law as set forth by the Supreme Court's decision. Finally, they should continue to document the business reasons for policies having any fair lending implications, with particular attention to their use, logic, and value. ■

[31] Final Rule, Implementation of the Fair Housing Act's Discriminatory Effects Standard, 78 Fed.Reg. at 11460.

[32] *Wards Cove Packing Co., Inc. v. Antonio*, 109 S.Ct. 2115, 2118 (June 5, 1989).

[33] *Id.*at 2512-2525.