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Raising the Bar: HUD Issues New Rule Imposing More Demanding Standard for Defending Against Discrimination Claims Under the Fair Housing Act

The Department of Housing and Urban Development (HUD) recently issued a new rule to formalize a national standard for determining whether a housing practice violates the Fair Housing Act (FHA) as the result of a discriminatory effect (the "Discriminatory Effects Rule"), which will likely have a wide impact on banks, lenders and others operating in the housing market.[1] The FHA, as amended, prohibits discrimination in the sale, rental and financing of housing.[2] The new rule establishes a three-part burden-shifting test to demonstrate liability for discriminatory effects under the FHA. Significantly, it allows a finding of liability without proof of any actual intent to discriminate. Accordingly, defendants (which include developers, banks, lenders and others) may find themselves subject to liability for lending practices that, as applied, may have an inadvertent or unintended impact on a protected class. The Discriminatory Effects Rule goes into effect on March 18, 2013.

Background

Courts have long recognized a public and private cause of action for "discriminatory effects" under the FHA, but varied in their analysis of the evidence. For example, the Seventh Circuit applied a multi-factor balancing test to assess discriminatory effects,[3] whereas the Fourth Circuit applied a four-factor balancing test for public defendants and a burden-shifting test for private defendants.[4] In private actions or actions brought by the government, the plaintiff may be awarded injunctive relief, actual and punitive damages (in private actions) or civil penalties (in an action by the government).

In response to the varying standards employed by the courts, HUD issued the Discriminatory Effects Rule to establish a three-part burden-shifting test. Pursuant to the new rule, a "discriminatory effect" occurs when a facially neutral practice actually or predictably results in a discriminatory effect on a group or person protected by the FHA. Such practices are only permitted under the FHA if they serve a significant business objective, and there is no less discriminatory alternative available to serve that interest. The new rule seeks to clarify and establish a uniform three-part test for courts to apply as follows:

- When determining whether a practice with a discriminatory effect violates the FHA, the plaintiff bears the initial burden of proving its prima facie case that the practice

1 24 C.F.R. §100.

2 The Fair Housing Act is codified at 42 U.S.C. §§ 3601-3619.

3 *Metro Hous. Dev. Corp. v. Vill. of Arlington Heights*, 558 F.2d 1283, 1290 (7th Cir. 1977) (applying a four-factor balancing test).

4 *Betsey v. Turtle Creek Assocs.*, 736 F.2d 983, 989 n.5 (4th Cir. 1984).

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in question results in, or would predictably result in, a discriminatory effect on the basis of a protected characteristic.[5]

- If the plaintiff shows the requisite discriminatory effect, the burden then shifts to the defendant to prove that the challenged practice is "necessary to achieve one or more of its substantial, legitimate, nondiscriminatory interests."[6]
- If the defendant satisfies this burden, the plaintiff may still establish liability by proving that the nondiscriminatory interest could be served by another practice that has a less discriminatory effect.[7] Thus, the defendant bears the burden to show that its practice is necessary to achieve a nondiscriminatory interest and that there is no other means to achieve this interest with a less discriminatory effect.

Implications

The new Discriminatory Effects Rule applies to a broad range of banking and lending practices, including the approval and denial of loan applications and the servicing of loans generally.[8] The broad reach of the new rule will likely encourage additional lawsuits, including class actions, against lenders, developers and others operating in the housing market. Furthermore, the new rule's burden-shifting test will likely make defending against such lawsuits more costly and time-consuming. Traditionally, defendants in disparate impact cases generally only needed to show a legitimate business justification for the challenged practice. Under the new rule, however, defendants are required to demonstrate that the practice was "necessary" to achieve a "substantial, legitimate nondiscriminatory interest"—a much higher standard. Additionally, banks and lenders need to take into account whether there exists any "less discriminatory" alternatives. At a minimum, the higher standard will likely foster more putative class actions alleging violations of the FHA and make it more difficult to successfully challenge such lawsuits at the pleading stage.

As a result of the new Discriminatory Effects Rule, banks and lenders should at a minimum reassess their fair lending practices. Specifically, banks and lenders should ensure that their practices and policies are supported by legitimate business justifications. Because the Discriminatory Effects Rule puts the burden on the defendants to justify their practices, banks and lenders need to be prepared to justify their practices and provide supporting documentation as necessary.

5 24 C.F.R. §100.500(c).

6 *Id.*

7 *Id.*

8 24 C.F.R. §§ 100.120(b), 100.130(b).