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GUEST COMMENTARY

APPLYING *INCLUSIVE COMMUNITIES* IN DISPARATE IMPACT CASES: A DISTRICT COURT TAKES JUSTICE KENNEDY SERIOUSLY

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A few issues back, in the immediate wake of the Supreme Court's *Texas Department of Housing and Community Affairs v. Inclusive Communities Project Inc.* decision, I wrote that while the case was a win for disparate impact theory, it was not necessarily a loss for consumer financial services defendants in disparate impact lawsuits. [1]

Justice Anthony M. Kennedy's limiting language in the *Inclusive Communities* majority decision -- a decision that found disparate impact claims generally cognizable under the Fair Housing Act -- also broadly criticized disparate impact claims that are based solely on statistical disparities unconnected to a particular policy or practice. It similarly criticized claims that attack a “valid” interest served by a challenged policy rather than “artificial, arbitrary and unnecessary barriers” that cause a disparity. [2]

Justice Kennedy's language was at times ambiguous. For example, the opinion offered little guidance to distinguish policies that cause a disparity for a “valid” purpose from those that create “artificial, arbitrary, and unnecessary” barriers. The gravamen of his caution to lower courts was that without a “robust” causation requirement at the pleading stage, specifically linking a statistical disparity to a challenged policy that did not advance a valid business or governmental interest, the threat of liability might cause race to be used in a pervasive way. This “would almost inexorably lead” entities to use “numerical quotas” and thus create serious constitutional questions. [3]

Those familiar with the outsized role the threat of disparate impact liability plays in the regulation and development of fair lending policies for consumer financial services firms can only smile at the Court's warning that, if not properly limited, disparate impact liability might “cause race to be considered in a pervasive way” -- which might lead to (gasp!) “numerical quotas.”

In the consumer financial services world, that Rubicon was crossed long ago.

For example, as I interpret the auto finance settlements entered by Ally Financial (November 2013) and Honda Finance (July 2015) with the DOJ and CFPB, the government's problem with Ally and Honda was that they were *inadequately* pervasive in their consideration of race.

According to the CFPB's own guidance, auto lenders seeking to avoid disparate impact enforcement actions by the government should monitor -- on a dealer and portfolio-wide basis -- any racial or age disparities that might arise in indirect auto-loan portfolios. [4]

The fact that indirect automobile lenders do not possess information about the racial identity of individual customers whose contracts are purchased (as broad collection of this information by automobile dealers is prohibited) [5] is not, according to the CFPB and DOJ, an impediment to this self-monitoring.

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The government believes indirect automobile lenders should hire an expert to guess the racial makeup of their portfolios by examining borrowers' last names and zip codes. [6] Once the statistician has estimated the portfolio's demographic makeup, the government's tolerance for disparities among (presumed) racial, ethnic or age groups is extremely limited.

For example, the government might demand remediation of a 14-basis-point interest-rate disparity (0.14 percent) between Asians/Pacific Islanders and non-Hispanic whites in a given line of business, regardless of whether any individual dealer had a disparity among rates charged to customers it served.

Hmmmm. I'm trying to think: What is the term used to refer to a strict numerical target, often associated with race or ethnicity, that must be met within narrow tolerances and has been the subject of Supreme Court litigation for decades?

I think it begins with Q ... rhymes with Toyota ... wait a minute! Of course!

In *Inclusive Communities*, Justice Kennedy explained that disparate impact should not be interpreted in such a way as to require pervasive use of race because that might create *quotas* -- presumably a bad, and likely unconstitutional, result.

All of this raises an important question: If Justice Kennedy, speaking for the Supreme Court, meant what he said in *Inclusive Communities* about wanting to avoid disparate impact theories that would result in "pervasive use of race" and "numerical quotas" by private (and governmental) entities, did the Court, while preserving a disparate impact cause of action under the FHA, deal a serious blow to disparate-impact claims brought against the financial services industry?

Did it (wittingly or not) undermine the DOJ and CFPB current requirements of "pervasive" analysis of race (to the point of creating racial data through statistical modeling where none exists) and elimination of all disparities through remediation?

A ray of hope

The decision of the U.S. District Court for the Central District of California in *City of Los Angeles v. Wells Fargo & Co.* provides a road map to argue that the answer to these questions is yes. [7] The city claimed that Wells Fargo's high-cost and U.S. Fair Housing Administration loans violated the FHA under a disparate impact theory of liability, alleging that these lending practices resulted in a disparate number of foreclosures for minority borrowers in Los Angeles. [8]

To prove its disparate impact claim with respect to high-cost loans, Los Angeles relied on such weak statistical evidence (a minority borrower had a 0.0033 percent-0.0067 percent likelihood of receiving a "high-cost" loan as opposed to a 0.0008 percent chance for a non-Hispanic white borrower) that even the city's own expert conceded the disparities were not statistically significant.

The District Court stressed that the city needed to show a *significantly* adverse effect on minorities and identify statistical disparities that were significant enough to raise an inference of causation. [9] The court also emphasized Justice Kennedy's instruction to examine disparate impact liability claims "with care" while concluding that "comparing thousandths of a percentage fails to meet the minimum threshold of *Inclusive Communities*." [10]

In further trying to establish its *prima facie* case of disparate impact liability, Los Angeles pointed to Wells Fargo's "inadequate monitoring policies" in an attempt to identify the lender "policy" that caused the disparity. In rejecting this argument, the court stated:

> The city's argument is problematic for two reasons. First, the city fails to actually identify any policy that created an artificial, arbitrary, or unnecessary barrier. Instead, the city argues that a lack of a policy produced the disparate impact. There is no authority that suggests that disparate impact claims are designed to impose

> new policies on private actors. Guidance from the Supreme Court is unambiguous that disparate impact claims must solely seek to remove barriers. Without identifying an actual policy that creates a barrier, the city cannot base its disparate impact claim on Wells Fargo's practice of issuing high-cost loans. [11]

The District Court then observed the implied requirement of a "monitoring" policy (i.e., collecting and studying racial disparities among a loan portfolio and taking action to minimize future disparities while remediating past disparities) that the city advocated is exactly what the Supreme Court was trying to avoid (and warned about) when it held that disparate impact claims are cognizable under the FHA:

> Second, the city is essentially advocating for racial quotas. When it argued that Wells Fargo must employ a policy that would "monitor relevant data" and "correct the disproportionate issuance" of high-cost loans to minorities, the assertion was simply a roundabout way of arguing for a racial quota. Los Angeles wanted Wells Fargo to keep a racial tally of each high-cost loan -- "monitor relevant data" -- and then specifically issue loans on the basis of race to "correct the disproportionate issuance." Such a policy is inapposite to the instructions from the Supreme Court. In *Inclusive Communities,* the Court specifically noted that disparate impact claims must not force private actors to "adopt racial quotas," explaining that such quotas "raise[ ] serious constitutional concerns."

The city argued that the lack of an unconstitutional racial quota caused the statistical discrepancy in the case. Wells Fargo cannot constitutionally issue high-cost loans based on a racial quota system, and its lack of such a policy does not create a *prima facie* case of disparate impact under the FHA's provisions.

Not only did the city fail to identify any policy that caused the negligible statistical disparities; it also advocated for the implementation of "serious constitutional concerns." There is no genuine dispute as to any material fact that high-cost loans issued by Wells Fargo to minority borrowers during the limitations period did not violate the act. [12]

In both its analysis of high-cost and USFHA loans, the District Court emphasized *Inclusive Communities*' instruction to examine disparate impact claims "with care."

In reviewing USFHA loans as a whole and noting the endorsement of these loans by the White House, the Housing and Urban Development secretary, and former city officials, the court concluded there was no evidence that minority borrowers with USFHA loans were *adversely* affected, but rather they were benefited from the availability of the program.

Although the city presented three policies in an attempt to identify a policy or practice causing the disparity, the court found each to be meritless or unsupported by evidence. The court also observed that "[o]utside of racial quotas, what practice could Wells Fargo possibly employ to avoid a disparate number of minorities receiving USFHA loans?" The court noted that subjecting banks to liability for the intended consequences of USFHA lending would likely have a chilling effect, resulting in fewer minorities having the ability to buy homes. [13]

So, while *Inclusive Communities* at first glance appears to be a win for disparate impact FHA claims, *City of Los Angeles* is a good example of how courts may use the limitations Justice Kennedy set out to attack specious disparate impact claims.

Specifically, after *Inclusive Communities*, it is clear that the mere use of numerical disparities as evidence -- without the identification of a concrete policy creating the disparity -- will not cut it.

Even if a disparity exists, if the challenged policy that created it is "valid" and is not an "artificial, arbitrary, and unnecessary" barrier, the case should not move beyond the pleading stage.

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Importantly, the *Inclusive Communities* decision's emphasizes the removal of barriers, not implementation of new policy. This stance suggests that complaining of a lack of adequate monitoring or suggesting the need for a monitoring policy essentially forces consumer financial services firms to adopt racial quotas. A policy to review loan data to ensure a certain percentage of minorities are or are not receiving a certain volume of loans on certain terms *is* a racial quota -- which raises serious constitutional concerns.

Turning back to the Ally and Honda enforcement actions, it is not a great leap to argue the government's theory in each case was that the companies had a duty to monitor disparities in indirect loan portfolios and essentially modify their policies (including taking the affirmative step of limiting or eliminating their dealer participation policies) to achieve a racial balance, or quota, in its portfolios with respect to interest rates.

If *City of Los Angeles* was correct in finding that having to monitor relevant data to correct for a disproportionate issuance of certain kinds of loans to minorities is the equivalent of a numerical quota, there is no reason why that holding would not apply equally to cases involving other lending categories.

To be sure, the CFPB and DOJ would likely argue the fact that these indirect auto lenders allowed dealers to offer customers interest rates above the minimum “buy rate” at which the lender agreed to purchase the contract means that a particular “policy” causing the disparity had been identified.

But even leaving aside the argument that such a policy is “valid” because it is designed to compensate dealers for their effort in providing financing to the customer, [14] it appears that, as with the “failure to monitor” theory advanced by Los Angeles in *City of Los Angeles*, a “failure to restrict dealer participation (in the manner we choose)” theory is arguably an effort to affirmatively require a certain policy rather than the removal of an existing “artificial, arbitrary, and unnecessary barrier” -- and thus cannot be used to establish a disparate impact claim.

“There is no authority that suggests that disparate impact claims are designed to impose new policies on private actors. Guidance from the Supreme Court is unambiguous that disparate impact claims must solely seek to remove barriers,” noted the *City of Los Angeles* court. [15]

To flesh out this point a bit, in the absence of any policy prohibiting or restricting “dealer participation” or “dealer reserve” -- what some would call the ability to “mark up” an interest rate beyond that minimum rate at which an indirect lender would purchase a contract -- an automobile dealer is analogous to a standard retailer, who must charge a certain amount to cover the cost of goods and then “mark up” that price to compensate for its efforts to sell the product at retail.

Different retailers have different cost structures and sell different lines of products at different volumes. Thus, the amount charged to the end customer will typically vary. For example, Coca-Cola sold at a newsstand or in a convenience store will be more expensive than Coca-Cola purchased at a warehouse store.

But no one would argue Coca-Cola's failure to restrict the price at which its retailers sell its product, or failure to monitor the racial composition of its retailers' customers to determine if the “average” price paid for a Coca-Cola varies by race (if, for example, proportionally more minority Coke drinkers purchase their Cokes from convenience stores, the average price paid per Coke might be higher) constitutes an affirmative “policy.” Rather, any such claim would essentially be seeking to require Coca-Cola to adopt retailer pricing discretion and monitoring and remediating its average pricing across racial groups on a nationwide basis. a policy of eliminating or restricting

None of this is to say that any court will follow the lead of *City of Los Angeles* [16] and extend its reasoning beyond the mortgage context (and the factually weak case) in which it arose.

Although styled as Equal Credit Opportunity Act cases and enforcement actions, it is clear that there is a consumer protection policy question (having little or nothing to do with race or discrimination) about the propriety of (undisclosed) dealer participation. The CFPB and DOJ are attempting to address this question using disparate impact discrimination claims as leverage, because the Dodd-Frank Act restricts the CFPB's ability to address the question with dealers directly.

A court's view of this policy question might well have an effect on its willingness to look past some of the tension between the CFPB and/or DOJ theory and the *Inclusive Communities* decision's warnings about disparate impact claims leading to "pervasive" use of race or devolving into "numerical quotas." But *City of Los Angeles* provides evidence that pointing out that tension might, in the right court, be well worth the effort.

Footnotes

1 Robert N. Driscoll, Commentary, *A Win for Disparate Impact, But Not a Total Loss for Lenders*, 19 No. 5 Consumer Fin. Services L. Rep. (2015).

2 Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project, Inc., 135 S.Ct. 2507, 2512 (2015) (citing Griggs v. Duke Power Co., 401 U.S. 424 (1971)).

3 Id. at 2523 (citing Wards Cove Packing Co. v. Atonio, 490 U.S. 642 (1989), superseded by statute on other grounds, 42 U.S.C. st2000e-2(k)).

4 CFPB Bulletin 2013-02, Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act.

5 12 C.F.R. st1002.5(b).

6 To those unfamiliar with the practice of Bayesian Improved Surname Geocoding ("BISG") proxy methodology, it is a statistician's slightly more rigorous and automated method of saying "that name kind of sounds Hispanic, and lots of Hispanics live in that neighborhood, so I'm going to assign that borrower a high probability of being Hispanic." It is the technique the government uses to generate a factual basis to accuse lenders of discrimination, notwithstanding the fact that neither the lender nor the government has the foggiest notion of the actual race or ethnicity of any particular borrower. (I am not joking.)

7 City of Los Angeles v. Wells Fargo & Co., No. 13-09007, 2015 WL 4398858 (C.D. Cal. 07/17/15), appeal docketed, No. 15-56157 (9th Cir. 07/29/15).

8 Although the city alleged eight types of predatory lending practices in its complaint, the parties stipulated that only two (the high-cost and USFHA loans) were issued during the statute of limitations period. As a result, he other six were not discussed in the order granting the motion for summary judgment.

9 City of Los Angeles, 2015 WL 4398858, at *7 (quoting Watson v. Fort Worth Bank and Trust, 487 U.S. 977, 995 (1988)).

10 Id. at *8.

11 Id. (citations omitted).

12 Id. (citations omitted).

13 Id. at *13.

14 In Abril-Rivera v. Johnson, the First Circuit, in the context of Title VII, emphasized Inclusive Communities' instruction that disparate impact theory is not a means to simply second guess policy decisions: ". . . regardless of whether plaintiffs have made out a *prima facie* case of impact, defendants have presented legitimate business justifications for their actions, and there is no contrary evidence. The recent Supreme Court decision in [Inclusive Communities] establishes this is so. There, the Court emphasized that 'disparate impact liability must be limited so employers and other regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant and dynamic free-enterprise system.' It must also be limited as applied to government entities so as to avoid 'inject[ing] racial considerations into every [agency] decision.' 'Governmental or private policies are not contrary to the

disparate-impact requirement unless they are artificial, arbitrary, and unnecessary barriers."' Abril-Rivera v. Johnson, No. 14-1316, 2015 WL 4578404 at *7 (1st Cir. Jul. 30, 2015) (citations omitted).

15 Id. at *8.

16 Indeed, an appeal has been filed in the case, so there is no guarantee the ruling will survive.

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