Update on Municipal Nuisance and Discrimination Litigation

*By Richard E. Gottlieb and Brett J. Natarelli**

Not since the round of municipal lawsuits against gun manufacturers six years ago have cities pursued such an aggressive campaign of litigation against private market players that have engaged in conduct—they claim—that has had devastating effects on the cities. The claimed public nuisance this time is not bullets and the associated personal trauma, medical, and justice system costs, but an alleged epidemic of foreclosures in urban neighborhoods in Baltimore, Birmingham, Buffalo, Cleveland, and elsewhere.[1] The cities in question claim that this epidemic of foreclosures has caused harm to the public in the form of increased police costs, lower tax revenue, reduced property values, the creation of "eyesores," demolition costs, and increased fire protection requirements.[2] The defendants in this new round of cases are mortgage lenders and other financial entities who, while not lenders per se, purchased mortgage-backed securities that allegedly allowed lenders to originate a larger number of subprime loans in urban areas.

Three of these municipal cases have now seen initial rulings. In a recent decision in Cleveland, U.S. District Judge Lioi dismissed, for failure to state a claim, the city's public nuisance claims in a lengthy opinion that will likely be cited by defendants in any future cases brought under a nuisance theory.[3] Two other federal courts, one in Baltimore and the other in Birmingham, took differing positions on municipal cases involving similar allegations but a different legal theory.[4] In both complaints, the cities alleged disparate treatment and disparate impact under the Fair Housing Act ("FHA").[5] Baltimore was able to allege specific wrongdoing

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1. In addition to the cases discussed herein, see *City of Minneapolis v. TJ Waconia, LLC*, No. 27CV0887880, 2008 WL 925273 (Minn. Dist. Ct. Apr. 2, 2008).

2. *See* Julie Kay, *Empty Homes Spur Cities' Suits*, NAT'L L.J., May 9, 2008, http://www.law.com/jsp/article.jsp?id=1202421240174.

3. City of Cleveland v. Ameriquest Mortgage Sec., Inc., 621 F. Supp. 2d 513, 536 (N.D. Ohio 2009).

4. Mayor & City Council of Balt. v. Wells Fargo Bank, N.A., 631 F. Supp. 2d 702 (D. Md. 2009); City of Birmingham v. Citigroup, Inc., No. CV-09-BE-467-S (N.D. Ala. Aug. 19, 2009), *available at* http://meetings.abanet.org/webupload/commupload/CL230000/relatedresources/ArgentOrder.pdf.

5. *See* Pub. L. No. 90-284, 82 Stat. 81 (1968) (codified as amended at 42 U.S.C. §§ 3601–3631 (2006)).

which, as explained below, probably saved its claim from dismissal. Birmingham, however, went down to defeat based on lack of standing.

This Survey first discusses the wave of municipal lawsuits generally and analyzes in depth the *City of Cleveland* opinion and its wider importance, then analyzes the perfunctory order in the *Baltimore* case denying the defendants' motion to dismiss and allowing that case to proceed to discovery, and concludes by briefly noting other municipal suits in Buffalo, New York, and, of course, Birmingham, Alabama.

The *City of Cleveland* Case

Basics of the Case

Public nuisance was the central claim of Cleveland's complaint in *City of Cleveland v. Ameriquest Mortgage Securities, Inc*.[6] Cities such as Cleveland have pursued the *public* nuisance route, since any *private* nuisance could only be felt by the individual borrowers upon whom the foreclosures occurred. Nuisance was the natural choice as a vehicle for Cleveland's suit because nuisance theory is notoriously flexible: "There is perhaps no more impenetrable jungle in the entire law than that which surrounds the word 'nuisance.' . . . There is general agreement that it is incapable of any exact or comprehensive definition."[7]

In attacking the public nuisance claim brought in *City of Cleveland*, the defendants brought eight separate motions to dismiss.[8] A number of theories were advanced that the court did not address. Instead, the court (per Judge Lioi) focused on four reasons why dismissal was proper under Rule 12(b)(6) of the Federal Rules of Civil Procedure. First, it held that the claims were expressly preempted by Ohio state law.[9] Second, the suit was barred under the economic loss doctrine.[10] Third, there can be no common law liability for a public nuisance where the conduct complained of was both regulated and lawful under said regulations.[11] Fourth and finally, the court decided that there was no proximate cause as a matter of law because the securitizers' conduct was too far removed from the harm—the individual foreclosures.[12] Each of these issues is discussed further below.

Ohio Law Expressly Preempts Mortgage Regulation by Municipalities, Even Regulation by Civil Lawsuit

On the first point, the *City of Cleveland* court ruled that Ohio state law expressly preempts any regulatory action by municipalities with respect to mortgage loans,

6. 621 F. Supp. 2d at 515–16.
7. W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, Prosser and Keeton on Torts § 86, at 616 (5th ed. 1984).
8. 621 F. Supp. 2d at 516.
9. *Id*. at 520.
10. *Id*. at 525–26.
11. *Id*. at 531.
12. *Id*. at 536.

including civil lawsuits.[13] In its analysis, the court focused on the state statutory language that includes in its definition of regulation "other action[s]" taken "directly or indirectly."[14] The court also cited to decisions of the U.S. Supreme Court explaining, in dicta, that regulation of conduct can sometimes occur through civil lawsuits for damages.[15]

Of course, statutes vary from state to state. This part of the court's opinion may have no wider applicability, depending upon a given state's preemption statute and case law interpreting state-municipality preemption. Ohio's statute *expressly* preempted municipal regulation; other states may lack such a provision.[16]

Economic Loss Rule

Not every state follows the economic loss rule. Ohio and many other states do, however, and the *City of Cleveland* court held that the doctrine barred the city's public nuisance suit.[17] Generally, the economic loss doctrine "precludes recovery in tort for purely economic losses not arising from tangible physical harm to persons or property."[18] Among other rulings, the *City of Cleveland* court found persuasive a decision in which the Illinois Supreme Court squarely held the economic loss doctrine applicable to public nuisance claims.[19] The city argued that even if the economic loss rule applies to public nuisance generally, at least some of the damages it alleged were not economic in nature.[20] Specifically, the city pointed to its claims that the foreclosed properties physically had deteriorated as a result of the subprime defendants' conduct, and thus their damages were in the nature of non-economic physical damage to property.[21] The court disagreed, finding that while property damage might be a non-economic loss, the property damage was felt by the owners of the foreclosed properties, not the city.[22]

13. *Id*. at 517–20. Ohio law provides, in relevant part: "The state solely shall regulate [mortgage lending]. Any [municipal] ordinance, resolution, regulation, or other action by a municipal corporation or political subdivision to regulate, directly or indirectly, [mortgage lending] . . . is preempted." Ohio Rev. Code Ann. § 1.63 (West 2006).

14. *City of Cleveland*, 621 F. Supp. 2d at 517–20.

15. *Id*. at 518 (citing Riegel v. Medtronic, Inc., 128 S. Ct. 999, 1008 (2008) (a common law action "limited to damages . . . can be, indeed is designed to be, a potent method of governing conduct and controlling policy" (internal quotation marks omitted)); S.D. Bldg. Trades Council, Millmen's Union, Local 2020 v. Garmon, 359 U.S. 236, 247 (1959) ("[R]egulation can be as effectively exerted through an award of damages as through some form of preventive relief.")).

16. Even without such provisions, however, implied preemption is a possibility. For an example in the mortgage context, see *American Financial Services Ass'n v. City of Oakland*, 104 P.3d 813 (Cal. 2005).

17. *City of Cleveland*, 621 F. Supp. 2d at 521–26.

18. *Id*. at 521.

19. *Id*. at 522 (citing City of Chi. v. Beretta U.S.A. Corp., 821 N.E.2d 1099, 1141 (Ill. 2004)). This was a public nuisance case against a gun company.

20. *Id*. at 525–26.

21. *Id*.

22. *Id*.

Lawful Actions—Court Holds that the Defendants Acted Within the Bounds of Pervasive Regulation

Although the first two grounds of the court's decision may be distinguishable in some other states because of the specifics of Ohio law, the final two grounds are more likely to be universally applicable. The first of these involved the defendants' argument that they could not be found to have caused a public nuisance because the city did not allege that they violated any of the myriad of federal and state laws regulating the mortgage industry.[23] In short and crisp language, the Ohio Supreme Court in 1935 put it this way: "What the law sanctions cannot be held to be a public nuisance."[24]

The *City of Cleveland* court found the issue to be slightly more complicated than that, but ultimately accepted the basic argument: where "conduct . . . is subject to regulation and, within the framework of . . . [the] regulatory scheme, encouraged," the perpetrator of that conduct is immunized from nuisance liability.[25] In disputing this, the city relied heavily on a gun case from Cincinnati.[26] There, guns were similarly subject to a comprehensive regulatory scheme—and yet the Ohio Supreme Court ruled that those public nuisance claims were cognizable.[27]

The *City of Cleveland* court saw a major difference between Cincinnati's allegations in the gun case and Cleveland's subprime lending-based allegations. Cincinnati alleged that it was damaged by illegal gun sales made via underground markets that the gun manufacturer's sales practices, while entirely lawful, allowed to develop; the gun manufacturers were alleged to have facilitated this underground market.[28] By contrast, Cleveland did not allege that any practice of the subprime lenders facilitated fraud or other illegalities by originators.[29]

The city attempted to draw a distinction between subprime *lending*, which is heavily regulated, and subprime *securitization*, which, they argued, was generally not regulated.[30] The court ultimately rejected the distinction. If the underlying loans were lawfully made, simply encouraging more lawful activities via securitization could not itself be a public nuisance, for the same reasons that the underlying lending could not be a public nuisance: "There is no question that the subprime lending that occurred in Cleveland was conduct which 'the law sanctions,' and as such, it cannot be a public nuisance. By extension, therefore, facilitating that lawful conduct by financing it cannot be a public nuisance either."[31]

23. *Id*. at 526.
24. City of Mingo Junction v. Sheline, 196 N.E. 897, 900 (Ohio 1935).
25. *City of Cleveland*, 621 F. Supp. 2d at 526.
26. City of Cincinnati v. Beretta U.S.A. Corp., 768 N.E.2d 1136 (Ohio 2002).
27. *Id*. at 1143–44.
28. *Id*. at 1136.
29. *City of Cleveland*, 621 F. Supp. 2d at 528.
30. *Id*. at 530–31.
31. *Id*. at 531 (citation omitted). The court cited, among other federal sources, the Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901–2908 (2006), the creation of Freddie Mac, and HUD statements approving of increased securitization of subprime loans by Freddie Mac. *City of Cleveland*, 621 F. Supp. 2d at 529–30.

Proximate Cause—City's Claim Lacked Directness

The fourth and final ground of the court's holding in *City of Cleveland* has even broader application. In order for an injury to be cognizable, its cause must bear directness to the harm suffered; the *City of Cleveland* court ruled that this directness was lacking in the city's allegations.[32]

Applying *Holmes v. Securities Investor Protection Corp.*,[33] the *City of Cleveland* court pointed to the broad array of factors that cause foreclosure—losing a job, the economy generally, a decline in manufacturing localized to Cleveland, and the broader housing crisis, among others.[34] Ultimately, the court concluded that foreclosures in Cleveland were "the product of a myriad of factors . . . many of which were completely beyond Defendants' control. Sorting out these contributing factors in an effort to assign liability would be a speculation-laden, uncertain endeavor . . . ."[35]

With respect to whether the more immediate victims could deter the conduct at issue, the *City of Cleveland* court focused on the conduct at issue—securitizing subprime mortgages—and concluded that individual borrowers were better situated to bring more direct claims to deter such conduct.[36] In the case of mortgages, the court noted, the *only* way Cleveland could have been damaged was via foreclosures that more directly affected borrowers.[37]

The *City of Baltimore* Case

Another case, *Mayor & City Council of Baltimore v. Wells Fargo Bank, N.A.*, also has seen an initial ruling and is currently still pending in the District of Maryland.[38] Baltimore came to court with a different legal theory than that advanced by Cleveland, namely that Baltimore was indirectly damaged by FHA violations committed by Wells Fargo.[39] Baltimore alleged that Wells Fargo targeted African-Americans with different underwriting policies more likely to lead to foreclosures—a "reverse redlining" disparate treatment claim.[40] Baltimore also alleged that Wells Fargo's

32. *City of Cleveland*, 621 F. Supp. 2d at 531–36.

33. 503 U.S. 258 (1992). *Holmes* is the leading case on directness. In *Holmes*, a stock scheme hatched by the defendant injured a group of brokers whose loans had been guaranteed. *Id.* at 261. The guarantor was forced to reimburse third parties due to Holmes's actions, and brought suit under the RICO statute, but dismissal for failure to state a claim was upheld on appeal because the alleged cause of the injury was simply too indirect. *Id.* at 274. Under *Holmes*, three factors are important to analyzing the directness of the causation: (i) the difficulty of proving which portion of the plaintiff's damages was caused by the defendant; (ii) the danger that the plaintiff will recover for its own indirect injuries as well as direct injuries caused to others; and (iii) the extent to which the more directly harmed can credibly deter the injurious conduct. *Id.* at 269.

34. *City of Cleveland*, 621 F. Supp. 2d at 533–35.

35. *Id.* at 535.

36. *Id.* at 535–36.

37. *Id.*

38. 631 F. Supp. 2d 702 (D. Md. 2009).

39. *City of Balt.*, 631 F. Supp. 2d at 703.

40. *Id.*

generally applicable underwriting policies had an adverse impact on African-American borrowers—a disparate impact claim.[41] While these claims are entirely different from the public nuisance claim in *City of Cleveland*, Baltimore sought to recover the same type of damages as Cleveland, i.e., increased city expenditures due to foreclosed or abandoned homes.[42] The core question presented is whether a city can recover for indirect damages arising from FHA violations that cause harm to third parties.[43]

With little discussion, and based largely on disparate treatment allegations, the court denied Wells Fargo's motion to dismiss.[44] Just prior to the hearing, Baltimore submitted declarations of two former Wells Fargo employees who described under oath certain practices they had observed which, according to the court, raised a question of fact as to whether Wells Fargo engaged in disparate treatment, i.e., intentional discrimination.[45] Although Wells Fargo also raised the standing issue, the court deferred any ruling on that issue, concluding in less than a paragraph that "the standing questions are inextricably intertwined with the facts central to the merits" and thus discovery should proceed.[46] While this is a true statement as a general matter, it is by no means a full analysis of the issue. As noted earlier,[47] standing questions can turn on causation and provability of damages.

Shortly after the court's ruling, Baltimore filed an amended complaint and the case took a surprising turn when the sitting judge recused himself based on an undisclosed potential conflict of interest.[48] Wells Fargo thereafter moved to dismiss the action, and a ruling on that motion—before a fresh set of eyes—was pending as this Survey went to press.[49]

Other Litigation: *City of Birmingham* and *City of Buffalo*

Two other municipal suits largely have been resolved in the past year. In *City of Buffalo v. ABN AMRO Mortgage Group, Inc.*,[50] the city originally filed suit against numerous lenders, asserting (as in the *Cleveland* litigation) that the defendants created a public nuisance because of their foreclosure activity and resulting code violations, and sought to hold those lenders jointly and severally liable for the costs of abatement, including demolition at an average cost of $16,000 per dwelling.[51]

41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.* at 704.
45. *Id.*
46. *Id.*
47. *See supra* notes 32–37 and accompanying text.
48. *See* Mayor & City Council of Balt. v. Wells Fargo Bank, N.A., No. 1:08-CV-00062-JFM (D. Md. Aug. 6, 2009) (memorandum to counsel reassigning case from Chief Judge Benson Everett Legg to Judge J. Frederick Motz).
49. *See* Motion to Dismiss Amended Complaint, Mayor & City Council of Balt. v. Wells Fargo Bank, N.A., No. 1:08-CV-00062-JFM (D. Md. Sept. 18, 2009), 2009 WL 3100269.
50. Complaint, City of Buffalo v. ABN AMRO Mortgage Group, Inc., No. 2008002200 (N.Y. Sup. Ct. Feb. 20, 2008), *available at* http://www.hppinc.org/_uls/resources/Buffalo_Lawsuit.pdf.
51. *Id.* ¶ 7.

During briefing on the lenders' motions to dismiss, however, the city reversed course and agreed to dismiss the count seeking to hold the lenders jointly and severally liable.[52]

In Birmingham, the city pursued a *Baltimore*-like "reverse redlining" theory, but without success. In *City of Birmingham v. Citigroup, Inc.*,[53] the city alleged not only an FHA claim of reverse redlining, but also state law claims of negligence, wantonness, misrepresentation, and outrage.[54] In particular, the city claimed that the defendants' targeting of minority borrowers for subprime loans resulted in higher foreclosure rates and diminished property values.[55] The court, however, echoing the *City of Cleveland* opinion, dismissed Birmingham's suit for lack of standing, concluding that "a series of speculative inferences must be drawn to connect the injuries asserted with the alleged wrongful conduct by the Defendants," and that "a myriad of other factors" could just as easily have caused the foreclosures.[56] Unlike the suit by Baltimore, Birmingham targeted a group of lenders rather than a single defendant, and failed to include any specifics tying any one particular lender to the alleged injuries suffered by that municipality.

In early 2009, Atlanta and Memphis, two other cities with large inner-city minority populations, likewise threatened to pursue suits and even approved resolutions authorizing suit.[57] As this Survey went to press, however, neither city had filed suit.

Conclusion

From these initial rulings, it appears likely that municipal suits targeting assignees or securitizers simply for purchasing mortgage loan contracts or partially financing the foreclosure process will face close scrutiny by the courts. If, however, a city is able credibly to allege specific violations of mortgage laws and regulations, some judges will want to hear more. As the *City of Baltimore* case proceeds to discovery, it will also be interesting to see how the courts will tackle the issue of alleged indirect damages.

52. City of Buffalo v. ABN AMRO Mortgage Group, Inc., No. 2008002200 (N.Y. Sup. Ct. Mar. 11, 2009) (order).

53. No. CV-09-BE-467-S (N.D. Ala. Aug. 19, 2009), *available at* http://meetings.abanet.org/webupload/commupload/CL230000/relatedresources/ArgentOrder.pdf.

54. *Id.* at 2.

55. *Id.*

56. *Id.* at 8. There is arguably little that distinguishes Birmingham's standing problem from the alleged standing of Baltimore in its action against Wells Fargo.

57. *See, e.g.*, Peter Vernon, *Atlanta Pursues Lenders that Caused Foreclosed Homes*, Bank Foreclosures Sale, Apr. 22, 2009, http://www.bankforeclosuressale.com/wp/article-0422696.html (noting approval by Atlanta city council); Amos Maki, *Council Says OK to City Lawsuit*, Com. Appeal, Jan. 7, 2009, http://www.commercialappeal.com/news/2009/jan/07/council-says-ok-to-city-02/ (noting approval by Memphis city counsel for suit against national lenders).