ABA Staff Analysis: Supreme Court of the United States Holding on Disparate Impact

Texas Department of Housing & Community Affairs v. Inclusive Communities Project
July 2015

On June 25, 2015, Associate Justice Anthony Kennedy, writing for the majority of the Supreme Court of the United States, announced that disparate impact claims are recognized under the Fair Housing Act (FHA). This case was the third time in recent years that a challenge to disparate impact theory came before the Court; the two prior cases settled before the Court could reach a determination.

While the decision affirms a fair lending standard that bankers have struggled to meet for more than two decades, the Court also placed important limitations on its application. The decision also leaves open the question whether the same rationale supports disparate impact liability under the Equal Credit Opportunity Act (ECOA).

Background
The case originated in Texas with a dispute over the allocation of tax credits for affordable housing projects. Under a federal program, state housing agencies distribute low-income housing tax credits to local developers. The Texas Department of Housing and Community Affairs (TDHCA) distributed the credits in Texas, using a point system to award credits, including factors like the financial feasibility of the proposed project.

A non-profit organization, the Inclusive Communities Project, sued TDHC, claiming TDHC helped further segregation and created a disparate impact that violated the Fair Housing Act (FHA). According to Inclusive Communities, TDHC allocated too many affordable housing credits in predominantly African-American urban communities and not enough in suburban predominantly Caucasian neighborhoods, causing further segregation.

The District Court agreed with Inclusive Communities and held that TDHC failed to show a less discriminatory alternative for allocating tax credits, concluding that the responsibility for demonstrating a less discriminatory alternative was the responsibility of the defendant, TDHC. TDHC appealed the decision to the Fifth Circuit Court of Appeals.

While the appeal was pending, the Department of Housing and Urban Development (HUD) issued a rule on disparate impact (see below).

The Fifth Circuit agreed with the lower court and agreed that the FHA recognizes disparate impact claims. However, relying on HUD’s new rule, the Circuit Court sent the case back for the lower court to reconsider the case and the HUD rule which shifted the burden to the plaintiff to show less burdensome alternatives.

TDHC appealed to the Supreme Court on the single question whether the FHA recognizes disparate impact claims.

1 http://www.supremecourt.gov/opinions/14pdf/13-1371_m64o.pdf

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Supreme Court Decision – Majority Opinion
The Supreme Court, in a 5-to-4 decision, held that disparate impact claims are recognized by the Fair Housing Act. In reaching this determination, the Court looked to two other antidiscrimination statutes, Title VII of the Civil Rights Act of 1964 and the Age Discrimination Act of 1967 (ADEA). Prior decisions had held that both of those statutes support a disparate impact claim, and the court concluded that there was sufficiently similar language in this case to support a like finding of disparate impact. In reaching its conclusion, the Court carefully analyzed the statutory text and determined that when the text of a statute refers to the consequences of an action and not just the mindset or intent of the actor, the statute includes a disparate impact claim.

The Court also relied on two additional bases for its conclusion. Over the years, all the lower Circuit Courts concluded that the FHA incorporated a disparate impact claim for discrimination. When Congress amended the FHA in 1988, nine lower Circuit Courts already had concluded that FHA encompassed disparate impact liability but Congress did nothing to change what the lower courts had found. Moreover, when Congress amended the FHA in 1988, it included language in the changes that the Court decided reflected Congressional awareness of the disparate impact theory since the amendments make no sense unless they are read in the context of disparate impact liability.

Finally, the Supreme Court found a basis for its decision in the public policy underlying the FHA, stating that “[r]ecognition of disparate-impact claims is also consistent with the central purpose of the FHA...to eradicate discriminatory practices within a sector of the Nation’s economy” and that it “plays an important role in uncovering discriminatory intent: it permits plaintiffs to counteract unconscious prejudices and disguised animus that escape easy classification as disparate treatment.”

Disparate Impact Analysis
The Court also determined that disparate impact must be approached carefully, since it could be easily subjected to abuse which would raise serious constitutional questions. Therefore, the Court laid out a three-step burden shifting framework to be applied by courts and government agencies analyzing disparate impact claims.

The first step is to demonstrate that a specific policy caused a statistical disparity affecting a protected class that cannot be explained by any reason other than the protected characteristic such as race or gender. However, the Supreme Court stated clearly that statistical analysis alone is never enough and that, “a statistical analysis must fail if the plaintiff cannot point to a defendant’s policy or policies causing that disparity.” It will be interesting to see how this affects the approach being taken by the Consumer Financial Protection Bureau which has brought several enforcement actions based solely on statistical disparities.

2 The provisions protect appraisals, restrictions based on convictions for illegal manufacture or distribution of controlled substances, and restrictions on the basis of number of occupants from FHA claims. For example, the Court theorized that certain criminal activity may show a higher correlation with sex and race but that Congress, by adopting the second provision, implicitly recognized and acknowledged the existence of disparate impact analysis.

3 As stated by the Court, “A robust causality requirement is important in ensuring that defendants do not resort to the use of racial quotas.”

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Further recognizing the potential for abusive disparate impact claims, the Court explained the second step in the framework is that the defendant must be given the ability to demonstrate a business rationale for the policy or procedure. The Court stated that a business must be “able to make the practical business choices and profit-related decisions that sustain the free-enterprise system.”

Finally, and consistent with the HUD rule, the burden then shifts back to the plaintiff to demonstrate that an alternative exists that would not place an undue burden on the defendant. Still concerned about potential abuse, though, the Court cautions that even after a finding of disparate impact, “Remedial orders in disparate-impact cases should concentrate on the elimination of the offending practice” and that “…orders that impose racial targets or quotas might raise more difficult constitutional questions.”

The Dissents
Four Justices, including the Chief Justice, dissented from the majority in two separate opinions.

The first dissent was filed by Justice Clarence Thomas. According to Justice Thomas, there is no legitimate basis for disparate impact liability. Instead, the Justice argues that a plaintiff must show clear intent to discriminate and Congress never intended and never sanctioned a disparate impact theory of liability. In fact, the Justice states that, “We should not automatically presume that any institution with a neutral practice that happens to produce a racial disparity is guilty of discrimination until proved innocent.”

Justice Samuel Alito wrote the second dissent, joined by the Chief Justice, Justice Antonin Scalia and Justice Thomas. Justice Alito also concluded that the FHA does not authorize disparate-impact claims, pointing out that, “intent makes all the difference” and that, “[p]roof of discriminatory motive is critical.” Despite the opinion of the majority, Justice Alito disagreed that Congress ratified the theory of disparate impact by not challenging it when the FHA was amended in 1988, basing his finding on Supreme Court precedents that rejected identical arguments of implicit ratification. Justice Alito also questioned HUD’s motives for adopting a disparate impact rule and whether deference to the rule is appropriate. Finally, the Justice suggested that a finding of disparate impact liability could have unintended consequences and “inadvertently harm the very people that the FHA is meant to help.”

4 The Court also suggests that leeway should be granted for business necessity and cautions that courts should avoid interpreting disparate impact liability in such a way that courts become forums for second-guessing policy decisions. Limitations are also important to protect defendants against abusive disparate-impact claims. And, remedial orders imposed by a court could raise constitutional questions if the remedy imposes racial targets or quotas.

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HUD Rule
In February 2013, HUD issued its rule on disparate impact.\(^5\) Although HUD had many opportunities to adopt such a rule during the nearly 20 years when disparate impact theory was debated and challenged in lower courts, it wasn’t until a case reached the Supreme Court that HUD finalized its rule.

The HUD rule validates claims of discrimination based on disparate impact even when a policy might be neutral on its face. Under the HUD rule, there is a three-step process to a disparate impact claim of discrimination.

First, a plaintiff must show that a practice has a disparate impact on a protected class.\(^6\)

Second, after a plaintiff has shown a disparate impact, the defendant has the burden to show that the practice has a legitimate business interest. This legitimate business interest must be demonstrated by facts and cannot be speculative. And, while HUD did not use the specific term “business necessity,” the agency indicated in the preamble to the rule that the concept is similar to the concept of “business necessity” found in the Joint Policy Statement on Fair Lending issued in March 1994.\(^7\) For example, the joint policy statement suggests that factors that may be relevant to the justification could include cost and profitability.

Third, after a defendant demonstrates a rational basis for a policy, the burden shifts back to the plaintiff to show that there are other, less discriminatory means, to accomplish the same goal.

Separately, in November 2014, a federal District Court in Washington, D.C. vacated the HUD rule,\(^8\) finding that the FHA did not authorize disparate impact. Now that the Supreme Court has ruled to the contrary, it remains to be seen what steps HUD will take.

Equal Credit Opportunity Act
For many years, the disparate impact analysis has also been applied under the Equal Credit Opportunity Act (ECOA) and Regulation B. While the theory under ECOA is similar to the FHA disparate theory decided by the Supreme Court in the *Inclusive Communities* case, it is not entirely clear whether the Supreme Court would rule the same way.

There are significant differences between the FHA and ECOA. For example, the FHA legislative history and language the Court relied on to support the finding of disparate impact under the FHA are lacking with respect to ECOA. However, the Court also relied on the public policy rationale, which is the same under both statutes. And the precedent that existed for finding a disparate impact theory under the FHA also exists under ECOA.


\(^8\) *American Insurance Association v. U.S. Department of Housing and Urban Development*
Prior to the Supreme Court’s decision, both the CFPB and the Department of Justice stated they would continue to pursue disparate impact claims under the ECOA even if the Supreme Court decided disparate impact claims were not recognized under the FHA.

Either way, even if the Court did find a disparate impact theory survives under ECOA, it still leaves open the question whether other elements of the Inclusive Communities decision would also apply under ECOA, such as whether simple statistical analysis fails to state a case under ECOA, whether a plaintiff must show clear cause-and-effect between a policy and the disparity, and whether business rationale is enough to justify a policy or procedure.

**Compliance Tips**

Fundamentally, under fair lending theory, the goal is to ensure that similarly situated borrowers and loan applicants are treated the same. While this case challenged the disparate impact theory under the FHA, banks have been coping with disparate impact for several decades and the federal banking agencies incorporated the concept into their examination procedures over 20 years ago. As a result, since the Court reaffirmed the application of a theory well-known to bankers, the immediate practical impact on the industry is likely to be limited.

However, the Court did underscore several important points that banks should keep in mind. First, statistical analysis alone is not enough. This increases the burden needed to raise a disparate impact claim. There must be two clear elements at the outset: a statistical disparity affecting a class based on a protected characteristic such as race or ethnicity and a clear connection between the disparity and the policy or procedure that caused the disparity.

Second, since the Court explained that a business rationale may justify a policy or procedure, it is important to ensure that the reasons or business justifications that underlie policies and procedures are clearly articulated. If the business justification that serves as the foundation for a policy is not already in place, that oversight should be corrected as soon as practical.

**Recommended Compliance Steps**

- Take full advantage of the ABA Toolbox on Fair Lending
- Consult your prudential regulator’s existing fair lending examination guidelines and ensure all policies and procedures are consistent with those expectations
- Review policies and procedures to ensure they clearly state a business rationale
  - When exceptions to policies are permitted, ensure the reasons are clearly outlined in the policy
  - Monitor exceptions to policies and ensure that the reason for an exception is clearly explained, approved and documented
- Schedule regular audits for loan portfolios and, where disparities exist, ensure there is a logical explanation for the difference and that senior management can explain and discuss the make-up of the portfolio

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9 [http://www.abacom/Tools/Toolboxes/Mem/Pages/FairLendingToolbox.aspx](http://www.abacom/Tools/Toolboxes/Mem/Pages/FairLendingToolbox.aspx)


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• Ensure staff are trained in FHA and ECOA compliance and that all employees are aware of the need to ensure diversity
• Watch for further updates from the American Bankers Association

Questions? Contact Rob Rowe for more information.