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Proposed Rule Could Substantially Affect 'Disparate Impact' Claims Under the Fair Housing Act

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In August 2019, the U.S. Department of Housing and Urban Development (HUD) proposed rulemaking that potentially would make it harder to bring disparate impact discrimination claims under the Fair Housing Act. The proposed rule, which HUD likely will finalize in 2020, would impose on plaintiffs a new five-part pleading requirement and create several new defenses. The proposal also would clarify a number of issues with HUD's current disparate impact standard, promulgated in 2013. The proposed rule has the potential to significantly affect mortgage and housing cases under the Fair Housing Act, and it may likewise affect non-mortgage credit, such as auto or student loans, as regulators and courts will likely draw on HUD's standard for guidance in interpreting the Equal Credit Opportunity Act.

Background — The Disparate Impact Theory

As a general matter, parties can be liable under certain anti-discrimination laws not only for intentional discrimination but also for practices that have an adverse impact on the basis of race, ethnicity or other protected classes. In particular, in the 2015 decision in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*, the U.S. Supreme Court upheld the finding that disparate impact is a valid theory of liability under the Fair Housing Act, though limits exist on its application. Specifically, the Court held that a plaintiff must demonstrate a "robust" causal connection between the challenged practice and alleged disparities. HUD's proposed rule was a direct response to the *Inclusive Communities* decision and seeks to conform the showing that plaintiffs must make to be consistent with the disparate impact limitations articulated by the Supreme Court.

Plaintiff's *Prima Facie* Burden

The proposed rule requires plaintiffs to allege that a "specific, identifiable policy or practice has a discriminatory effect" and to "plausibly allege" the following:

- The challenged policy or practice is arbitrary, artificial and unnecessary to achieve a valid interest or legitimate objective;
- A robust causal link exists between the challenged policy or practice and a disparate impact on members of a protected class that shows the specific practice is the direct cause of the discriminatory effect;
- The alleged disparity caused by the policy or practice has a significant adverse effect on members of a protected class; and
- A direct link exists between the disparate impact and the complaining party's alleged injury.

New Defenses

The proposed rulemaking also includes two categories of new defenses.

Models. One new defense will permit a defendant to provide the "material factors" for quantitative models or algorithms used in its business (*e.g.*, underwriting or pricing models) and show that the factors are not "substitutes or close proxies for protected classes" and that the model is predictive of risk. Likewise, lenders can show that a model from a

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third party meets "industry standards" and is used only for its intended purposes. Creditors also will be able to demonstrate that a model has been validated by a neutral third party, which has determined that it is empirically derived and based on a demonstrably and statistically sound algorithm that accurately predicts risk, with none of the factors relying on substitutes or close proxies for protected classes.

With the advancement of artificial intelligence and "big data," and the widespread use of models and algorithms across the consumer finance industry for loan underwriting, pricing and other decisions, the availability of this new defense could prove significant.

External limits on discretion. Another proposed defense would apply when the defendant's "discretion is materially limited by a third party," such as through a law or a "binding or controlling court, arbitral, regulatory, administrative order, or administrative requirement." If a lender could show, for example, that a challenged practice was necessary to promote compliance with regulations requiring a creditor to evaluate a customer's ability to repay a debt, the lender might be able to rely on this defense.

Less Discriminatory Alternative and Business Justification Standards

The proposed rule also would modify the less discriminatory alternative and business justification standards.

"Equally effective" less discriminatory alternative. Under the proposed rule, as well as current law, if the defendant shows that a valid interest for the challenged practice exists, the burden shifts to the plaintiff to show that an alternative practice with less discriminatory impact would serve the defendant's interest. HUD's proposal, however, clarifies that a plaintiff's less discriminatory alternative must serve the defendant's interest "in an equally effective manner" and without "imposing material greater costs" or "creating other material burdens" for the defendant.

Possible easing of business justification standard. The proposed rule states that a "valid interest" for a challenged policy can include "a practical business, profit, policy consideration, or requirement of law." The proposal also allows the defendant to rebut the plaintiff's *prima facie* case by showing that the challenged policy "advances" a "valid" interest.

Looking Ahead

Questions as to when and whether the rule will be finalized in its current form aside, the changes proposed by HUD would significantly affect the litigation of disparate impact cases under the Fair Housing Act and may influence non-mortgage fair lending cases brought under the Equal Credit Opportunity Act or state laws, insofar as regulators or courts look to the new HUD standards for guidance. Under the proposed standards, plaintiffs would have a higher burden to proceed with disparate impact claims, and lenders would have an additional incentive to use quantitative models that meet the standards for the new defenses set forth in the proposal.