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BANK THINK

A New Defense Against Municipal Disparate Impact Claims

By Valerie L. Hletko and Ann D. Wiles

Banks and non-bank lenders face a variety of fair lending disparate impact claims, which allege unintentional and unfavorable disparate impacts of otherwise neutral policies or practices on minority borrowers. Regulators, consumer groups and the mortgage industry have long debated whether disparate impact claims are permissible under the federal Fair Housing Act. Lenders take the position that they are not because the statute covers only intentional discrimination and not discriminatory effects, while consumer advocacy groups argue that discriminatory effects are implied in the statute.

Banks have defended themselves by relying on a 2005 Supreme Court decision, Smith v. City of Jackson, which held that the Age Discrimination in Employment Act only permits claims for intentional discrimination. Like the FHA, the ADEA does not include language covering discriminatory effects. The Supreme Court has twice agreed to hear FHA disparate impact cases in the last two years, but litigants in each case dismissed their appeals before the court could decide the issue. In a late March ruling that had nothing to do with either housing or discrimination, however, the court quietly established an alternative way to defend far-fetched claims—including under the FHA.

The case, Lexmark International v. Static Control Components, stemmed from a conflict between laser printer manufacturer Lexmark and parts manufacturer Static Control. Static Control alleged that Lexmark sent letters to companies that manufacture replacement cartridges for its printers suggesting that it was unlawful to use chips produced by Static Control. The question presented to the court was whether Static Control could sue Lexmark for false advertising under the Lanham Act, which governs trademarks, service marks and unfair competition. The Supreme Court held that Static Control could sue, radically clarifying in the process the framework for bringing claims under federal statutes. Specifically, the court held that, in order to have standing to sue under a federal statute, a plaintiff must fall within the statute's "zone of interest" and also show "proximate cause." In other words, a plaintiff's injury must flow directly from a violation of the statute, and the plaintiff must be the party Congress wanted to protect in enacting the statute.

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These standards are especially impactful in the context of mortgage lending discrimination litigation. Until now, courts have permitted anyone to file a lawsuit under the FHA and many other statutes as long as they could establish standing under Article III of the U.S. Constitution with an "injury in fact" that was "fairly traceable" (no matter how indirect) to the alleged wrong, which could be redressed through a favorable court decision. In Gladstone Realtors v. Village of Bellwood, the Supreme Court found that the village of Bellwood, Ill., could allege an injury in fact as a result of discriminatory housing market manipulation.

This decision opened the door to an array of lawsuits. Cities and counties including Baltimore; Los Angeles; Miami; Birmingham, Ala.; and Memphis, Tenn., have filed lawsuits blaming one or two lenders for municipal woes following the financial crisis, seeking tens of millions of dollars on the theory that subprime loans to minority residents injured the cities. The plaintiffs argue that resulting foreclosures and vacancies decreased property tax revenues and increased costs for government services.

Banks targeted by these cases have argued that the purported injuries were not "fairly traceable" to the terms of the loans and that foreclosures are attributable to a myriad of factors, including overall economic decline or personal circumstances such as job loss, divorce, or illness that typically precede default. Proving this common-sense intuition in court could, however, require isolating every relevant macro and micro social and economic force involved and examining the terms and servicing histories of every single loan originated in a city over several years. This could impose a time-consuming and expensive burden on lenders.

Lexmark should clarify that these types of cases are not permissible. The Supreme Court said in Lexmark that the Lanham Act's stated purpose of preventing injury to a commercial interest in reputation or sales requires "no guesswork." Nor does the FHA's. The FHA's statement of purpose is "to provide, within constitutional limitations, for fair housing throughout the United States." It protects integrated housing patterns and persons discriminated against in housing transactions on the basis of race, color, national origin, religion, sex, familial status and disability. It does not protect the tax receipts of municipalities.

Justice Antonin Scalia's 9-0 opinion acknowledged that the Supreme Court's earlier standing discussions now look "misleading" in light of Lexmark. While Lexmark has yet to be applied to the FHA, this higher standard is likely to eviscerate standing for a range of theories of liability. While banks will have to wait for another disparate impact case to make it to the Supreme Court for a ruling on whether disparate impact claims are viable under the FHA at all, they may now avoid FHA disparate impact claims brought by plaintiffs alleging daisy-chain standing well outside the statute's zone of interest.

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