

**A SUB-PRIME TORT?  
PUBLIC NUISANCE AN UNFIT TOOL  
FOR LENDING REGULATION**

By

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WLF

**Washington Legal Foundation**  
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The opinions expressed herein are solely those of the authors.

# **A SUB-PRIME TORT? PUBLIC NUISANCE AN UNFIT TOOL FOR LENDING REGULATION**

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For the last decade, lawyers representing governmental entities such as cities, counties and states have used public nuisance claims to sue product manufacturers. These governmental authorities hope to recover monies spent to administer and/or create public health care or other social programs, as well as to abate health hazards and social problems allegedly caused by a wide range of products, including asbestos, guns, tobacco, lead paint and fossil fuels that produce greenhouse gases. They use public nuisance law because it supposedly allows them to avoid traditional causation and product identification problems and to bypass legislative programs – programs often passed to address the very problems they seek to redress. See Richard O. Faulk and John S. Gray, *Alchemy in the Courtroom? The Transmutation of Public Nuisance Litigation*, 2007 MICH. ST. L. REV. 941 (2007).

One recent use of public nuisance litigation, however, strains common law concepts even further. On January 10, 2008, the City of Cleveland filed suit against twenty-one financial institutions, such as Countrywide Financial

Corporation, Lehman Brothers Holdings, Inc. and Wells Fargo, for allegedly creating the sub-prime mortgage fiasco plaguing most of the nation. See *City of Cleveland v. Deutsche Bank Trust Co.*, CV 08-646970, in the Court of Common Pleas, Cuyahoga County, Ohio [hereinafter “Cleveland Complaint”].<sup>1</sup> According to the City of Cleveland, the defendants’ conduct in creating and selling sub-prime mortgages created a public nuisance that is forcing the City to incur damages associated with urban blight as hundreds and thousands of homeowners default on their mortgages and move out of their homes, leaving the City to deal with the vacant houses and associated criminal and social problems in affected neighborhoods.

As this WORKING PAPER will show, public nuisance is not a viable cause of action to address the social problems resulting from the mortgage crisis and sub-prime debacle. Ohio courts should join other state courts, such as those in Illinois, New Jersey and Rhode Island, by rejecting attempts to distort this ancient tort.

## **I. BACKGROUND: THE SUB-PRIME CRISIS**

For the past year, the country’s real estate markets have experienced an economic slump. Hardly a news day goes by without a story about the nation’s

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<sup>1</sup>The City of Cleveland filed suit in the Court of Common Pleas, Cuyahoga County, Ohio. However, the Defendants removed the case to federal district court (Cause No. 1:08CV00139 pending in the Northern District of Ohio district court). After several reassignments, the case is currently pending before the Honorable Sara Lioi in the Northern District of Ohio (Cleveland). Plaintiff filed a Motion to Remand the case back to state court alleging that the Defendants did not have the proper consent to remove the case. Final briefing on the issue was due on June 30, 2008 after which time the court will determine if jurisdiction lies with the federal district court.

housing or associated banking problems. In June, it was reported more than one million homes were in foreclosure.<sup>2</sup> In July, former Federal Reserve president William Poole rocked the banking industry when he announced that Freddie Mac and Fannie Mae – American institutions created decades ago to foster affordability and stability in the U.S. housing market – may need bailing out.<sup>3</sup>

Sub-prime loans, once lauded for expanding opportunities for home ownership to poorer, higher-risk borrowers, are now blamed for much of the problem. Because sub-prime loans are made to borrowers with less than perfect credit reports (history of late or missed payments) or other underwriting deficiencies (high outstanding debt, income or assets that are hard to document), lenders charge a higher interest rate to compensate for potential losses from customers who may run into trouble or default. See e.g., CLEVELAND COMPLAINT at ¶¶ 33, 37.

For example, a common sub-prime mortgage was the 2/28 adjustable rate mortgage, or ARM, in which the interest rate is fixed for 2 years, and then reset at a specified index rate plus a margin. Many sub-prime borrowers agreed to this ARM, planning to rebuild their credit during the 2-year period and refinance

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<sup>2</sup>See Chris Isidore, *Homes in Foreclosure top 1 Million*, CNN Money (June 5, 2008), available at <http://money.cnn.com/2008/06/05/news/economy/foreclosure/index.htm>.

<sup>3</sup>According to Mr. Poole, Fannie Mae's assets are down 66 percent and Freddie Mac is \$5 billion in the red. Consequently, they might not have enough capital to survive the sub-prime crisis. See Peter Ryan, *Freddie Mac, Fannie Mae Hurting In Sub-prime Fallout*, ABC News (July 15, 2008), available at <http://www.abc.net.au/news/stories/2008/07/11/2301423.htm> (together, Freddie Mac and Fannie Mae guarantee around \$6 trillion in outstanding home loans and is currently “weathering the lion’s shares of the sub-prime mortgage crisis”); see also, CLEVELAND COMPLAINT at ¶ 36.

their mortgage at a better rate before the interest rate was adjusted higher. Other borrowers agreed to the ARM based on their mistaken belief that their property's value would continue to appreciate, putting them in a position to refinance the loan at no real cost to them. Unfortunately, many borrowers were unable to rebuild their credit during the two-year window. The situation worsened when real estate markets declined and the United States economy weakened, impacting not only property values but the ability of borrowers to refinance adjustable rate mortgages. This double impact negatively affected the value of housing to the tune of \$3 trillion in home equity – and many cities and families are suffering the aftermath.<sup>4</sup>

According to the City of Cleveland's pleadings, sub-prime loans were not an issue until the mid to late 1990s when lenders discovered ways to profitably sell them to Wall Street and remove the risks from their own books. Lenders accomplished this feat by selling their mortgage loans to investment bankers who bundled them together into mortgage-backed securities, or a securitized pool of mortgages. See e.g., CLEVELAND COMPLAINT at ¶ 35. The mortgage pools were then rated by services such as Moody's, Standard & Poor's and Fitch. Once rated, the investment bankers sold the mortgage pools to Wall Street investors. By providing the mortgage industry with an entrée to Wall Street, mortgage lenders no longer had to wait 10 to 30 years to get their money back. Instead, they recouped their investment when they placed the mortgages in the pool. This

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<sup>4</sup>See Christie, Jim, *Economic Outlook "Sub-prime," No Recession: Report*, Reuters, June 18, 2008, available at [www.reuters.com/articlePrint?articleId=USN1737272620080618](http://www.reuters.com/articlePrint?articleId=USN1737272620080618).

practice allowed mortgage lenders and investment bankers to increase the number of mortgages they could write and earn “lavish paydays.” See e.g., CLEVELAND COMPLAINT at ¶ 40. It also allowed lenders to write more sub-prime loans which they bundled with other loans and sold to Wall Street.<sup>5</sup> This “house of cards” fell last year when the housing bubble popped. Whatever the truth of these allegations may be, they still beg the question of whether Cleveland’s problems amount to a “public nuisance.” The answer to that concern lies in the common law of torts, not in financial markets or newspaper headlines.

## **II. THE CITY OF CLEVELAND’S ALLEGATIONS: IS THIS REALLY A PUBLIC NUISANCE?**

### **A. Cleveland’s Complaint**

Cleveland’s response to the sub-prime crisis was a public nuisance suit against the banking institutions. The City acknowledges that other cities<sup>6</sup> have also been hurt by what it terms “[s]ub-prime lending abuses,” but Cleveland claims that its predicament is “distinctive and unique.” CLEVELAND COMPLAINT at ¶ 4 (alleging that its “economy and housing situation differed significantly from the rest of the country’s”). It also claims that the financial institutions it sued

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<sup>5</sup>See Lowenstein, Roger, *Triple-A Failure*, NY TIMES Apr. 27, 2008 (available at <http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html?pagewanted=print>).

<sup>6</sup>Although all states have been affected by the sub-prime fiasco and the housing decline, Ohio has been particularly hard hit. There have been a total of 83,230 foreclosures in Ohio since 2000 and more than 8,500 properties have been identified by the City of Cleveland as abandoned or nuisance properties. See *Ohio Homeowners Need a Hand*, June 17, 2008. According to the Center for Responsible Lending, in Cuyahoga County, Ohio, it was estimated that 3,268 homes were lost to foreclosure in the county between 2005-2006. *Sub-prime Spillover: Foreclosures Cost Neighbors \$202 Billion; 40.6 Million Homes Lose \$5,000 on Average*, Center for Responsible Lending, Jan. 18, 2008.

knew or should have know that “the City’s struggling, Rust-Belt economy, the disappearance of the manufacturing sector as a significant financial presence, and its inability at the beginning of this decade to attract any meaningful replacement” “should have eliminated Cleveland as a market for sub-prime lending.” *Id.* at ¶¶ 50, 53.

Instead, Cleveland claims, the “‘securitizers’ and lenders” “focused their sites more intensely upon the City, rather than shying away from it” because its “demographic profile largely comport[ed] with the prototype sub-prime clientele” (*i.e.*, high concentration of lower-income families with below-average credit). *Id.* at ¶¶ 53, 54. Cleveland claims that “the purveyors of sub-prime mortgages could have and should have foreseen (and in all likelihood actually did foresee) a foreclosure crisis as the inescapable consequence of their conduct.” *Id.* at ¶ 5. Still, the City alleges that the financial institutions “ignored obvious facts” and “pump[ed] hundreds of millions in sub-prime loans into Cleveland.” *Id.* at ¶ 48.

Although Cleveland never specifically defines the “public nuisance” from which it suffers or where the nuisance is specifically located, it does describe in detail the extent of home foreclosures that have occurred in the City over the past few years and the impacts these foreclosures have had on its citizens. CLEVELAND COMPLAINT at ¶¶ 55-57. According to the City, “[e]ach and every foreclosure creates certain tangible costs for Cleveland, particularly if the property remains vacant for any extended period of time. . . . [T]hese may include increased expenditure for fire and police protection, or the cost of demolition.” *Id.* at ¶ 59.

Additionally, Cleveland claims that the sub-prime mortgage crisis has “ravaged [its] property-tax revenues” because the foreclosures have decreased “the value not only of the affected homes, but surrounding properties as well.” *Id.* at ¶¶ 60-61 (citing recently released study by the Center for Responsible Lending which states that Cleveland homes “collectively depreciated more than \$462 million due to their proximity to foreclosed property”). According to Cleveland, “[r]esponsibility for [the City’s] plight rests principally with sub-prime’s so-called “securitizers” – investment banking firms from Wall Street and elsewhere that actually provided the cash used to make loans, regardless of the lender or broker nominally involved in the transactions.” CLEVELAND COMPLAINT at ¶ 6.

The City claims that the “propagation of sub-prime mortgages in Cleveland and the corresponding foreclosures constitute a public nuisance as defined by Ohio common law.” *Id.* at ¶ 9. It claims that Defendants’ conduct proliferated “toxic sub-prime mortgages within its borders, under circumstances that made the resulting spike in foreclosures a foreseeable and inevitable result.” *Id.* at ¶ 64. As for the redress being sought, the City simply wants to “recoup the losses it has suffered.” *Id.* at 9. Cleveland describes these losses as “(a) the cost of monitoring, maintaining, and demolishing foreclosed properties, and (b) decreased tax revenues resulting from the depreciated value of the affected homes and all surrounding real estate.” *Id.* at ¶ 65.

## **B. Ohio's Definition of Public Nuisance**

Ohio adopted the Restatement (Second) of Torts' definition of public nuisance, which defines public nuisance as an "unreasonable interference" with a "public right." *Cincinnati v. Beretta U.S.A. Corp., et al.*, 768 N.E.2d 1136 (Ohio 2002) (adopting RESTATEMENT (SECOND) OF TORTS § 821B(1) (The American Law Institute 1979)). According to the Restatement, the following circumstances may be considered in determining whether an interference with a public right is "unreasonable":

- (a) whether the conduct involves a significant interference with the public health, the public safety, the public peace, the public comfort or the public convenience, or
- (b) whether the conduct is proscribed by a statute, ordinance or administrative regulation, or
- (c) whether the conduct is of a continuing nature or has produced a permanent or long-lasting effect, and, as the actor knows or has reason to know, has a significant effect upon the public right.

RESTATEMENT (SECOND) OF TORTS § 821B(2). *See generally*, Faulk & Gray, *supra* at 962-968 (describing elements of public nuisance claims at common law).

In 2002, Ohio's Supreme Court adopted an expansive view of public nuisance by holding that, "under the Restatement's broad definition, a public-nuisance action can be maintained for injuries caused by a product." *Cincinnati v. Beretta U.S.A. Corp., et al.*, 768 N.E.2d at 1142. Shortly thereafter, Ohio's Legislature rejected this view by "clarifying" its intent to preempt common law public nuisance claims brought against manufacturers or suppliers of products

when it enacted the state’s product liability act. See 2006 AM. SUB. S.B. NO. 117 (“the Act”). Hence, so long as sub-prime mortgage loans are deemed to be “products,”<sup>7</sup> the City of Cleveland’s sole remedy against the investment banks is a products liability cause of action. If, however, sub-prime mortgage loans are found not to be a “product” subject to the Act, the question remains whether the marketing of these mortgages to private individuals constitutes a public nuisance.

### **C. What is the “Public Right?”**

Under Ohio law, a public nuisance is an unreasonable interference with a “public right.” Ohio generally defines a public right as “rights common to all members of the public.” *Brown v. Scioto Cty. Bd. of Commrs.*, 622 N.E.2d 1153, 1158 (Ohio Ct. App. 1993). Ohio also recognizes that “conduct does not amount to a public nuisance merely because it interferes or ‘bothers’ a large number of people.” *Id.* This rule insists that the impact must affect the public generally, not individuals specifically – no matter how many individuals are affected. Accordingly, for public nuisance purposes, the “public right” must be derived from something other than the individual interests of homeowners who suffer foreclosures as a result of improper sub-prime practices or defective “intangible products.” Such claims cannot support a public nuisance cause of action.

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<sup>7</sup>A “product” is “any object that constitutes *tangible* personal property that is produced, manufactured, or supplied into trade or commerce for sale or lease to persons for commercial or personal use.” 1988 Ohio Products Liability Act, R.C. § 2307.71(A)(12) (2006)(emphasis added). Since mortgages, by their nature, appear to be “intangible,” there is some question whether they qualify as “products” under the Act.

Rhode Island's Supreme Court recently addressed this issue in *Rhode Island v. Lead Industries Association, Inc., et al.*, \_\_\_ A.2d \_\_\_, 2008 WL 2605396 at \*13 (R.I. July 1, 2008). Like Ohio, Rhode Island's definition of public nuisance is consistent with that of the Restatement (Second) of Torts. Moreover, Rhode Island's Supreme Court spent considerable time addressing the concept of "public rights," holding that they were "indivisible resources shared by the public at large, such as air, water, or public rights of way." *Id.* at \*20. This holding does not mean that a public nuisance is actionable only if it occurs on public property. But to be actionable, the nuisance (whether on public or private property) must affect the rights of the general public. *Id.* at \*14 (citing *Chicago v. American Cyanamid Co.*, 823 N.E.2d 126, 132 (Ill. App. Ct. 2005)).

A "public right" is *collective* in nature, not an individual right such as a right to live free of harm. *Id.* Ohio also recognizes this limitation. See *Brown*, supra at 1158. Focusing on the nature of the "interest common to the general public," Rhode Island's Supreme Court limited that interest to a "public *right*" and defined it as "an *indivisible resource* shared by the public at large, like air, water, or public rights of way." *Rhode Island*, 2008 WL 2605396 at \*15 (quoting *Chicago v. American Cyanamid Co.*, 823 N.E.2d at 131) (emphasis added). It then distinguished a "public right" from the broad, malleable, and public policy infused term "public interest" by stating:

That which might benefit (or harm) "the public interest" is a far broader category than that which actually violates "a public right." \* \* \* While it is in the

public interest to promote the health and well being of citizens generally, there is no common law public right to a certain standard of medical care or housing.

*Id.* (quoting Donald G. Gifford, *Public Nuisance as a Mass Products Liability Tort*, 71 U. CIN. L. REV. 741, 815 (2003)).

Several barriers to the City's recovery arise from these precedents. First, since all of the alleged harm is associated with private individuals and their private residences, what is the "public right" that Cleveland is protecting? Is there a "public right" that protects citizen's private homes from the impact of nearby foreclosures? Is there a "public right" that shields citizens from funding public services to protect foreclosed properties? Is a *neighborhood* an "indivisible resource" shared by the public at large? Surely not. Instead, these claims arise from *individual* deals made between *individual* borrowers and *individual* lenders. Even if those particularized circumstances were unlawful in their uniquely *individual* scenarios, there is no basis for declaring a "public nuisance," however widespread the individual impacts may be.

Moreover, by proceeding to litigate the issue collectively as a public nuisance claim, instead of insisting on individual adjudications, the City transparently attempts to "leap frog" over all of the strict requirements otherwise applicable to claims between borrowers, lenders and underwriters – such as proof of actual fraud and an established relationship between the parties who suffered from and those who actually engaged in tortious conduct. Indeed, the claim perversely seeks to litigate liability for *effects* without even attempting to

demonstrate the *cause* to any particular citizen by any particular tortfeasor.<sup>8</sup> Public nuisance is not a tort that imposes “collective” responsibility without proof of specified harms caused by identified parties. Indeed, Ohio has already rejected arguments based upon unsound “alternative liability” concepts such as “market share” liability – arguments that sought to excuse the absence of traditional causation proof.<sup>9</sup>

By erroneously invoking a “public right,” the City attempts to evade virtually every traditional requirement of the common law of torts by:

- (a) seeking to impose liability for fraud – without proving that any person was actually defrauded;
- (b) seeking to impose liability for defective “products” – without proving that any particular consumer purchased or that any particular defendant manufactured the product that allegedly caused the consumer’s harm;
- (c) seeking to impose liability collectively on defendants without proof of intentional misconduct or intentional overt acts in furtherance of a conspiracy;
- (d) seeking to impose liability in a *de facto* “common law” class action for an aggregate liability without any of the safeguards applicable to class action practice – safeguards that guarantee participation of actual claimants and a determination regarding whether the preponderance of individual issues precludes aggregate treatment.

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<sup>8</sup>Indeed, the City’s claim parallels the “public nuisance” claim recently rejected by the Rhode Island Supreme Court because it is based upon “*unidentified* ills allegedly suffered by *unidentified* people caused by *unidentified* products in *unidentified* locations.” See Faulk & Gray, *supra* at 981-982 (emphasis in original).

<sup>9</sup>*Sutowski v. Eli Lilly & Co.*, 696 N.E.2d 187 (Ohio 1998).

At its core, therefore, the City’s public nuisance claim is a vehicle carefully constructed to overcome the requirements of traditional torts that, if litigated on their merits, could never succeed on their own. However creative this device may be, individual issues in public nuisance litigation cannot be summarily dismissed in a headlong rush to collective recovery – any more than they can be ignored in a class action scenario.<sup>10</sup> Otherwise, as the New Jersey Supreme Court so aptly held, public nuisance would be transformed into “a monster that would devour in one gulp the entire law of tort.”<sup>11</sup>

#### **D. Who “Controls” the Nuisance?**

Although space does not permit a full discussion of other obstacles by the City’s suit, the lack of a “public right” is certainly not its only defect. Although certain financial institutions allegedly created the sub-prime mortgages, they may not presently *control* the mortgages (*i.e.*, hold them) on the foreclosed properties. A defendant must have control over the instrument causing the alleged nuisance at the time the injury occurs – control at some earlier point in time is not sufficient. *Rhode Island*, 2008 WL 2605396 at \*13-\*14. Such control is critical

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<sup>10</sup>See generally Richard O. Faulk, *Armageddon Through Aggregation? The Use and Abuse of Class Actions in International Dispute Resolution*, 10 MSU-DCL J. OF INT’L LAW 205 (2001).

<sup>11</sup>*In re: Lead Paint Litigation*, 924 A.2d 484, 505 (N.J. 2007). The court emphasized that if the complaints proceeded, “[it] would stretch the concept of public nuisance far beyond recognition and would create a new and entirely unbounded tort antithetical to the meaning and inherent theoretical limitations of the tort of public nuisance.” *Id.* at 494; see generally, Faulk & Gray, *supra* at 967.

because the remedy in governmental public nuisance cases is abatement.<sup>12</sup> Since parties who lack control over the instrumentality that created the nuisance are in no position to abate it, they cannot be held responsible.<sup>13</sup>

The “responsible” parties in Cleveland are not necessarily the originators of the mortgages – nor are they necessarily the packagers or brokers or investment bankers that allegedly perpetrated the controversy. Instead, the present owners of the properties are the persons who control them – whether those persons be the companies who foreclosed, the persons who purchased them at foreclosure, or more remote purchasers “down the line.”<sup>14</sup> There is simply no basis for holding financial institutions responsible for creating a public nuisance that they do not presently control.

## CONCLUSION

Although the City of Cleveland may be struggling with widespread housing foreclosures caused by the sub-prime mortgage crisis, those circumstances,

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<sup>12</sup>See Faulk & Gray, 2007 MICH. ST. L. REV. at 1003-1004 (“Traditionally . . . governmental entities may only seek an injunction to stop the activity causing the nuisance or force the party to abate the nuisance itself, but they may not seek monetary damages.”); see also, Victor E. Schwartz & Phil Goldberg, *The Law of Public Nuisance: Maintaining Rational Boundaries on a Rational Tort*, 45 WASHBURN L.J. 541, 542 (2006).

<sup>13</sup>See Gifford, 71 U. CIN. L. REV. at 820 (“[L]iability for nuisance-both public and private-is premised not on the creation of a nuisance but rather on the defendant’s current control of the instrumentality causing the nuisance.”)

<sup>14</sup>See Gifford, 71 U. CIN. L. REV. at 820 (“The essence of public nuisance law . . . is ending the harmful conduct. This is impossible for the manufacturer or distributor who has relinquished possession by selling or otherwise distributing the product.”); see also, Schwartz and Goldberg, *supra* note 11, at 568 (“[F]urnishing a product or instrumentality-whether it be chemicals, asbestos, guns, lead paint, or other products-is not the same as having control over that instrumentality.”)

standing alone, do not constitute a common law “public nuisance.” By claiming that the sale of sub-prime mortgages to willing Cleveland citizens created a “public nuisance,” the City seeks to excuse its inability to prove elements of traditional torts, such as fraud, and rushes to impose collective liability for harms that are quintessentially *individual* in nature. By pursuing relief on the basis of an *effect* rather than a cause, the City seeks nothing more than a redistributive wealth transfer – rather than a judgment based on common law standards. Indeed, it does not employ traditional “public nuisance” standards at all, but rather alleges an entirely *new* cause of action that imposes absolute liability under a jurisprudential alias.

Although the sub-prime mortgage fiasco may have inflicted great harm throughout this nation, courts “do not have a commission to solve society’s problems, as they see them, but simply to decide cases before them according to the rule of law.” *Rhode Island*, 2008 WL 2605396 at \*3 (quoting United States Supreme Court Chief Justice John G. Roberts, Jr.). If an Ohio court allows this public nuisance claim to proceed, “it would stretch the concept of public nuisance far beyond recognition and would create a new and entirely unbounded tort antithetical to the meaning and inherent theoretical limitations of the tort of public nuisance.” *Id.* at \*22 (quoting *In re Lead Paint Litigation*, 924 A.2d 484, 494 (N.J. 2007)). However serious the sub-prime situation’s consequences may be, they do not justify selective distortion of principles designed to protect all citizens – plaintiffs and defendants alike – from liability arbitrarily imposed

without reference to reliable standards. Nothing in the City's allegations resembles the cause of action traditionally known as "public nuisance." Despite the familiar "common law" moniker, the City has, by eliminating the tort's essential elements, unmistakably crafted a new and dangerous program of social insurance that merely masquerades as a tort. Public nuisance law is clearly a "sub-prime" response to the sub-prime crisis.