

Ohio Court Rejects “Public Nuisance” Claim Against Subprime Loan Securitizers

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In a decision issued today that likely will have far-reaching ramifications in subprime lending litigation, the United States District Court for the Northern District of Ohio dismissed a complaint filed by the City of Cleveland against 21 financial institutions that had securitized subprime loans originated in Cleveland into mortgage-backed securities. The City of Cleveland had alleged that the activities of financial institutions in securitizing subprime loans constituted a “public nuisance” under Ohio law. Although the complaint — which sought to hold securitizers responsible for urban blight resulting from foreclosures — generated a great deal of media attention as well as copycat lawsuits filed by other municipalities, the Court ruled that the city’s claim was invalid as a matter of law.

According to the decision issued by Judge Sara Lioi – *City of Cleveland v. Ameriquist Mortgage Securities, Inc. et al.*, No. 1:08 cv 139 (N. D. Ohio, May 15, 2009) – the city could not proceed with its public nuisance claim because (i) the claim was preempted by Ohio laws regulating mortgage lending; (ii) the claim was barred by the “economic loss rule”; (iii) the allegations failed to demonstrate that securitizing subprime loans constituted an “unreasonable interference with a public right”; and (iv) the allegations were insufficient to demonstrate that the securitizers’ conduct caused problems faced by the City of Cleveland as a result of home foreclosures.

In holding that the City of Cleveland’s claims were preempted by Ohio lending laws, the Court held that the city’s attempt to accomplish via lawsuit what it could not accomplish via regulation was improper. Because the lawsuit was “an indirect attempt to regulate the origination and granting of mortgage loans,” it was preempted by state law. While not binding on judges in other states, Judge Lioi’s carefully-reasoned preemption analysis likely will be given close consideration by judges dealing with analogous preemption arguments.

Judge Lioi also rejected the theory that securitizing subprime loans constituted a public nuisance, for two reasons. First, Judge Lioi held that the “economic loss doctrine,” which generally precludes recovery in tort for purely economic losses not arising from physical harm to persons or property, applied to the city’s claims. Second, and perhaps more significantly, the Court held that the conduct at issue could not be deemed a public nuisance because the City of Cleveland had not alleged that the defendants had violated any law. Notably, the decision emphasized that the federal government had encouraged the very expansion in subprime lending that the complaint decried as illegal.

Finally, the Court held that funding subprime lending did not proximately cause the damages that the lawsuit sought to remedy — i.e., harm to the city as a result of increased expenditures and decreased tax revenue as a result of home foreclosures.

Judge Lioi's decision is subject to appeal to the Court of Appeals for the Sixth Circuit and is not binding on other state and federal judges. Nevertheless, the court's reasoning on the novel claim presented by the City of Cleveland as well as the preemption and proximate cause issues likely will be given careful consideration by courts in other jurisdictions. Among other things, the decision may lead municipalities and other entities pursuing similar claims to allege that the defendants violated one or more laws or regulations, in order to distinguish their case from *City of Cleveland* and survive a motion to dismiss. The impact of the decision on class action claims by actual subprime borrowers is less clear, but Judge Lioi's decision will give financial institutions facing "subprime meltdown" litigation significant support in setting forth preemption and causation defenses.