

Legal analysis to guide the mortgage industry and protect its interests.

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Birmingham, Ala. Joins Nationwide Trend of Cities Suing Lenders by *Shaun Ramey*

This summer, the Birmingham City Council endorsed a plan to sue mortgage companies, alleging unfair and deceptive lending practices. In doing so, Birmingham will likely be the first Southern city to file such a suit, joining the likes of other Northern cities that filed suit in 2008, including Cleveland, Buffalo, Minneapolis and Baltimore.

Cities allege a variety of damages

While the decision to sue has been made by Birmingham, a lawsuit has not yet actually been filed. We, nevertheless, anticipate that a lawsuit will be filed within the next 90 days. In addition, we are currently unaware which company or companies will be sued. The prior cities that have filed suit have taken different approaches to the lenders they targeted. The City of Buffalo, for example, specifically sued 28 lenders concerning 57 specific properties. Baltimore and Minneapolis, on the other hand, specifically targeted one lender each (Wells Fargo and CitiMortgage, respectively). Alternatively, in what appears to have been an obvious public relations move, the City of Cleveland initially filed suit only against non-Ohio banks, even though Ohio banks made similar loans to those at issue in the lawsuit. Cleveland subsequently amended their complaint to add Ohio banks, but for what clearly appears to have been tactical reasons.

It is also unclear what theories of liability Birmingham will pursue. The city suits that have previously been filed have predominantly focused on origination issues, although servicing issues permeate the suits. For example, in one of the first city suits filed by the City of Cleveland, the city claimed that it had been damaged as a result of the increased cost it incurred in “monitoring, maintaining and demolishing foreclosed properties.” Likewise, Cleveland claimed that these blighted properties increased crime and destabilized the surrounding community, as well as resulted in decreased tax revenue to the city. In a similar suit filed by the City of Buffalo, the city claimed that the mortgage servicers “have failed to take appropriate action to protect or dispose of these properties,” and that the city “has a duty to abate these nuisances by demolishing the abandoned and blighted properties.” Thus, it can be argued that but for the mortgage servicers’ alleged poor management of the foreclosed properties, the cities would not have filed suit.

If these service issues are the immediate cause of the cities’ alleged damages, the cities claim that the origination of the underlying loans is the true cause of the damages (i.e., bad loans led to foreclosures, which led to mismanaged or abandoned properties, which led to the city’s damages). For example, in claiming the impact upon its city exceeded the national average, Cleveland challenged the validity of the loans that were made to its constituency by claiming that the lenders it had sued created a public nuisance by “proliferating toxic sub-prime mortgages within [the City’s] borders, under circumstances that made the resulting spike in foreclosures a foreseeable and inevitable result.” Likewise, the other cities that have already filed suit have focused on the loan products themselves and their alleged inevitable by-product — foreclosure. The cities have typically challenged adjustable and other “high cost” loans. They have claimed that the lenders made “financially irrational” loans to borrowers without the “wherewithal” to pay. These cases thus subtly challenge the “suitability” of these loans (which is not a recognized cause of action) under the guise of more recognized causes of action such as public nuisance.

The City of Baltimore took it one step further when it filed suit against Wells Fargo, claiming that it engaged in the practice of “reverse redlining” by targeting the city’s African-American borrowers for high cost loans. Also, rather than file a state cause of action for public nuisance or violation of city ordinances as had been done in Cleveland and Buffalo respectively, Baltimore filed its claim under the Federal Fair Housing Act.

It is unclear if Birmingham will model its lawsuit after one of the other city’s prior lawsuits or if Birmingham will endeavor to take a new approach. It would not surprise this author if Birmingham pursues relief more on behalf of its constituency than on behalf of itself. In a press release concerning the upcoming lawsuit, the attorney retained by the city stated that “the city is there to protect its citizens and that takes on a wide gamut of responsibilities. They are to help the individuals who can’t speak for themselves.” Likewise, a member of the Birmingham City Council who approved the suit stated, “This will not only benefit the citizens of Birmingham, but all of the citizens who have been affected by unfair housing treatment.” If these statements are indicative of the allegations that will be made in the forthcoming lawsuit, then Birmingham might be taking the city suits one step further by making them into more of a quasi-class action on behalf of its citizens than merely a suit that only directly benefits the city (and, of course, which results in potential political gain).

Lenders assert a variety of defenses

The question of whether the cities have the right or standing to pursue these actions is already a hotly contested debate. Since the cities are not privy to the actual loans, lenders argue that cities do not have the right to challenge the terms of those loans. This, of course, is why the cities have focused on the actual damages they claim to have incurred in the form of increased municipal costs and lost tax revenue. Historically, however, cities have not been permitted to recoup the costs of their public services. This is commonly referred to as the “firefighter rule.” With respect to lost tax revenue, lenders have argued that they are being singled out when the city does not pursue lost tax revenue in a multitude of other contexts. For example, a lost job can result in lost tax revenue to the city. Furthermore, lenders still have a duty to pay the taxes on their foreclosed properties or else they risk losing their properties to tax sales. In an interesting turn of events, Wells Fargo claimed in its motion to dismiss the lawsuit filed by Baltimore that the City of Baltimore forecloses on far more properties than Wells Fargo through its own tax lien programs. In fact, Wells Fargo claimed that more than half of the 2006 tax lien sales in Baltimore “involved properties in census tracts that are more than 80 percent African American.”

Depending on the individual facts of the cases and the situation of the defendants, lenders have several other defenses as well. These defenses include procedural defenses such as the states’ lack of personal jurisdiction over many of the holding companies they have sued. Also, many mortgage servicers who have been sued did not actually originate the loans at issue. Likewise, many trustees that have been sued did not even buy any of the loans (rather they merely managed the securitized pool of loans). Furthermore, it is questionable whether a city can challenge individual loans on a mass basis when the terms of many of those loans greatly vary. These defenses can also be substantive in nature. For example, most lenders will claim that their lending practices are not racially motivated, but are based on credit risk. Also, there is evidence that many of the cities encouraged the same lending practices that they now condemn.

While we may still not know which lenders Birmingham will name or under what theories of liability it will seek relief, we do know that Birmingham will be joining the nationwide trend of cities that have targeted lenders for potential recovery of millions of dollars and the furtherance of political agendas. We can also be quite sure that Birmingham will not be the last city to file suit. Indeed, the plaintiff’s attorney who filed the lawsuit on behalf of Baltimore has said he has been contacted by several other cities inquiring about suit. He has publicly said that “any city that has racially segregated housing patterns and high levels of foreclosure could wind up suing — cities across the Midwest, cities in California, it’s almost everywhere.” Consequently, lenders need to prepare themselves for this fight if they have not already done so.