

# Financial Institutions Webinar: *Inclusive Communities* – One Year Later

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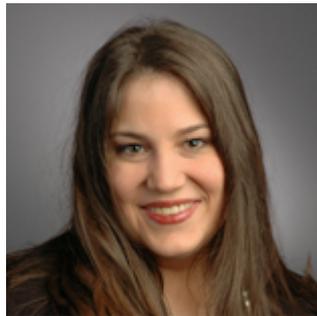
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# Speakers



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# Agenda

1. Legal and *Inclusive Communities* background
2. Disparate impact claims post-*Inclusive Communities*
3. Emerging issues in disparate impact



## Anti-Discrimination & Fair Lending

- Anti-discrimination and fair lending compliance is a very hot topic, with increased enforcement (CFPB, DOJ, etc.) and civil/class action litigation.
- Non-compliance can have consequences.
  - Litigation and Enforcement
    - Injunctive Relief
    - Monetary Penalties and/or Damages
    - Consent Decrees
  - Reputational Harm
  - Community Reinvestment Act and Compliance Ratings



# Relevant Federal Laws

## ECOA

- Prohibits discrimination in any aspect of a credit transaction.
- Implemented by Regulation B.
- Covers:
  - Race/color
  - National origin
  - Religion
  - Sex
  - Marital status
  - Receipt of public assistance
- Primary enforcement authority is CFPB.

## FHA

- Prohibits discrimination in all aspects of residential real-estate related transactions.
- Implemented by 24 C.F.R. Part 100.
- Covers:
  - Race/color
  - National origin
  - Religion
  - Sex
  - Familial status
  - Disability
- Primary enforcement authority is HUD.



# Types of Discrimination

## Overt Discrimination

- Policy or practice, on its face, treats members of a protected class less favorably.

## Disparate Treatment

- Policy or practice gives rise to differences in treatment that are not adequately explained by legitimate nondiscriminatory factors and justifications are deemed pretexts for intentional discrimination.

## Disparate Impact

- Policy or practice is facially neutral but results in a disproportionate disadvantage to a protected class, and the lender cannot defend the policy or practice by showing that it serves a legitimate business purpose and that cannot be served by another less-discriminatory alternative.



## *Inclusive Communities Overview*

- *Texas Department of Housing & Community Affairs v. Inclusive Communities Project* (“*Inclusive Communities*”)
  - Facts:
    - In 2008, the Inclusive Communities Project accused a Texas agency of disproportionately allocating the tax credits to properties in minority-concentrated areas.
    - The plaintiffs sued under a disparate impact theory, arguing that the agency’s practice generated segregated housing patterns in violation of the FHA.
  - Issue: Whether disparate impact liability is cognizable under the FHA
  - Many speculated that the Court would find disparate impact claims to not be cognizable under the FHA, but in a 5-4 decision authored by Justice Kennedy, the Court held they were.



## Rationale for Disparate Impact Under the FHA

- The Court based its decision in *Inclusive Communities* on the following rationales:

**Statutory Text and Prior Precedent.** The Court relied on language in the FHA and found it to be similar to language in statutes held to provide disparate impact liability in previous decisions.

**Congressional Intent.** The Court found persuasive that Congress amended the FHA in 1988, fully aware that regulators and the U.S. Courts of Appeals had found disparate-impact liability under the statute, and did not change the FHA's text to exclude such liability categorically; Congress also included exemptions that assumed the existence of disparate impact claims.

**Statutory Purpose.** Court stated that recognition of disparate-impact liability is consistent with the FHA's "central purpose" of eradicating discriminatory practices in the housing sector.



# Limitations of Disparate Impact

- The *Inclusive Communities* decision emphasizes limitations on the scope and reach of the theory.

## ***Robust Causality***

- Plaintiffs must make ***prima facie*** case that defendant's policy ***caused the disparity***.

## ***Business-Necessity Defense***

- Defendants may defend their policies by “explain[ing] the valid interest [they] serve.”
- Disparate impact not an “instrument” to force lenders “to reorder their priorities.”

## ***Limitations on Remedies***

- Race-conscious remedies “must be consistent with the Constitution.”
- Remedies must “concentrate on the elimination of the offending practice” and avoid “impos[ing] racial targets or quotas.”



## Projections of Decision's Impact



“Bolstered by this important ruling, the Department of Justice will continue to vigorously enforce the Fair Housing Act with every tool at its disposal—including challenges based on unfair and unacceptable discriminatory effects.”

– *Attorney General Loretta Lynch*



“The court's decision upholds the use of disparate impact under the Fair Housing Act. Though we do not enforce the Fair Housing Act, we are encouraged that today's decision will continue to promote fair housing and help protect Americans from unlawful discrimination. As an agency responsible for enforcing the Equal Credit Opportunity Act, we will continue our own work to ensure nondiscriminatory access to credit for all Americans.”

– *CFPB Director Richard Cordray*

## Disparate Impact Litigation: Municipal Suits

- Defendants have successfully used the “limitations” to seek dismissal of disparate impact claims.
- ***City of Los Angeles v. Wells Fargo & Co.*** (C.D. Cal. July 17, 2015) — summary judgment granted for Wells Fargo because, inter alia, City failed to identify any policy that created an artificial, arbitrary, or unnecessary barrier on minorities.
  - Also rejected argument that Wells Fargo violated the FHA by failing to implement a policy *to prevent* disparate impact discrimination, on ground that disparate impact claims may only seek to *remove* barriers, not to implement desired “racial quotas.”
- ***Merritt v. Countrywide Fin. Corp.*** (N.D. Cal. Sept. 17, 2015) — ECOA and FHA claims dismissed because, inter alia, Plaintiffs failed to identify a specific policy causing alleged disparities.



## Disparate Impact Litigation: Plaintiff Victories

- Disparate impact claims have met with success when (1) the complaint specifically identifies disparity and the policy that caused the disparity, and (2) where defendants fail to provide a viable business justification.
- ***Rhode Island Comm’n for Human Rights v. Graul*** (D.R.I. Aug. 13, 2015) — summary judgment granted on claim that a rule allowing only two persons to occupy one bedroom apartments resulted in a disparate impact on families with children, in violation of the FHA.
  - Plaintiff’s expert provided data showing that the rule disproportionately affected families with children as compared to similarly situated households with no children.
  - Court rejected the defendants’ justification that a building inspector had suggested a minimum square footage requirement for one-bedroom units containing three or more people as inconsistent with the text of local building codes and not “necessary to achieve a valid interest.”

## Disparate Impact Litigation: Rule Challenge

- A 2013 HUD regulation embraces a burden-shifting framework for disparate impact claims: (1) plaintiff establishes *prima facie* case, (2) defendant establishes business necessity, and (3) plaintiff shows interest could be served by less discriminatory option.
- ***American Insurance Association and National Association of Mutual Insurance Companies v. HUD*** (D.R.I. Aug. 13, 2015) — two homeowners-insurance trade associations have challenged that framework as violating the FHA in light of *Inclusive Communities*, arguing that the rule:
  - Allows plaintiffs to make out a *prima facie* claim solely by identifying a statistical disparity without identifying a policy that caused the impact.
  - Violates the Supreme Court’s caution that disparate-impact liability under the FHA should not be used to “second-guess which of two reasonable approaches” an entity should follow or force defendants to “reorder their priorities” by requiring defendants to show practice is “necessary” and allowing plaintiffs to establish liability by showing another practice has “less discriminatory” effect.
  - The associations’ opening brief is scheduled to be filed on Thursday, June 30.



## Disparate Impact Litigation: *Inclusive Communities*

- The *Inclusive Communities* case itself is currently pending in US District Court for the Northern District of Texas.
- Both parties filed motions to supplement the trial record, and the litigants are now in the first round of merits briefing to determine whether the plaintiffs sufficiently established a *prima facie* case.
  - Plaintiffs argued that a series of discretionary policies perpetuated racial segregation by, among other things, excluding significant numbers of Low Income Housing Tax Credit units from Caucasian areas in the Dallas metro area.
  - Defendants central argument in response is that Plaintiffs failed to show causation because the discretionary decisions identified did not constitute a “common policy or procedure” and that the use or presence of discretion in its decision-making process did not create racial disparities.
- The district court held oral argument on June 17.



## Disparate Impact & ECOA

- Although ECOA and the FHA are similar in statutory purpose (eradicating discrimination), there are some relevant distinctions between the statutes:
  - **Statutory Text:** No “**otherwise make[s] unavailable**” or equivalent language in ECOA.
  - **Congressional Intent:** No equivalent consensus among federal circuit courts regarding Congressional intent when ECOA was amended.
- Regulators and courts take the view that disparate impact is cognizable under ECOA.
- *Lenders **should** avoid policies or practices that could give rise to disparate impact liability.*



## Emerging Issues: Jumbo Loans

- Lenders are increasingly turning to high-dollar loans as a way to reduce default risk and servicing costs.
- The practice, however, could raise disparate impact concerns.
- *WSJ Analysis:* As major banks are granting more jumbo loans, they “are granting fewer mortgages to African-Americans and Hispanics.”



## Emerging Issues: Redlining

- Increased government enforcement involving allegations of redlining/reverse redlining.
- CFPB and DOJ's \$27M settlement with Hudson City serves as an example.
  - CFPB Director Cordray: *Hudson City* settlement was a “shot across the bow.”
  - Alleged conduct included allegations involving branch locations and racial/ethnic make-up of retail loan officers.
  - The agencies relied on disparate impact-type evidence—statistical disparities as compared to peers—to support disparate treatment claims.

## Emerging Issues: Small Business Lending

- CFPB intends to issue rule regarding collection of loan data for women-owned, minority-owned, and small business credit applicants.
- Collection will provide wealth of data on which disparate impact claims could be based.
- Relatively unique in the ECOA context, as lenders are generally prohibited from collecting such data outside a few exceptions (e.g., mortgage).



## Emerging Issues: Big Data

- Lenders are increasingly looking for ways to analyze big data for marketing and other purposes.
- Big data capabilities could help lenders reach underserved populations and market credit offerings (e.g., expand access to credit to borrowers with thin-credit files).
- But big data could also serve to target or exclude protected classes through the application of filters that appear to be neutral.
- Regulators, including CFPB, have warned that use of big data could lead to disparate impact.



## Emerging Issues: Secondary Market Activity

- Lenders may face liability on claims that a practice of purchasing loans on the secondary market creates disparate effects.
  - ***Adkins v. Morgan Stanley*** (S.D.N.Y. May 14, 2015) — plaintiffs alleged that Morgan Stanley violated fair lending laws through purchasing and securitizing allegedly “risky” home mortgages issued by a subprime lender, leading to a disparate impact on African American borrowers.
- WilmerHale obtained dismissal of the ECOA and state consumer law claim at the motion to dismiss stage, and then defeated plaintiffs’ motion for class certification on the FHA claim after a period of discovery.



## Disparate Impact Practice Points

- Disparate impact liability under ECOA is unlikely to go away any time soon, absent legislative amendment or an intervening decision by the Court (unlikely given the changing Court).
- It remains prudent to analyze practices to ensure that there are no arbitrary racial or ethnic imbalances—exclusion or inclusion based on zip codes or other geographical distinctions should be considered with care.
- It is also critical to test business justifications for practices that may give rise to disparate results, and to consider alternatives, when possible **before** engaging in the practices.



# Questions?

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