Litigation

Public Nuisance Litigation against Subprime Industry Hits Roadblock in Cleveland

*By Brian P. Brooks**

Over the past decade, elected city officials around the country have attempted to achieve political goals, and to fill municipal coffers, by suing unpopular industries for damages because they have supposedly caused a "public nuisance." That is not hyperbole—these cities have sued entire industries, not merely particular companies. Invoking the "public nuisance" theory, city governments from Chicago to Philadelphia to St. Louis have sued gun manufacturers, companies that once made lead paint, and others in an attempt to use the litigation process to shut down industries engaged in lawful but locally unpopular businesses. Although most such lawsuits were dismissed as legally meritless in the early part of this decade, the City of Cleveland in 2008 decided to take a turn at the wheel by suing virtually every major participant in the subprime mortgage industry. U.S. District Judge Sara Lioi of the Northern District of Ohio has now dismissed the Cleveland action in its entirety,[1] leaving industry observers to speculate on whether Judge Lioi's decision will deter other cities from filing similar actions.

The City of Cleveland's original complaint against the subprime mortgage industry named 21 defendants, representing every segment of the market. The complaint asserted claims against mortgage companies that originated loans using lines of credit from Wall Street investment houses, commercial banks and thrifts that originated large volumes of mortgage loans, investment banks that both provided financing for mortgage lenders and assisted in the process of "securitizing" pools of loans so they could be sold as mortgage-backed securities to investors, and others. The city alleged a variety of injuries that supposedly flowed from high foreclosure rates, ranging from increased police and fire department costs to a depressed local tax base. But the city made no effort at all to identify any particular foreclosure to any particular form of economic injury (a particularly problematic pleading problem given that Ohio is a judicial foreclosure state, where individual foreclosures are reviewed and approved by courts). Instead, the complaint attacked the overall process of subprime mortgage lending and securitization, a process the city summarized in its complaint as follows:

> (1) WALL STREET made financing available to sub-prime lenders, which
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> (2) used the cash to make sub-prime loans to consumers, then
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> (3) sold the related mortgages back to WALL STREET, which
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> (4) packaged and resold them to investors in the form of mortgage-backed securities, and
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> (5) used the proceeds to repeat the process.

The city's bold, capitalized references to "Wall Street" strongly signaled its view that there was something inherently wrong with the intersection between the global capital markets and local consumer lending, notwithstanding the direct connection between the growth of the mortgage securitization markets and the significant increase in national homeownership rates since the early 1990s. The complaint made that suspicion explicit, alleging that "[i]n 2003, a fundamental shift took place in how Wall Street constructed their securities offerings backed by subprime mortgages. By that juncture, the demand for [subprime mortgage-backed securities] had grown so significantly that the offerings essentially involved 'money seeking borrowers.'" According to the city, the expansion of subprime mortgage lending to borrowers farther and farther down the credit spectrum made an increase in foreclosure rates inevitable (or at least foreseeable), and thus constituted a public nuisance.

The Cleveland complaint was filed in early 2008 against a backdrop of public nuisance case law that was almost uniformly unfavorable to the city's legal theories. State supreme courts in Illinois, New Jersey, Rhode Island, Missouri, and the District of Columbia, along with numerous other courts, had squarely rejected the idea that entire industries could be held liable under a public nuisance theory without establishing both that particular industry participants had caused injury to a "public right" (as opposed to merely causing private property damage or economic loss) and that the conduct of specific defendants proximately caused specific instances of damage.[2] While the Ohio Supreme Court early on had taken a more accommodating posture with respect to public nuisance actions against gun manufacturers,[3] its decision in the gun context was legislatively overruled long before Cleveland filed its lawsuit against the subprime mortgage industry.[4]

Within a few days after the complaint was filed, the defendants removed the action to federal court. Somewhat surprisingly, although the city had sued 21 different defendants, it had failed to name as defendant any Ohio citizen. (The city's elected officials presumably had political reasons for not wanting to name any of the several large Ohio financial institutions as defendants in the case.) The defendants therefore invoked diversity jurisdiction as the basis for removal. The city fought hard to have the case remanded to state court, making such adventurous arguments as that some of the defendants filed their consents to removal only after the removal was effectuated, and that some of the defendants' consents were executed by in-house counsel who were not their company's chief legal officer and thus may not have had authority to give consent on behalf of the company. After briefing and submission of affidavits concerning the authority-to-consent issue, the district court denied the city's remand motion and proceeded to consider the merits of the case.[5]

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The district court's opinion dismissing the city's lawsuit draws from prior public nuisance cases against other industries, but also breaks some new legal ground. The district court initially considered whether the city's public nuisance claims are preempted by an Ohio state statute that precludes municipalities from undertaking "[a]ny ordinance, resolution, or other action" to "regulate, directly or indirectly, the origination, granting, servicing, or collection of loans."[6] The city argued that it merely sought money damages from the defendants, and thus was not attempting to "regulate" the subprime mortgage industry. Judge Lioi rejected this argument, noting the U.S. Supreme Court's repeated holding that "regulation can be as effectively exerted through an action for damages as through some form of preventive relief."[7] She also noted that, but for a generalized public interest in regulating subprime mortgage lending, the city could not establish the critical "public right" element of its nuisance claim, since a claim of public nuisance is not available to redress purely private injuries such as property damage or economic loss.[8]

Independent of the state statutory preemption problem, Judge Lioi held that the city failed to make out the elements of a public nuisance claim as a matter of common law. As an initial matter, the court ruled that the economic loss doctrine—a doctrine that precludes recovery in tort of purely economic losses that are not accompanied by physical injury—bars claims for public nuisance. The city had asked the court not to apply the economic loss doctrine on the ground that it did not bar the Ohio Supreme Court from affirming public nuisance claims against the gun industry in the *City of Cincinnati* case, but Judge Lioi observed that the economic loss doctrine was not even raised in that decision. More persuasive, she held, was the fact that the only two Ohio decisions to directly address the matter (both of which were decided after *City of Cincinnati*) agreed that the economic loss doctrine applies to nuisance claims.[9]

The court also held that the city's allegations could not establish an unreasonable interference with a public right, as required to state a claim for public nuisance. The court was particularly influenced by the fact that the challenged subprime mortgage products were not only lawful, but affirmatively regulated and encouraged by various federal and state regulators. Judge Lioi noted that in 2000 the U.S. Department of Housing and Urban Development (HUD) released a report encouraging Fannie Mae and Freddie Mac to expand into the subprime market because doing so "could be of significant benefit to lower-income families, minorities, and families living in underserved areas."[10] Four years later, another HUD report found that the growth in subprime lending had indeed delivered significant benefits to credit-impaired borrowers.[11] And, as part of a national effort to make credit more available in communities that had traditionally lacked access to home mortgages, the court noted that "the federal government has enacted numerous laws and issued significant regulatory guidance specifically aimed at encouraging lending to traditionally underserved segments of the population."[12] Under established law, activity that is specifically authorized and regulated by law cannot constitute an "unreasonable interference with a public right."[13]

Finally, the district court concluded that the city's complaint foreclosed any possibility of showing proximate causation. This holding came as no surprise to anyone who read the complaint, which affirmatively alleged that the rising foreclosure rate in Cleveland has been caused by "the City's struggling, Rust-Belt economy, the fading prominence of the manufacturing sector, and Cleveland's challenges in attracting a meaningful replacement," among other things. In addition to these factors, the court concluded that the city could not satisfy the causation requirement because "the City's losses are... contingent upon the insolvency (or inability or unwillingness to repay) of non-parties—namely, the subprime borrowers whose homes were foreclosed and became fire hazards, eyesores, etc."[14]

One would think that Judge Lioi's 36-page opinion dismissing the Cleveland action in its entirety would deter future municipal lawsuits seeking to recover damages against the subprime mortgage industry on a public nuisance theory. The history of municipal lawsuits against other industries, however, suggests that a single dismissal ruling, however well reasoned, will not end the litigation onslaught. A subprime mortgage lawsuit including fair lending claims brought by the City of Baltimore against Wells Fargo Bank is currently pending, and other lawsuits either have been filed or reportedly will be filed in the near future by the cities of Atlanta and Birmingham, with others reportedly weighing their litigation options. These developments suggest that elected city leaders still see political advantage, not to mention potential financial benefits, in attacking an unpopular industry, however weak their claims may be in light of established precedent.

Endnotes

1 *See* City of Cleveland v. Ameriquest Mortgage Sec., Inc., 2009 U.S. Dist. LEXIS 41303 (N.D. Ohio May 15, 2009).

2 *See, e.g.,* Rhode Island v. Lead Indus. Ass'n, 951 A.2d 428 (R.I. 2008) (dismissing public nuisance claim against lead paint manufacturers); City of St. Louis v. Benjamin Moore & Co., 226 S.W.3d 110 (Mo. 2007) (affirming lower court's dismissal of public nuisance claim against manufacturer of lead paint); *In re Lead Paint Litigation*, 924 A.2d 484 (N.J. 2007) (dismissing public nuisance claim against lead paint manufacturers); District of Columbia v. Beretta, U.S.A., Corp., 872 A.2d 633, 647 (D.C. 2005) (refusing "to recognize a claim of common-law public nuisance that disregards, or greatly dilutes, the liability-limiting factors"); City of Chicago v. Beretta U.S.A. Corp., 821 N.E.2d 1099 (Ill. 2004) (dismissing city's and county's public nuisance claim against handgun manufacturers).

3 *See* City of Cincinnati v. Beretta U.S.A. Corp., 768 N.E.2d 1136 (Ohio 2002).

4 *See* Ohio Rev. Code § 23071(A)(13)(c).

5 *See* City of Cleveland v. Deutsche Bank Trust Co., 571 F. Supp. 2d 807 (N.D. Ohio 2008).

6 Ohio Rev. Code § 1.63.

7 San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236, 247 (1959); *see also, e.g.,* Riegel v. Medtronic, Inc., 128 S. Ct. 999, 1008 (2008); Cipollone v. Liggett Group, Inc., 505 U.S. 504, 521 (1992).

8 *City of Cleveland*, 2009 U.S. Dist. LEXIS 41303, at *18-19.

9 *See* Ashtabula River Corp. Group II v. Conrail, Inc., 549 F. Supp. 2d 981, 987-88 (N.D. Ohio 2008); RWP, Inc. v. Fabrizi Trucking & Paving Co., 2006 Ohio 5014, 2006 WL 2777159, at *3 (Ohio App. 8th Dist. 2006).

10 *City of Cleveland*, 2009 U.S. Dist. LEXIS 41303, at *49 (quoting 65 Fed. Reg. 65044, 65106 (Oct. 31, 2000)).

11 *Id.* at *49-50.

12 *Id.* at *47.

13 *See* Allen Freight Lines, Inc. v. Consolidated Rail Corp., 595 N.E.2d 855 (Ohio 1992).

14 *City of Cleveland*, 2009 U.S. Dist. LEXIS 41303, at *63.