# Client Alert.

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# HUD Issues Aggressive New Fair Housing Rule

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The U.S. Department of Housing and Urban Development ("HUD") has finally issued its much-debated disparate impact rule. HUD argues that the rule—which it plans to apply retroactively—is simply a codification of its existing position that the Fair Housing Act authorizes disparate impact claims. But the rule goes well beyond that. It articulates a burden-shifting framework that places significant new legal burdens onto defendants, and it "clarifies" the standard for "business justification" that HUD had originally proposed into a test that courts have affirmatively rejected.

## THE NEW RULE

HUD is charged with interpreting and enforcing the Fair Housing Act ("FHA"). The new rule adds a provision entitled "Prohibiting Discriminatory Effects" to HUD's existing FHA regulations.[1] Under the new provision, a defendant may be liable for practices with a discriminatory effect unless there is a legally sufficient justification. The showings and burdens of proof unfold as follows:

> **1) "Discriminatory Effect":** The government and private plaintiffs may challenge any practice that (i) "actually" or "predictably results" in a "disparate impact" on protected classes of individuals or (ii) "creates, increases, reinforces, or perpetuates segregated housing patterns." Thus, plaintiffs need not allege any *intent* to discriminate or any disparate *treatment* of borrowers. They need only allege that some neutral, non-discriminatory policy will have a disparate *impact* or "perpetuate" preexisting "segregated housing patterns."
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> **2) Business Justification:** The defendant then has the burden of proving that the challenged practice is "*necessary* to achieve one or more substantial, legitimate, nondiscriminatory interests." (In its proposed rule, HUD had provided a different standard—that the challenged practice "has a necessary and manifest relationship to a legitimate business interest.")
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> **3) "Less Discriminatory" Alternatives:** Even if the defendant meets its burden under the second step, the plaintiff can still prevail by showing that the defendant's interests "could be served" by some other, theoretical practice "that has a less discriminatory effect."

This type of back and forth is a trademark of disparate impact analysis. Somewhat confusingly, however, the rule combines the second and third steps under the notion of a "legally sufficient justification," but then splits the burden of proof as noted above. If a defendant *meets* its burden under step 2, and a plaintiff *fails to meet* its burden under step 3, then there is a legally sufficient justification and the practice with the discriminatory effect is not actionable. Each party's showing must be supported by evidence and may not be "hypothetical or speculative."

[1] The rule is codified at 24 C.F.R. 100, and is available at http://portal.hud.gov/hudportal/documents/huddoc?id=discriminatoryeffectrule.pdf.

The rule applies to a broad range of housing activity. For example, it applies not only to approval or denial of loan applications, but also to the alleged failure to provide equal "information regarding the availability of loans" or "application requirements"; the "type of loan, . . . loan amount, interest rate, cost, duration, or other terms offered"; and the servicing of loans generally.[2]

## THE RULE'S BROAD IMPACT

Although questions remain about the propriety of doing so, the government has long interpreted the FHA as allowing disparate impact claims. The new rule cements that position and doubles down in at least three areas. First, under most decided cases, defendants in disparate impact cases generally only need to show a legitimate business justification for the challenged practice. The new rule, however, requires defendants to "prove" that the practice was "necessary" to achieve a "substantial, legitimate nondiscriminatory interest." In addition, HUD specifically expresses the belief that disparate impact claims may be used to challenge the cumulative results of individual acts taken pursuant to grants of discretion.[3]

Finally, the rule's articulation of the third prong—allowing the plaintiff to prevail by showing a "less discriminatory" alternative—may well begin to swallow the general rule. The government often points to rough data that appear to show that a protected class of borrowers, on average, has statistically worse outcomes, and formulates a policy that it thinks the lender ought to change. While defendants are forced to prove that their practices are "necessary" to achieve legitimate interests, the existence of an alternative that merely "serves" such interests in a less discriminatory manner could now result in liability. HUD specifically rejected the idea that the alternative must be "equally" or "at least as" effective in meeting the defendant's goals. This lack of symmetry vastly increases the risk of second-guessing and 20-20 hindsight at this stage of the analysis. The new rule's breadth exacerbates the potential that reputational and regulatory concerns will prevent lenders from raising legitimate challenges to overreaching disparate impact claims.

## SHAKY LEGAL FOUNDATION

HUD's new rule can be criticized on a number of grounds.

**1) Does the FHA Even Authorize Disparate Impact Claims?** There is a strong argument that the FHA does not permit disparate impact claims. Although lower courts have deferred to regulatory interpretation in this area, the Supreme Court has expressed interest in this issue in the past and is now poised to take up another case to address this question. In *Township of Mount Holly*, the Third Circuit held that disparate impact claims are cognizable under the FHA.[4] Mount Holly petitioned the Supreme Court to review the decision. It argued that the Supreme Court recently interpreted nearly identical language in the Age Discrimination in Employment Act and Title VII of the Civil Rights Act to hold that those statutes address *intentional* discrimination *only*.[5] In contrast, the Court has required "effects" language—language that is not present in the Fair Housing Act—to be present in a

[2] 24 C.F.R. §§ 100.120(b), 100.130(b).

[3] This is particularly problematic in light of the Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 1255-56 (2011), which held that "merely proving that the discretionary system has produced a racial or sexual disparity is not enough" to support liability under a disparate impact theory, specifically noting that a corporate policy "of allowing discretion by local supervisors . . . is a very common and presumptively reasonable way of doing business -one that should itself raise no inference of discriminatory conduct."

[4] *Mt. Holly Gardens Citizens in Action, Inc. v. Township of Mt. Holly*, 658 F.3d 375 (3d Cir. 2011).

[5] *Ricci v. DeStefano*, 129 S. Ct. 2658 (2009); *Smith v. City of Jackson, Miss.*, 544 U.S. 228 (2005).

statute in order to find that the statute permits disparate impact claims.[6] On October 29, 2012, the Supreme Court issued an "Invitation" to the United States Solicitor General to express its views on whether the Court should take up *Mount Holly*. Supreme Court watchers generally interpret an Invitation as an indication that the Court is inclined to grant review but first wants the government's views on a case's broader implications. The *Mount Holly* appeal comes on the heels of the last-minute settlement of *Magner v. Gallagher*, which was engineered to avoid Supreme Court review after it had granted certiorari on this issue.[7]

**2) Business Necessity:** Even if the FHA is interpreted to allow disparate impact claims, HUD's new articulation of the second prong of the inquiry, requiring a defendant to "prove" that a challenged practice is "necessary" to make out business justification, is highly questionable. In its November 2011 proposed version of this rule, HUD had required that defendants show that the challenged practice "has a necessary and manifest relationship to a legitimate business interest." In the final rule, HUD has taken that standard—which itself was an overly aggressive interpretation of the law—and "clarified" it into something that has already been affirmatively rejected in a series of cases.[8] The concern is heightened by the fact that under the third prong, the plaintiff need only show that the defendant's interests "*could be served* by another" allegedly less discriminatory practice, suggesting that HUD and private plaintiffs have the option of using their own judgment to prioritize and potentially compromise defendants' business interests.

The Supreme Court has addressed the proper business justification standard in the employment context, from which HUD's new rule is loosely drawn. In the *Wards Cove* case, under what was, at the time, nearly identical language in Title VII, the Court held that a defendant need only show that a "challenged practice serves, in a significant way, the legitimate employment goals of the employer."[9] The Court specifically rejected the notion that the defendant must prove its policy is "essential" or "indispensable." Congress later overrode *Wards Cove* with the Civil Rights Act of 1991, and required defendants to articulate a "business necessity" for the challenged practice.[10] But Congress has never made any such amendment to the FHA. The more lenient standard articulated in *Wards Cove* should therefore continue to apply to the FHA.[11]

**3) Burden Shifting**: HUD's shifting of the burden under both the second and third prongs of the disparate impact test onto the defendant is also inconsistent with legal authority. In *Wards Cove*, the Supreme Court held that while an employer bears the burden of *producing* a legitimate business reason, the burden of *persuasion* "remains with the disparate-impact *plaintiff*." Again, Congress later legislatively overrode this portion of *Wards*

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[6] *See id.*; *Griggs v. Duke Power Co.*, 401 U.S. 424, 426 n.1, 429-30 (1971).

[7] *St. Paul Withdraws Supreme Court Appeal on Key Housing-Code Case* (Feb. 12, 2012), *available at* http://www.minnpost.com/two-cities/2012/02/st-paul-withdraws-supreme-court-appeal-key-housing-code-case.

[8] *See Mountain Side Mobile Estates v. Secretary of Housing and Urban Development*, 56 F.3d 1243, 1254-55 (10th Cir. 1995) ("[F]or the purposes of . . . FHA housing discrimination cases, the defendant must demonstrate that the discriminatory practice has a manifest relationship to the housing in question. A mere insubstantial justification in this regard will not suffice . . . At the same time, there is no requirement that the defendant establish a 'compelling need or necessity' for the challenged practice to pass muster since this degree of scrutiny would be almost impossible to satisfy."); *Graoch Assocs.*, 508 F.3d at 374 (requiring the defendant to provide a "legitimate business reason"); *Langlois v. Abington Hous. Auth.,* 207 F.3d 43, 51 (1st Cir. 2000) (holding defendant need only articulate a "legitimate and substantial goal of the measure in question," but need not demonstrate that the business necessity outweighed the disparate impact); *Pfaff v. U.S. Dep't of Hous. & Urban Dev.*, 88 F.3d 739, 747-49 (9th Cir. 1996) (refusing to apply a "compelling business necessity" standard advocated by HUD, and instead merely requiring the landlord to demonstrate "reasonableness").

[9] *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642, 659 (1989).

[10] *See* 42 U.S.C. §§ 2000e-2(k)(1)(A)-(B); *Smith*, 544 U.S. at 240.

[11] *See* note 8 above, listing cases articulating variations on the more lenient standard in light of *Wards Cove.*

*Cove*, but it made no such change to the FHA. There is therefore a strong argument that the burden of persuasion under the FHA ought to remain squarely on the plaintiff. Recent Supreme Court authority interpreting analogous language in the Age Discrimination in Employment Act supports that interpretation.[12]

## CONCLUSIONS

The new Discriminatory Effects Rule, which shifts additional burdens onto defendants and requires concrete evidence to establish business justification, underscores the importance of proactively documenting processes and addressing potential fair lending concerns. That is especially the case in the current environment of increasing fair lending enforcement actions and government announcements of "aggressive, coordinated and proactive" prosecution. A lender can risk running afoul of regulators and private plaintiffs even if its policies and practices are entirely nondiscriminatory and race and gender-neutral. There are strong legal arguments against the new rule, but until the Supreme Court decides the issue, district and appellate courts will likely continue to defer to the government's interpretation.

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[12] *See Smith*, 544 U.S. at 240 (holding that "*Wards Cove*'s pre-1991 interpretation of Title VII's identical language remains applicable to the ADEA" because Congress did not amend the ADEA).