

# Financial Services Litigation

June 2011

NEWSWIRE

## Court Dismisses Madoff Investors' Suit Over SEC's Failure to Detect Ponzi Scheme

By Thomas J. Hall and Laura Rowntree

A New York federal district court has dismissed a lawsuit brought by two investors in Bernard Madoff's Ponzi scheme who sought to hold the federal government liable for the purported gross negligence of the Securities and Exchange Commission ("SEC") in failing to detect the massive fraud. *Molchatsky v. United States*, 2011 WL 1471798 (S.D.N.Y. 2011). Judge Laura Taylor Swain dismissed the action for lack of subject matter jurisdiction on the grounds of sovereign immunity, holding that the exception to the government's sovereign immunity set forth in the Federal Tort Claims Act ("FTCA") did not apply. Specifically, because the court found that the SEC's actions complained of were discretionary, the FTCA sovereign immunity exception was inapplicable.

### Allegations of Negligence and Incompetence

The complaint alleged that plaintiffs had suffered \$2.4 million in losses as a result of the Madoff scheme. They premised their lawsuit on allegations that the SEC and its agents and employees failed in their oversight, investigations and examinations to detect, disclose and end the scheme perpetuated by Madoff and his firm, Bernard L. Madoff Investment Securities LLC ("BLMIS"), despite numerous tips and warnings beginning in 1992. The plaintiffs' allegations were largely borrowed from a 457-page report prepared by the Office of Inspector General entitled "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme – Public Version" ("OIG Report") released on August 31, 2009, six weeks before the plaintiffs filed their lawsuit. That report concluded that "despite numerous credible and detailed

/ continued page 2

#### IN THIS ISSUE

- 1 Court Dismisses Madoff Investors' Suit Over SEC's Failure to Detect Ponzi Scheme
- 4 Regulators Uncover Foreclosure Process Deficiencies, Resulting in Consent Orders
- 6 U.S. Sues Deutsche Bank AG Over Toxic Mortgages
- 8 By Acquiring Countrywide's Assets, Bank of America Did Not Become Liable for Its Liabilities
- 10 Noteholder Claims Proceed Against Trustee for Withholding Funds to Indemnify Itself for Litigation Costs
- 12 Court Dismisses Derivative Suits Arising from Merrill's Allegedly Reckless Investments Prior to Acquisitions by Bank of America
- 14 Mismanagement Causing Wachovia's Demise Does Not Constitute Securities Fraud
- 17 Defense of Temporary Commercial Impracticability Unavailable to Loan Guarantors
- 18 Court Dismisses Securities Act Claims Against Countrywide Based on Statute of Repose
- 20 Public Risk Disclosures May Not Defeat Auction Rate Securities Claims Based on Private Misrepresentations
- 23 Merged Bank Awarded Summary Judgement in Lieu of Complaint on Predecessor's Notes and Guarantees

## Madoff Investors' Suit

*continued from page 1*

complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme."

The court's decision chronicles numerous instances when the SEC was purportedly notified of the suspicious nature and improbable success of BLMIS, but either failed outright to respond to these seemingly credible notifications or neglected to conduct competently the few investigations it did undertake. The most egregious claims against the SEC included allegations that different offices or divisions within the SEC failed to coordinate with one another because they were ignorant of concurrent investigations or because of "an atmosphere of jealousy and secrecy" between them; that tips specifically alerted the SEC to the existence of a Ponzi scheme, but the agency responded by investigating "front-running" instead; and that several investigations were limited to interviewing

have discovered Madoff's scheme" as early as June 1992, well before each of the plaintiffs invested in the scheme, and years before the economic crisis of 2008 made it impossible for Madoff to continue his Ponzi scheme, compelling his confession.

### The Scope of the Federal Tort Claims Act

The U.S. government enjoys sovereign immunity, immunizing it from civil suits or criminal prosecutions, unless federal legislation specifically authorizes otherwise. The FTCA provides such an exception to this immunity by permitting plaintiffs to bring an action against the government "for money damages . . . for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred."

The most telling impact of the court's decision is its assertion that "detrimental reliance by members of the public on assumptions that government agencies will perform regulatory functions competently is not determinative of the ability of injured citizens to seek redress against the Government in a civil action."

Madoff rather than conducting a more in-depth review of documents, which the SEC deemed "burdensome."

More specifically, according to the complaint, the SEC ignored the repeated admonitions of Harry Markopolos, an industry analyst and Certified Fraud Examiner. Markopolos allegedly contacted the SEC no less than four times — in May 2000, March 2001, October 2005 and June 2007 — to alert it to the likelihood of a Ponzi scheme, often providing extensive documentation of Madoff's fraud that included evidence and analysis as well as a proposed investigation strategy. The SEC either ignored his communications; declined to investigate after minimal consideration; or conducted a limited investigation, much of which was managed by an "inexperienced, junior staff member" and "was compromised by the vendetta of a supervisor against Markopolos."

The plaintiffs further alleged that, "if the SEC had performed its functions with the most basic level of competence, it would

The FTCA, however, contains an exception to this waiver of sovereign immunity. Known as the "discretionary function exception" ("DFE"), the FTCA provides that the FTCA's immunity waiver does not apply to "[a]ny claim . . . based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused." As the court explained, sovereign immunity and the DFE are each based on "three core principles: separation of powers, protection of decisionmaking by government policymakers, and preservation of public revenues and property."

For the DFE to apply, thus barring a waiver of sovereign immunity, courts have developed two conditions that must be satisfied. First, the alleged action or failure to act must have been discretionary — requiring some "element of judgment or choice" by the government actor — rather than have been

compelled or mandated by a statute or regulation. Second, the “judgment or choice” must have been grounded in considerations of public policy or otherwise “susceptible to policy analysis.” Put more simply, an act of discretion triggers the DFE if it is the type of judgment or choice that would be made after taking an applicable governmental policy into consideration.

### Discretionary Conduct Entitled to Sovereign Immunity

The U.S. government moved to dismiss the plaintiffs’ claims that the SEC had negligently failed to detect the Madoff fraud, by asserting that the DFE applied and, thus, that the government was entitled to sovereign immunity stripping the court of jurisdiction to hear the dispute. The government argued that the DFE shielded it from liability “because the SEC’s decision regarding whom to investigate and how to conduct such investigations are discretionary.”

As a preliminary step in its analysis, the court noted that the plaintiffs, in bringing a claim pursuant to the FTCA, had the burden of showing that the DFE does not apply to their claims. The plaintiffs argued that their allegations fell outside the scope of the DFE because the SEC’s responses to warnings about Madoff and BLMIS were not discretionary but, rather, violated agency mandates found in the Securities and Exchange Act of 1934 (the “Act”) or provided for by internal guidelines and practices or formal policies. For example, the plaintiffs alleged that the SEC failed to comply with internal policies regarding the proper method to file investigative reports, and that it failed to seek investigative materials from third-party sources when it was warranted.

In considering the first prong of the DFE inquiry, whether the conduct the plaintiffs complained of was either discretionary or in violation of a particular statute or regulation binding the agency, the court determined that the plaintiffs failed to identify a “specific, non-discretionary mandate that the SEC conduct investigations under particular circumstances, or that such investigations be conducted in a particular manner.” The only provision of the Act which the plaintiffs’ complaint cited directs authorities who are conducting concurrent investigations to share their information. Even that provision, the court found, had to be read in the context of another section of the Act that directs the SEC to coordinate with other agencies only “as appropriate,” thereby casting this directive as discretionary. The court determined that the remaining allegations that the SEC had violated agency policies or practices also failed to “demonstrate[e] relevant mandatory obligations.” Here, the

court also noted that many instances of the purported wrongdoing cited by the complaint were actually vague allegations of unacceptable conduct rather than allegations of specific acts or omissions that constituted violations of specific and direct agency mandates. Accordingly, the court held that the plaintiffs had failed to satisfy their initial burden of showing their injuries were caused by a negligent violation of a non-discretionary duty. Further, the court observed that the Act itself and other SEC guidelines actually define the agency’s investigative and enforcement authority as permissive and discretionary. As a result, the judiciary has routinely rejected challenges to the SEC actions as it did here.

With respect to the second prong, whether the allegations of wrongdoing implicate considerations of public policy, the court pointed to the historical disinclination of the judiciary to allow suits against the SEC. The court noted that, because of the agency’s “inherent policy-oriented nature, often involving considerations of resource allocation and opportunity costs,” courts are “ill-suited” to second guess SEC decision making. Importantly, the court stated that courts analyzing the second prong of the DFE test must examine the “general nature of the conduct at issue” rather than the individual factual allegations of SEC wrongdoing. Therefore, no matter how troublesome the allegations of, for example, “jealousy, secrecy, laziness [or] inexperience” underlying the SEC’s failure to detect Madoff’s fraud, because the general nature of SEC activity is rooted in policy considerations, the complaint failed to satisfy the second prong as well. Accordingly, the DFE applied, negating the applicability of the FTCA’s waiver of sovereign immunity.

Finally, the plaintiffs asserted that they were entitled to jurisdictional discovery to learn more about the specific mandatory policies that existed and were potentially violated. The court rejected this request, holding that the plaintiffs had identified no statutory or regulatory provision to suggest the existence of SEC guidelines violations of which further discovery might uncover.

### Conclusion

The most telling impact of the court’s decision is its assertion that “detrimental reliance by members of the public on assumptions that government agencies will perform regulatory functions competently is not determinative of the ability of injured citizens to seek redress against the Government in a civil action.” Given the highly inflammatory nature of the complaint’s alleged wrongdoing and the terrible losses that plaintiffs, like so many others, suffered / *continued page 4*

## Madoff Investors' Suit

*continued from page 3*

because of Madoff's scheme, it is difficult to conceive of what kind of allegations would support an action against the SEC under the FTCA. ☉

# Regulators Uncover Foreclosure Process Deficiencies, Resulting in Consent Orders

*By Stacey Trimmer*

The Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (the "agencies") recently released a joint report summarizing their findings from on-site reviews of 14 federally regulated mortgage servicers, resulting in consent orders being signed by the mortgage servicers and respective parent holding companies agreeing to remedial actions. The report, entitled "Interagency Review of Foreclosure Policies and Practices," comes in light of increased mortgage foreclosures and claims against lenders alleging fraud in foreclosure practices. See "Multidistrict Court Dismisses Mortgage Foreclosure Class Actions," *Financial Services Litigation Newswire* (December 2010). Lenders and servicers need to take instruction from this report as to the foreclosure procedures these agencies deem unacceptable.

## Risks Associated With Weak Foreclosure Processes and Controls

The report provides a comprehensive background of mortgage servicing and the risks associated with weak foreclosure processes and controls. The report notes the importance of mortgage servicers because they act as the intermediary between lenders and borrowers in collecting payments, reporting to investors, and foreclosing when loans are in default. The 14 mortgage servicers examined by the agencies make up over two-thirds of the mortgage servicing industry (or nearly 36.7 million mortgages). The report noted that "a necessary consequence of the growth in foreclosures since 2007 is increased demands on servicers' foreclosure

processes." Thus, the agencies expressed concern that deficiencies in foreclosure processing among the major servicers may adversely impact the housing market and borrowers.

The report described the potential impact of shoddy foreclosure practices on borrowers, the mortgage industry and its investors, the judicial process, the mortgage market and communities. In particular, the report observed that the risks to borrowers "presented by weaknesses in foreclosure processes are more acute when those processes are aimed at speed and quantity instead of quality and accuracy." Further, the risks to the financial services industry and investors include the financial costs of remedying errors and refile documents, legal costs related to disputes over authority to foreclose, allegations of procedural violations and claims by investors due to delays or other damages, general uncertainty amongst investors of securitized mortgages, and reputational risks. The report also stated that courts may lose confidence in the reliability of foreclosure documentation by servicers. Moreover, the impact on the mortgage market and communities has already been demonstrated by the suspension or slowing of foreclosures by several servicers in late 2010. When delays in foreclosure processing increase, the clearing of excess inventory of foreclosed properties slows which leads to extended periods of depressed home prices. This, in turn, may affect local property values if foreclosed homes remain vacant and ill-maintained. Therefore, proper foreclosure processes influence the stability of the entire housing market.

## The Agencies' Findings

The agencies found a variety of issues in the current processing of mortgage foreclosures across all 14 servicers, including weaknesses in foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of outside law firms and vendors. Specifically, the major problems related to staff, affidavits and their notarization, documentation, and audit practices. Generally, servicers had an insufficient level of staff and had inadequately trained their current staff. The examiners found numerous affidavits and other documents to be inaccurate because of the staffing issue and servicers' affidavit signing protocols that expedited the affidavit process. These signing protocols resulted in individuals attesting to information without personally reviewing the foreclosure documents. In addition, a majority of servicers had improper notary practices that did not comply with state legal requirements. For example, individuals failed to sign documents in the presence of a notary. Furthermore, "some

foreclosure documents indicated they were executed under oath when no oath was administered.” As a result, some affidavits inaccurately stated amounts owed by borrowers, stating that borrowers owed more than their file actually reflected (although typically the amount was less than \$500). Regarding documentation practices, the examiners determined, although “servicers generally had possession and control over critical loan documents such as promissory notes and mortgages,” there were instances where proof of authority to foreclose required reference to additional information outside of a foreclosure file.

The report then summarized issues with outside law firms and vendors. Servicers often use outside law firms to prepare legal documents, file pleadings in court, and litigate foreclosure proceedings. Arrangements with law firms created problems for several reasons: the relationship typically lacked a formal contract; the servicers provided inadequate oversight; servicers relied on firms to retain foreclosure documents, rather than having a central location for foreclosure files; and there was an absence of formal guidance or procedures governing law firms, including instances where law firms signed documents on behalf of servicers without authority or changed the content of affidavits without the servicers’ knowledge. The examiners observed related issues with Default Management Service Providers (DMSPs), in particular Lender Processing Services, Inc., which provide services to support mortgage servicing and foreclosure processing. Generally, servicers had inadequate contracts with DMSPs and provided inadequate oversight, resulting in cases where DMSP employees signed affidavits without reviewing the foreclosure information.

Similarly, the report discussed problems found in the agencies’ review of Mortgage Electronic Registration Systems, Inc. (“MERS”), which had relationships with all examined servicers. MERS assists servicers by streamlining the mortgage recording and assignment process through a computer database of mortgages that tracks the servicing rights and beneficial ownership of mortgage notes and by serving in a nominee capacity as the mortgagee of record in public land records. The examiners found that servicers failed to assess internal control processes at MERS; failed to ensure accuracy of servicing transfers; failed to ensure that servicers’ records matched MERS’ records; and had inadequate quality control, demonstrated by a lack of independent audits; and a need for more frequent and complete reconciliation between the MERS’ registry and the servicers’ systems.

Finally, the report described general ineffective quality control and internal auditing procedures at all servicers. Servicers did not meet a satisfactory level of ensuring accurate foreclosure documentation, incorporating mortgage-servicing activities into servicers’ loan-level monitoring, evaluating compliance with applicable law and regulations, and ensuring proper controls to prevent foreclosures when intervening events occurred.

### Supervisory Response: Enforcement Actions

As a result of the agencies’ findings, the agencies took formal enforcement action against each of the 14 servicers, the servicers’ respective parent holding companies, as well as Lender Processing Services, Inc. and MERS, resulting in the execution of consent orders. The report stated “the deficiencies and weaknesses identified by examiners during their reviews involved unsafe or unsound practices and violations of law, which have had an adverse impact on the functioning of the mortgage markets.” Accordingly, the consent orders require servicers to establish a compliance program; conduct a foreclosure review by an independent firm of residential foreclosure actions from January 1, 2009 through December 31, 2010; dedicate a single point of contact to ensure timely and appropriate communication with borrowers; establish policies and procedures to manage third-parties’ functions in the foreclosure process; improve management information systems; and conduct a comprehensive risk assessment by an independent firm. The agencies will monitor the actions taken by servicers to comply with the consent orders.

### Conclusion

The report issued by the agencies indicates that lenders and servicers need to be conscientious at all stages of the foreclosure process, and should establish standard practices and procedures that address the agencies’ concerns. A significant finding in the report, however, is that servicers generally had control of promissory notes and mortgages, and thus the authority to foreclose. This finding essentially refutes an argument made in much of the foreclosure litigation that servicers do not have authority (or standing) to foreclose on behalf of the lenders. Thus, while lenders and servicers must tighten controls on the foreclosure process, the mortgage industry’s legal right to foreclose is likely not in jeopardy based on this report. ☉

# U.S. Sues Deutsche Bank AG Over Toxic Mortgages

By Thomas J. Hall, Thomas N. Pieper and Andrea Voelker

The United States government recently filed suit in New York federal court against Deutsche Bank AG and its wholly owned subsidiary, MortgageIT, Inc., for alleged misrepresentations relating to mortgages insured by the Federal Housing Administration. *United States v. Deutsche Bank AG and MortgageIT, Inc.*, No. 11-02976. The lawsuit, which seeks recovery of over \$1 billion in damages, is believed to be the first of several lawsuits to be brought by the United States against major banks pursuant to the federal False Claims Act. Private lenders who endorsed federally insured mortgages should be on notice that the United States can, and likely will, pursue litigation against lenders who it believes made misrepresentations in connection with mortgages they endorsed for Federal Housing Administration mortgage insurance.

## Background

The Federal Housing Administration (“FHA”) of the Department of Housing and Urban Development (“HUD”) has provided mortgage insurance to millions of borrowers who might not otherwise be able to obtain mortgages due to their inability to meet standard underwriting requirements. FHA operates the Direct Endorsement Lender program, which grants lenders in the private sector “the authority to endorse mortgages that are qualified for FHA insurance.” The private lenders that participate in the program, known as Direct Endorsement Lenders, underwrite and close mortgages without any prior review or approval of HUD.

In 2007, Deutsche Bank AG (“Deutsche Bank”) acquired MortgageIT, Inc. (“MortgageIT”) for \$430 million. Between 1999 and 2009, MortgageIT was a Direct Endorsement Lender and, during this time, MortgageIT endorsed more than 39,000 mortgages for FHA insurance “totaling more than \$5 billion in underlying principal obligations.” On May 3, 2011, the U.S. government (the “Government”) sued both Deutsche Bank and MortgageIT for allegedly misleading the Government into giving federal insurance for non-qualifying mortgages in order to make “substantial profits through its resale of these endorsed FHA-insured mortgages.” The suit was brought by the Office of U.S. Attorney Preet Bharara for the Southern District of New York, which opened a new civil unit in March of 2010 to fight mortgage and other types of fraud.

## Direct Endorsement Lenders’ Duties

The complaint alleges that Direct Endorsement Lenders “are entrusted with safeguarding the public from taking on risks that exceed statutory and regulatory limits . . . [and] act as fiduciaries of HUD in underwriting mortgages and endorsing them for FHA insurance.” In addition to the fiduciary duty of good faith existing between Direct Endorsement Lenders and HUD, the complaint alleges that Direct Endorsement Lenders owe HUD “a common law duty of due diligence.” A duty of due diligence is also owed by Direct Endorsement Lenders to HUD, pursuant to federal regulation 24 C.F.R. § 203.5(c).

To qualify as a Direct Endorsement Lender, a private lender must implement a quality control plan that ensures that it is in full compliance with all HUD rules. To comply with HUD rules, lenders must conduct due diligence on all mortgages to ensure that they are eligible for FHA insurance, in addition to “auditing [] all early payment defaults, i.e., those mortgages that default soon after closing.” For every mortgage it endorses, a Direct Endorsement Lender must certify that it has conducted due diligence in accordance with HUD rules. Further, Direct Endorsement Lenders must make an annual certificate of compliance that states that it has met the program’s qualification requirements, including the implementation of a compliant quality control plan.

After Deutsche Bank acquired MortgageIT in 2007, Deutsche Bank allegedly managed the quality control functions of MortgageIT’s Direct Endorsement Lender business. In addition, Deutsche Bank was allegedly responsible for the annual certifications to HUD regarding MortgageIT’s compliance with Direct Endorsement Lender program rules.

## The Claims

The Government asserts that 12,500 FHA-insured MortgageIT-endorsed mortgages have gone into default — almost one-third of the mortgages that MortgageIT endorsed as a Direct Endorsement Lender. The complaint alleges that, in connection with these defaults, Deutsche Bank and MortgageIT misrepresented both MortgageIT’s qualifications for the Direct Endorsement Lender program and the eligibility of the mortgages that MortgageIT endorsed for FHA insurance. The complaint alleges that these actions constitute violations of the False Claims Act for causing false claims, using false statements and for “knowingly ma[king], us[ing] or caus[ing] to be made or used false records and/or statements to conceal, avoid, or decrease an obligation to pay or transmit money

or property to the United States.” The complaint further alleges claims for breach of fiduciary duty, gross negligence and negligence.

With regards to the Direct Endorsement Lender program, the complaint alleges that Deutsche Bank and MortgageIT “repeatedly lied to HUD to obtain and maintain MortgageIT’s Direct Endorsement Lender status.” Specifically, the complaint alleges that Deutsche Bank and MortgageIT made annual certifications that MortgageIT was eligible to be a Direct Endorsement Lender despite not meeting the qualifications and that, when HUD found evidence supporting the fact that MortgageIT had violated the quality control plan requirement, MortgageIT “deceived HUD by falsely promising HUD that it had corrected the failures.” The failures specifically mentioned in the complaint included failing to audit early payment defaults, failing to dedicate sufficient staff members to quality control, and failing to “address dysfunctions in the quality control system, which were reported to upper management.” The Government’s complaint takes specific issue with the fact

conduct due diligence as required by HUD rules was “reckless, grossly negligent, and/or negligent.”

### Consequences

As a result of the defaults, the Government alleges it has paid out more than \$386 million in FHA insurance claims and related costs “arising out of MortgageIT’s approval of mortgages for FHA insurance . . . based on MortgageIT’s false certifications of due diligence.” Further, the Government “expects to pay at least hundreds of millions of dollars in additional FHA insurance claims as additional mortgages underwritten by MortgageIT default in the months and years ahead.” Thus, the complaint seeks the recovery of damages of \$386 million trebled “for past claims paid by the Government . . . compensatory damages for past claims paid, and future claims expected to be paid . . . civil penalties as are required by law . . . punitive damages . . . an award of costs pursuant to 31 U.S.C. § 3729(a) . . . [and] an award of any such relief as is proper.”

**Specifically, Direct Endorsement Lenders should conduct due diligence to ensure the eligibility of mortgages for FHA insurance, audit early default payments, assign sufficient staff to handle quality control, and diligently work to improve any alleged violations in the quality control system.**

that the only person at MortgageIT dedicated to auditing the federally insured mortgages was allegedly reassigned to “increase production instead.” As a result of Deutsche Bank’s and MortgageIT’s “false annual certifications and deceptions,” the complaint alleges that “hundreds of millions of FHA dollars [were put] at risk.”

The complaint claims that Deutsche Bank’s and MortgageIT’s failure to implement a quality control program in accordance with HUD rules “rendered them unable to prevent patterns of mortgage underwriting violations and mortgage fraud.” As such, the mortgages endorsed by MortgageIT were not eligible for FHA insurance in accordance with HUD rules. Specifically, the Government alleges that MortgageIT falsely certified that it had conducted due diligence for the mortgages it endorsed for FHA insurance, when in fact it had not. The Government alleges that the false certifications and failure to

### Conclusion

Private lenders that participate in the Direct Endorsement Lender program should be vigilant in meeting the strict program requirements as set forth by HUD rules. Specifically, Direct Endorsement Lenders should conduct due diligence to ensure the eligibility of mortgages for FHA insurance, audit early default payments, assign sufficient staff to handle quality control, and diligently work to improve any alleged violations in the quality control system. Private lenders that are considering participating in the Direct Endorsement Lender program should ensure that they have the necessary resources and infrastructure to meet the stringent requirements as set forth by HUD. ©

# By Acquiring Countrywide's Assets, Bank of America Did Not Become Liable for Its Liabilities

By Maureen Schad

In a recent decision underscoring the significance of choice of law in determining successor liability, a California federal district court dismissed a purported class action against Bank of America ("BofA"), holding that, under Delaware law, by acquiring substantially all of Countrywide's assets, BofA did not assume Countrywide's liabilities. See *Maine State Retirement System v. Countrywide Financial Corp.*, No. 10-CV-0302, 2011 WL 1765509 (C.D. Cal. Apr. 20, 2011). In contrast, in April 2010, a New York trial court applying New York law had come to a different result in *MBIA Insurance Corp. v. Countrywide Home Loans*, No. 602825/08 (N.Y. Co. Apr. 27, 2010), finding that a *de facto* factor merger had occurred.

## Background

In January 2010, the plaintiffs filed in California federal court a putative class action on behalf of all holders of certain mortgage-backed securities issued in 427 public offerings between January 2005 and November 2007. Named plaintiffs included several employee benefit and pension organizations, with the Iowa Public Employees' Retirement System appointed as lead plaintiff. The complaint alleged that Countrywide Financial Corporation ("CFC"), Countrywide Securities Corporation, Countrywide Home Loans ("CHL"), and Countrywide Capital Markets (collectively, "Countrywide") made materially false or misleading statements or omissions regarding loan origination practices in their public offering documents. Plaintiffs also named BofA and NB Holdings Corporation ("NB Holdings") as defendants, contending that they were liable for Countrywide's actions under a theory of *de facto* merger. Under the *de facto* merger doctrine, a widely recognized exception to the rule of successor non-liability, a purchaser is liable for all of a seller's debts by operation of law, just as in a merger. In December 2010, plaintiffs amended their complaint to avoid standing and statute of limitations issues by reducing the offerings at issue from 427 to 14 that were made between October 2005 and December 2006.

Between 2005 and 2007, Countrywide — primarily through its subsidiary CHL — allegedly originated or purchased a total of approximately \$1.4 trillion in mortgage loans. In July 2008, CFC merged into a wholly owned BofA subsidiary, Red Oak Merger Corporation ("Red Oak"), in a stock-for-stock merger that was approved as fair by the Delaware Supreme Court. Red Oak was renamed CFC and remained a subsidiary of BofA. In November 2008, "substantially all" of Countrywide's assets, along with "certain of Countrywide's debt securities and related guarantees," were allegedly transferred to BofA. Plaintiffs argued that the November 2008 asset transfer, in conjunction with the July 2008 subsidiary merger, constituted a *de facto* merger — an exception to the general rule of successor liability that when one company sells or transfers all of its assets to another, the second entity does not become liable for the debts and liabilities of the transferor — and thus BofA was on the hook for Countrywide's liabilities.

The plaintiffs further alleged that NB Holdings, a wholly owned subsidiary of BofA, was one of the shell entities used to effectuate the BofA-CFC merger. In July 2008, CHL completed the sale of substantially all of its assets to NB Holdings and the plaintiffs contend that NB Holdings is thus a successor in interest as well.

In support of the *de facto* merger argument, the amended complaint asserted that the Countrywide brand was retired shortly after the merger, that the CFC's former website now redirects the user to the BofA website, and that "many of the same locations, employees, assets and business operations" continue now under the BofA brand. The plaintiffs noted that CFC ceased filing its own financial statements at the time of the asset transfer and that its assets and liabilities are now included in BofA's financial statements. They also alleged that BofA had assumed CFC's liabilities, having paid to resolve other litigation arising from misconduct such as predatory lending allegedly committed by CFC.

## The Court's Decision

The court first addressed the choice of law issue, analyzing whether the law of Delaware, CFC's state of incorporation, or the law of California, the forum state and CFC headquarters prior to the merger, applied. Under the *Erie* doctrine and Ninth Circuit law, the court explained, the choice of law rules of the forum state determine which state law applies. The court thus applied California's "governmental interest" test, determining first whether a true conflict exists and then analyzing the two jurisdictions' competing interest in having its law applied.

The court found that a conflict exists between Delaware and California law on the issue of successor liability. Although both recognize *de facto* merger, Delaware courts apply the doctrine far more narrowly, requiring intent to defraud. The court explained that “[b]ecause Delaware respects a corporation’s ability to structure transactions to its advantage, so long as the statutes governing such transactions are fully complied with, Delaware is reluctant to find an asset sale is a *de facto* merger in the absence of fraud.” In fact, the court noted, some treatises go so far as to conclude that Delaware has rejected the *de facto* merger doctrine. In contrast, California is more willing to find *de facto* merger “if the court concludes — notwithstanding the structure of the transaction — that an asset sale produces the same result as a merger.” As long as the other indicia of a merger are present, California does not require an allegation of fraud or intent to harm to find that successor liability exists.

Next, the court concluded that Delaware had a greater interest in having its law applied. According to Section 302 of the Restatement (Second) of Conflict of Laws, issues involving the rights and liabilities of a corporation — such as mergers, reorganizations, and matters that may affect the interests of the corporation’s creditors — are determined by the law of the state of incorporation.

The court turned to analyzing whether the amended complaint adequately pled that a *de facto* merger occurred. Delaware courts consider the following factors when determining whether a *de facto* merger has been adequately alleged: (1) whether adequate consideration was received and held by the transferor corporation in exchange for the assets that were transferred; (2) whether the asset transfer complied with the statute governing such an asset sale; (3) whether creditors or stockholders were injured by a failure to comply with the statute governing an asset sale; and (4) whether the sale was designed to disadvantage shareholders or creditors.

The court found that the complaint failed adequately to allege any of these factors and, thus, failed to demonstrate a *de facto* merger under Delaware law. Specifically, the complaint failed to allege that the asset sale failed to comply with any relevant statute governing such sale; indeed, the July 2008 subsidiary merger between Red Oak and CFC had already been reviewed by the Delaware courts and found to be fair. Further, Delaware law allows parties to choose whatever reorganization structure they wish — whether asset sale or merger — as long as they follow the statutory guidelines, as BofA did here. The court noted that contemporaneous public Securities and

Exchange Commission (SEC) filings demonstrate that BofA acquired CFC’s assets in exchange for valuable consideration totaling billions of dollars; it explained that CFC has retained that consideration and that CFC’s creditors can look to BofA to satisfy those obligations that the bank has expressly assumed. In addition, the complaint failed to allege that the November 2008 asset sale was designed to disadvantage stockholders or creditors.

In dismissing BofA and NB Holdings from the lawsuit, the court wrote that “[p]laintiffs’ attempt to characterize two separate, legal transactions as one combined fraudulent transaction must fail under Delaware law. Delaware respects the independent legal significance of transactions, even when under common ownership and control, as long as they comply with statutory authority.”

### The New York Decision

In the earlier New York action *MBIA Insurance Corp. v. Countrywide Home Loans*, No. 602825/08 (N.Y. Co. April 27, 2010), MBIA — which had provided credit enhancement for 17 second-lien mortgage securitizations originated by Countrywide — brought suit against Countrywide for its purported misrepresentations in connection therewith. MBIA also bought claims against BofA on a successor liability theory. The court applied New York law and held that the complaint sufficiently alleged that BofA was vicariously liable for Countrywide’s actions under New York’s *de facto* merger doctrine. Unlike Delaware, New York does not require an allegation of fraud to find a *de facto* merger; instead, the doctrine applies when an acquiring corporation has effectively merged with the acquired corporation.

New York courts analyze four main factors to determine whether a *de facto* merger has occurred: continuity of ownership; cessation of ordinary business and dissolution of the acquired corporation as soon as possible; assumption by the successor of liabilities ordinarily necessary for the uninterrupted continuation of the business of the acquired corporation; and continuity of management, personnel, physical location, assets, and general business operation. These factors are analyzed in a manner that “disregards mere questions of form and asks whether, in substance, it was the intent of the successor to absorb and continue the operation of the predecessor.” In *MBIA Insurance Corp.*, the court held that MBIA sufficiently alleged each of these four factors under New York law; accordingly, BofA could not be dismissed from the lawsuit on a theory of successor non-liability. ☺

# Noteholder Claims Proceed Against Trustee for Withholding Funds to Indemnify Itself for Litigation Costs

By Benjamin D. Bleiberg

A New York trial court recently held that a breach of contract claim brought by a third-party beneficiary noteholder of an indenture could proceed to trial against the indenture trustee, JPMorgan Chase Bank (“JPMC”), based on JPMC’s withholding disbursements from the noteholder to indemnify itself for fees and expenses for anticipated litigation. *Harch International Limited v. Harch Capital Management, Inc.*, 601312/2005 (N.Y. Co.). JPMC moved for summary judgment arguing that its decision to create a reserve account to indemnify itself for future liabilities was contemplated by the terms of the indenture. In denying JPMC’s motion, the court found that material issues of fact existed regarding the reasonableness of JPMC’s decision to withhold the funds, and that JPMC had not established that it was entitled to indemnify itself with the specific funds at issue as a matter of law.

## Background

In 1997, Harsh Capital Management, Inc. (“HCM”) sponsored the formation of Harch International Limited (“HIL”), an off-shore hedge fund, and subsequently became HIL’s investment advisor. In 2000, HCM additionally sponsored the formation of Harch CLO I Limited (“Harch CLO”), a special-purpose entity created to issue notes secured primarily by collateralized debt obligations. HCM was further retained as Harch CLO’s collateral manager pursuant to a collateral management agreement. Harch CLO issued four classes of notes pursuant to an indenture (the “Indenture”) between itself, as issuer; Harch CLO I Corporation, as co-issuer; and JPMC, as trustee. The noteholders further were the intended third-party beneficiaries of the Indenture, but not parties to it. JPMC’s rights and obligations as trustee were defined by the Indenture, including its obligation to administer the proceeds from the note issuance. The Indenture included an indemnification clause pursuant to which Harch CLO was to indemnify JPMC against losses or

expenses arising out of its obligations as trustee, and reimburse JPMC for certain funds expended in accordance with its terms (the “Indemnification Clause”).

As HIL’s investment advisor, HCM invested \$30 million of HIL’s capital in 100% of the Class D Subordinated Notes issued under the Indenture. In early 2005, after determining that HCM had failed to inform HIL of certain reinvestments in additional Class D Subordinated Notes, HIL demanded that Harch CLO redeem all the outstanding notes. Harch CLO complied with this request in March 2005, but retained an incentive fee. As part of Harch CLO’s requested liquidation, JPMC received approximately \$1.45 million in accrued interest payments from the note issuance (“Accrued Interest Funds”), which it held in trust in a specifically designated account (the “Collection Account”).

In April 2005, HIL commenced an action against HCM and Harch CLO to recover the retained incentive fee. Upon the threat and eventual commencement of the lawsuit, HCM and Harch CLO sent demands for indemnification to JPMC to pay their legal fees in connection with the litigation. In anticipation of the accruing costs associated with the pending action, its probable involvement in the litigation, and its belief that it would be entitled to the Accrued Interest Funds pursuant to the Indemnification Clause, JPMC sent notice to HIL and other noteholders that it had transferred the Accrued Interest Funds to a separate interest-bearing account (the “Reserve Account”) and refused any request to disburse those funds pending resolution of the action.

In September 2005, HIL filed an amended complaint adding JPMC as a defendant, and asserting two additional causes of action against JPMC for breach of contract. The amended complaint alleged, in part, that JPMC breached the Indenture when it transferred the Accrued Interest Funds to the Reserve Account and refused to disburse the funds to the noteholders. In November 2005, JPMC served its answer and asserted two counterclaims. JPMC’s first counterclaim interpleaded the Accrued Interest Funds due to the conflicting claims arising over them, and asserted JPMC’s right to indemnification for fees and expenses. The second counterclaim sought a declaration that JPMC was entitled to payment priority from the Accrued Interest Funds under the terms of the Indenture. After more than five years of motion practice, including several previous motions and cross-motions for summary judgment, JPMC filed a motion for summary judgment to dismiss HIL’s remaining breach of contract claim and to grant JPMC’s counterclaims for indemnification and payment priority. The court denied the motion in its entirety.

## The Breach of Contract Claim

JPMC first argued that HIL's claim for breach of contract should be dismissed because the terms of the Indenture permitted JPMC's decisions to preserve the Accrued Interest Funds and to withhold disbursements to address any potential future liabilities. Although the Indenture did not explicitly authorize the establishment of the Reserve Account, JPMC believed that it was authorized, in part, by a broadly drafted section of the Indenture stating that "the Trustee shall not be liable for any action it takes or omits to take in good faith that it reasonably and prudently believes to be authorized or within its rights or powers hereunder." JPMC argued that it did not breach the Indenture because its decision to create the Reserve Account to preserve the Accrued Interest Funds was made in good faith and prudent under the circumstances. JPMC reasoned that if it had disbursed the Accrued Interest Funds, it potentially would have put its own funds at risk and incurred liabilities to HCM and Harch CLO, each of whom demanded indemnification from JPMC.

that its actions were not a breach of the Indenture and, therefore, the case should proceed to trial on that issue.

## Counterclaims for Indemnification

JPMC further argued for summary judgment in favor of its counterclaims seeking a declaration that JPMC was (i) entitled to indemnification from the Reserve Account, and (ii) entitled to payment priority of the Accrued Interest Funds. JPMC argued that the indemnification's broad language applies to third-party claims and that the Indenture's "waterfall" provision required Harch CLO to pay any indemnification claims by JPMC before HIL or HCM received any payments.

The court, however, found that JPMC had not conclusively shown that it was entitled to indemnification from the Accrued Interest Funds pursuant to the terms of the Indenture. Although the express terms of the Indenture required indemnification for attorney's fees expended for third-party claims such as the instant lawsuit, the Indenture did not similarly explicitly entitle JPMC to indemnification specifically from the interpleaded Accrued Interest Funds. The court noted that,

*The Harch International Limited decision demonstrates the importance of a well-drafted indemnification provision to mitigate the potential upfront litigation costs faced by indenture trustees whom are often thrust into disputes between issuers and noteholders.*

The court rejected this argument, ruling that whether JPMC's decision to withhold the Accrued Interest Funds was prudent or made in good faith was not an issue for the court to decide on summary judgment. Instead, the terms of the Indenture required an additional inquiry into whether JPMC's belief that its actions were authorized under the Indenture was reasonable. Because the Indenture did not explicitly authorize Defendant to establish a Reserve Account or to refuse disbursement of the Accrued Interest Funds, the court ruled that whether JPMC's actions in doing so were reasonably necessary depended on all of the relevant circumstances, and is generally a question of fact that precludes summary adjudication. The court further clarified that despite rejecting JPMC's summary judgment motion, it was not finding that JPMC had breached the Indenture. Instead, the holding only determined that JPMC failed to conclusively establish as a matter of law

while the Indenture allowed JPMC to deduct money deposited in a "Payment Account," it did not address whether JPMC could further indemnify itself from the funds deposited in the separate Collection Account, the original source of the Accrued Interest Funds before JPMC transferred them to the Reserve Account. Similarly, while the Indenture granted JPMC payment priority for its accrued fees and expenses over any the noteholders' rights to interest payments, the explicit right to payment priority referred only to deposits in the Payment Account. Finding that the Indenture did not resolve all questions of fact regarding whether JPMC could indemnify itself from the Accrued Interest Funds or its right to payment priority from the Collection Account, the court denied JPMC's motion.

*/ continued page 12*

## Noteholder Claims

continued from page 11

### Conclusion

The *Harch International Limited* decision demonstrates the importance of a well-drafted indemnification provision to mitigate the potential upfront litigation costs faced by indenture trustees whom are often thrust into disputes between issuers and noteholders. Even a broadly worded provision providing comprehensive indemnification for a trustee's "reasonable" actions may force the trustee to later litigate through trial its right to recoup its costs and expenses. ☺

# Court Dismisses Derivative Suits Arising from Merrill's Allegedly Reckless Investments Prior to Acquisition by Bank of America

By Thomas J. McCormack and Caroline Pignatelli

A New York federal district court recently dismissed two derivative actions brought in connection with "unprecedented losses" suffered by Merrill Lynch, Inc. ("Merrill") due to "aggressive investments" in collateralized debt obligations ("CDOs") and similar mortgage-backed securities in the time period prior to Merrill's acquisition by Bank of America ("BofA"). *In re Merrill Lynch & Co., Inc., Securities, Derivative and ERISA Litigation and Lambrecht v. O'Neal*, Case Nos. 07 Civ. 9696, 09 Civ. 8259 (S.D.N.Y. Mar. 29, 2011). The two actions — a consolidated case referred to as the "Derivative Action" and a later-filed case *Lambrecht v. O'Neal* ("Lambrecht") — were brought by plaintiffs who were shareholders of Merrill at the time of Merrill's "allegedly reckless investments" and who later became shareholders of BofA as a result of Merrill's acquisition by BofA. The key factual distinction between the two cases is that the plaintiff in the Derivative Action argued that a demand upon the BofA Board to pursue the claims would be futile, whereas the Lambrecht plaintiff made the demand upon the BofA Board

(and the pre- and post-Merger Merrill Boards) which was rejected. Despite this distinction, the court dismissed both cases in their entirety holding that the demand was not excused in the Derivative Action and that the BofA Board did not wrongfully reject the Lambrecht plaintiff's demands.

### Facts

The Derivative Action and the Lambrecht action both sought to require the BofA Board to force its Merrill subsidiary to bring claims against certain of Merrill's officers and directors in connection with the "allegedly reckless investments" in CDOs and mortgage-backed securities. Both complaints contain similar factual allegations. The court's discussion and analysis focuses on: (i) whether the Derivative Action plaintiff demonstrated that a demand upon the BofA Board would be futile and (ii) whether the Lambrecht plaintiff's demands upon the Board were properly rejected by the Board.

### The Derivative Action

With respect to demand futility, the court explained that the Delaware Supreme Court held in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993) that a demand is futile in the context of a double derivative suit — being a suit where the stockholder of a parent corporation seeks recovery for a cause of action belonging to the subsidiary corporation — if "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." The Delaware Supreme Court further explained that the "mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterested of directors, but must rise to a substantial likelihood." In this case, plaintiff alleged that the BofA Board "could not make a disinterested and independent assessment of a demand" to bring claims against the Merrill officers and directors because a majority of the BofA Board faced a "substantial likelihood" of liability related to the Merger. In support of that allegation, plaintiff argued that at the time of the filing the operative complaint the BofA Board consisted of 16 individuals (two of which were also on Merrill's pre-Merger Board and 10 of which were on BofA's pre-Merger Board). Therefore, plaintiff alleged "the vast majority of the current members of the BofA Board approved the Merger . . . and have potential liability resulting from that approval."

In response to plaintiff's arguments, the court explained

that “[t]he legal adequacy of a complaint’s allegations of demand futility must be assessed on a claim-by-claim basis.” The court went on to explain that as all of the claims in the operative complaint (except one) relate to pre-Merger activity “the overwhelming majority of the members of the BofA Board have no potential liability.” Specifically, “[p]laintiff fails to explain why the BofA Board would be incapable of performing a disinterested assessment of a demand to sue the Merrill Defendants for their *pre-Merger* conduct (mostly relating to CDO underwritings undertaken in 2006-2007 and stock repurchases or sales also made in 2007).” Therefore, the court determined that plaintiff failed to demonstrate demand futility with respect to the pre-Merger claims alleged in the complaint.

With respect to the one allegation in the complaint that expressly related to Merger-related activities, the court determined that plaintiff had also failed to demonstrate demand futility. Specifically, plaintiff alleged corporate waste with respect to bonus payments to Merrill employees and argued that the BofA Board approved the payments without first determining the amount of such payments or to whom they would be given. The court explained, however, that “[i]t is undisputed that the BofA directors received no personal benefit from Merrill’s approval of bonuses for Merrill employees” and that “a lack of diligence without a personal interest in the bonus payments is insufficient to establish a breach of duty subjecting any member of the BofA Board to liability.” Accordingly, the court determined that plaintiff “failed to state allegations sufficient to create a reason to doubt that the BofA Board was capable of properly exercising its independent and disinterested business judgment in responding to a demand” to pursue the claim for corporate waste in connection with Merger-related activities.

With respect to plaintiff’s additional allegations that the BofA Board and the Merrill defendants allegedly shared liability for other wrongdoing in connection with the Merger, the court again stressed that “demand futility must be assessed with respect to the particular causes of action that the board would otherwise be asked to consider if demand were made.” Therefore, the shared liability for alleged wrongdoing in connection with the Merger is insufficient to excuse the demand requirement with respect to the claims alleged in the complaint. As the court explained, “were it otherwise, a plaintiff could always avoid having to make a demand in a double derivative situation by merely alleging that the members of the board of the acquiring company had some knowledge at the time of acquisition of the prior wrongdoings alleged

against the officers and directors of the acquired company.” The court further explained that Delaware law “requires far more than such boot-strapping to excuse the obligation of a demand.” Accordingly, the court rejected plaintiff’s argument — which it characterized as a “variation on such boot-strap-ping” — that the demand would be futile because the BofA Board caused BofA to indemnify and hold harmless the directors and officers of Merrill from liability from the Merger “to the fullest extent provided by applicable law” and to maintain Merrill’s directors’ and officers’ insurance policies (or equivalent policies) for six years after the Merger.

The court rejected all of the plaintiff’s demand futility arguments holding that “plaintiffs have failed to make a legally adequate showing that the BofA Board was so involved in the underlying wrongdoing alleged in the Derivative complaint that it could not impartially consider a demand to pursue claims against the *Merrill* officers and directors.”

### The Lambrecht Action

Unlike the plaintiff in the Derivative Action, the plaintiff in the Lambrecht action made several demands upon the various Boards to pursue the claims. The court explained that “[a] board’s decision to reject a demand is entitled to the benefit of the business judgment rule.” The court further explained that “[u]nder Delaware law, the directors’ decision will be shielded by the business judgment rule unless the shareholder plaintiff can carry the considerable burden of showing that the decision not to bring the lawsuit was made in bad faith or was based on an unreasonable investigation.”

The plaintiff primarily argued that the refusal was wrongful because the Board did not seriously consider the demand. Plaintiff pointed to the fact that consideration of the demand was held in a single meeting and that the Board responded to the demand in a boilerplate rejection letter. Plaintiff further argued that some of the Board members were not independent and challenged the substance of the Board’s decision not to pursue the claims. The court easily dispensed of these arguments stating “[i]t is well-established that where a shareholder instead chooses to make a demand upon a board of directors, she concedes the independence of a majority of the board” and “Delaware law does not permit a plaintiff to overcome the business judgment rule simply by asserting that the substance of a board of director’s decision was wrong.”

The court further explained that the balance of plaintiff’s allegations were conclusory and failed to satisfy the Federal Rules of Civil Procedure which requires / *continued page 14*

## Reckless Investments

*continued from page 13*

that the plaintiff “state with particularity” “legally sufficient reasons to call into question the validity of the Board of Directors’ exercise of business judgment.” In addition, the court pointed out that the Board’s rejection letter was not in fact “inadequate boilerplate” as the plaintiff asserted but explained the reasons for rejecting the demand. Accordingly, the court determined that “it does not appear that the investigation and analysis described in the BofA rejection letter was unreasonable or conducted in bad faith.” Therefore, the court held that plaintiff’s conclusory assertions that the Board’s investigation was inadequate “are insufficient to overcome the presumption of the business judgment rule.”

### Conclusion

As the court concluded that the demand in the Derivative Action was not excused and that the BofA Board did not wrongfully reject the demand in the Lambrecht action, the court dismissed both complaints in their entirety. Although the court dismissed both actions, the court made clear that it was keenly aware of the impact of the allegedly “risky” behavior of Merrill’s officers and directors — if true — in creating the economic crisis. The court explained:

“The Court does not take this step lightly, for the allegations of the complaints, if true, describe the kind of risky behavior by high-ranking financiers that helped create the economic crisis from which so many Americans continue to suffer. But a derivative action is brought for the benefit of the company, and nothing here alleged in the complaints raises a reason to doubt that the board of the relevant company, BofA, was at all times fairly positioned to determine whether bringing an action against Merrill’s former officers and directors was in the company’s interest.” ☺

## Mismanagement Causing Wachovia’s Demise Does Not Constitute Securities Fraud

*By Nicolas Stebinger*

In a recent decision over liability for losses incurred as a result of the subprime lending crisis, Judge Richard J. Sullivan of the United States District Court for the Southern District of New York threw out numerous claims by stock and bond holders against Wachovia, in addition to several of its officers, directors, and auditors, which alleged that the defendants had overstated the stability and value of Wachovia’s holdings. *Stichting Pensioenfonds ABP v. Wachovia Corp. (In re Wachovia Equity Sec. Litig.)*, 1:08-CV-6171, 2011 U.S. Dist. LEXIS 108279 (S.D.N.Y. 2011). Judge Sullivan’s holding highlights that, no matter how compelling the overarching narrative, claims of securities fraud must still be plausible and pleaded with particularity to survive a motion to dismiss.

### Wachovia’s Demise

The allegations in the several complaints stemmed from Wachovia’s acquisition of Golden West in 2006, a company specializing in “Pick-A-Pay” adjustable-rate mortgages. Pick-A-Pay mortgages allowed borrowers to choose their payment rate each month, and even allowed for payments that did not cover the amount of interest that accrued monthly. Wachovia characterized these loans as “Alt-A,” or better than subprime. As the subprime lending crisis progressed, however, it became clear that the mortgages were drastically overvalued. The complaints alleged that this valuation was due, at least in part, to Wachovia’s failure to conform to its own purported appraisal standards. Wachovia lost billions of dollars from its books, causing the failure of the entire company, which was ultimately acquired by Wells Fargo for less than Wachovia had paid to acquire Golden West.

The plaintiffs’ complaints painted an overarching narrative of Wachovia’s poor management and public statements that did not conform with reality, which allegedly led to tremendous losses. According to the complaints, the defendants overstated the quality of Golden West’s investments before the acquisition, and misrepresented the stability of the mortgages

as the subprime lending crisis began. The plaintiffs also alleged that Wachovia did not follow its stated quality control procedures. In dismissing the majority of these claims, however, Judge Sullivan found that the complaints' primary flaw was their failure to allege that the defendants either had information contradicting their allegedly fraudulent statements, or had an actual intent to defraud.

### The Exchange Act Claims

The bulk of the securities fraud claims arose under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), which imposes liability for material misstatements or omissions only if a defendant acted with scienter or, stated differently, with recklessness or motive and intent to defraud. Federal Rule of Civil Procedure 9(b) together with the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4(b), require that a plaintiff plead such claims with particularity, and that the allegations give rise to a strong inference of scienter. A "strong inference" of scienter exists when the inference is at least as compelling as any inference of lawful behavior.

The court first dismissed the plaintiffs' attempt to establish motive and intent to defraud by defendants' profiting from the inflated value of Wachovia's holdings and share value which resulted from the alleged misstatements. To show motive and intent to defraud, a plaintiff must allege that the defendants "benefitted in some concrete and personal way from the purported fraud." The court noted that, although the defendants had sold "tens of thousands" of Wachovia shares during the relevant time period, their net holdings of vested Wachovia stock actually *increased*. This signaled "only confidence in the future of the company," instead of suggesting that the defendants were trying to benefit by dumping their holdings while prices were inflated. Furthermore, while acknowledging that the artificial inflation of stock prices to use as "currency" for an acquisition could support a showing of scienter, the court found that the allegations of the complaints regarding Wachovia's acquisition of Golden West merely demonstrated "a generalized desire to achieve a lucrative acquisition proposal." Finally, the court noted that the complaints' attempt to demonstrate motive and intent to defraud on the part of Wachovia's directors and executives through the mere fact of executive compensation tied to stock value must fail, because otherwise "every company . . . that experiences a downturn in stock price could be forced to defend securities fraud actions." The court thus held that the complaints had failed to adequately plead motive and intent to defraud.

The court also rejected the plaintiffs' allegations that the defendants made reckless statements because information existed which contradicted the defendants' public statements regarding Wachovia's lending practices and the strength of Wachovia's portfolio. In the securities fraud context, a finding of recklessness based upon possession of contradictory information requires a plaintiff to "specifically identify the reports or statements containing this information." The complaints presented allegations of confidential witnesses who stated that — contrary to the defendants' public statements — Wachovia did not follow its stated lending practices in certain cases and held subprime loans. The court pointed out, however, that the complaints failed to allege facts showing that the defendants actually possessed any of this information, and therefore the allegations of recklessness failed.

The plaintiffs attempted to bridge this gap by invoking the "core operations theory." Under the core operations theory, "scienter may be imputed to key officers who should have known facts relating to the 'core operations' of their company." Therefore, the plaintiffs alleged, because the defendants should have been aware of the company's practice of hiring outside auditors and of the risky nature of the Pick-A-Pay mortgages, they should be charged with that knowledge when making the contradictory statements. Judge Sullivan acknowledged that the courts were split regarding the viability of the core operations theory in the securities fraud context. Judge Sullivan noted, however, that the core operations theory was in tension with the PSLRA's requirement of particularity in pleading which "would seem to limit the force of general allegations about core company operations." The court ultimately held that, because the PSLRA requires a plaintiff to allege that a defendant had actual knowledge contradicting his statements, the general core operations allegations were not sufficient to support a showing of recklessness.

Finally, the court rejected the plaintiffs' assertions that the defendants' numerous laudatory statements regarding Wachovia's practices and optimism regarding the quality of its various holdings constituted fraudulent statements. The court held that the defendants' statements that Wachovia had a "highly disciplined" risk management process" and a "reputation for 'integrity'" were mere "puffery," as statements too general to cause a reasonable investor to rely upon them and support a securities violation. The court also held that the defendants' statements that the Pick-A-Pay loans were not "subprime" did not support an inference of scienter. The plaintiffs' definition of subprime loans

/ continued page 16

## Wachovia's Demise

*continued from page 15*

essentially applied the subprime label to any loan that defaulted during the subprime lending crisis; the court noted that such a *post hoc* definition could not support a finding that the defendants knowingly made misleading statements at the time of those statements.

Taking into account the allegations as a whole under the exacting pleading standard of the PSLRA, the court found that the complaints had not established that an inference of scienter was at least as compelling as an inference of lawful behavior. The court found that the most compelling inference based upon the facts alleged in the complaints was that the defendants “simply did not anticipate the full extent of the mortgage crisis and the resulting implications for the Pick-A-Pay loan portfolio.” Because negligence is insufficient to state a claim under Section 10(b), the court dismissed the 10(b) claims.

among the class purportedly represented by the named plaintiffs. Therefore, the court dismissed claims based upon over half of the securities at issue, because the named plaintiffs had not purchased those securities.

The court, however, did allow certain Securities Act claims to proceed. Because Section 11 and 12(a)(2) claims may be premised upon negligence, and not fraud, the heightened pleading requirement of Federal Rule of Civil Procedure 9(b) does not necessarily apply. Therefore, although alleged misrepresentations regarding the value of mortgages in Wachovia's portfolio were insufficient to support an inference of scienter necessary for liability under the Exchange Act, they did suffice to support a cause of action under the Securities Act.

Additionally, Section 11 imposes liability on all parties that play a role in a misleading registered offering, allowing for liability against a company's auditors. Although auditors may technically avoid Section 11 liability by showing that they had reasonable grounds to believe that the statements at issue

Although the plaintiffs may have justifiably felt wronged and injured by Wachovia's allegedly false statements and disastrous collapse, they were unable to allege facts that showed any specific fraudulent intent or possession of contradictory information by the defendants, and the bulk of their claims were thus doomed to fail.

### The Securities Act Claims

The plaintiffs also alleged violations of Sections 11 and 12(a)(2) of the Securities Act, 15 U.S.C. §§ 77k(a), 77l(a)(2), which “create liability only for material misrepresentations or omissions in connection with a registered securities offering.” The court dismissed a number of these claims for lack of standing. The named plaintiffs argued that they had standing to sue as class representatives on behalf of all those who purchased securities traceable to the same shelf registration statements. A shelf registration statement permits an issuer to register multiple securities within a single SEC filing. The court disagreed with the plaintiffs, noting that Section 11 limits its causes of action to “any person acquiring . . . [a] security” under a given registration statement. Because the plaintiffs did not suffer injury from sales of securities they did not purchase, they could not assert standing to sue for injury suffered by purchasers of other securities registered within the same shelf registration statement, even if those other purchasers may have been

were true, such a “due diligence” defense is an affirmative defense, and therefore will not defeat a Section 11 claim at the motion to dismiss stage. The court thus also allowed certain Securities Act claims against Wachovia's auditor, KPMG, to continue.

### A Narrative Is Not Enough

Judge Sullivan's decision in *In re Wachovia Equity Securities Litigation* highlights that a compelling narrative of mismanagement and misstatements is insufficient to support a claim of securities fraud unless a complaint points to specific facts demonstrating actual fraudulent intent or knowledge of contradictory information. Although the plaintiffs may have justifiably felt wronged and injured by Wachovia's allegedly false statements and disastrous collapse, they were unable to allege facts that showed any specific fraudulent intent or possession of contradictory information by the defendants, and the bulk of their claims were thus doomed to fail. ☉

# Defense of Temporary Commercial Impracticability Unavailable to Loan Guarantors

By C. Jonathan Wood

A New York federal district court recently ruled that the defense of “temporary commercial impracticability” is not available under New York law to guarantors of a loan. The ruling allowed a lender to recover under a loan guaranty where the defendants argued that performance was temporarily impracticable as a result of the ongoing financial crisis. *Walden Fed. Sav. & Loan v. Slaine*, No. 09 Civ. 1042 (DLC), NYLJ 1202490025504, at \*1 (S.D.N.Y. April 5, 2011). The decision followed the reasoning of a Seventh Circuit decision which discussed the unavailability of the temporary commercial impracticability defense under New York law.

## Background

Walden Federal Savings & Loan Association (“Walden”) made several loans to Oxford Landing, LLC totaling approximately \$2.9 million. These loans were made in 2005 and subsequently refinanced in 2007 and 2008 with a maturity date of June 1, 2009. Charles Slaine, Daniel Slaine and the Slane Company, Ltd. (“defendants”) guaranteed repayment of the notes. Oxford Landing allegedly defaulted on the notes in August 2008 by failing to make payments due. Walden filed the instant proceeding against the guarantors to recover on the guarantees. In response, the defendants asserted a defense of temporary commercial impracticability. Specifically, the defendants argued that performance on the guaranty was impossible as a result of the ongoing financial crisis. Walden moved for summary judgment.

## The Holding

In ruling for the lender on summary judgment, the court found that the defense of temporary commercial impracticability is not available under New York law. The court based its decision on the Seventh Circuit’s analysis in *Hoosier Energy Coop., Inc. v. John Hancock Life Ins. Co.*, 582 F.3d 721 (7th Cir. 2009), which reached the same conclusion. The *Walden* court concluded

that “New York courts refuse to excuse performance where difficulty is occasioned only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy.”

The court rejected the defendants’ contention that New York trial court’s decision in *Twin Holdings of Delaware LLC v. CW Capital, LLC*, CW, 906 N.Y.S.2d 784 (Nassau Co. 2010), had allowed this defense. The court noted that this reliance was unavailing because the court in *Twin Holdings* “dismissed [the] cause of action seeking a declaration that the plaintiffs were ‘temporarily excused’ from performance of a loan agreement because of the financial crisis.” The *Walden* court stated “[i]n sum, New York courts do not recognize the defense of temporary commercial impracticability.”

## The Hoosier Energy Decision

The *Walden* court relied almost exclusively on the Seventh Circuit’s decision in *Hoosier* to support its conclusion that temporary commercial impracticability is unavailable in New York. In that case, the court examined a lease-back between Hoosier and John Hancock. To guard against the possibility that Hoosier may become insolvent and be unable to perform under the lease-back, Hoosier provided John Hancock with security in the form of a credit default swap and surety bond. Under this agreement, Ambac Assurance Corp. and several other entities agreed to pay John Hancock nearly \$120 million upon the occurrence of defined events.

Ambac’s credit rating subsequently fell below a defined threshold level and John Hancock demanded that Hoosier find a replacement. Hoosier could not find a suitable replacement for Ambac within the time provided by John Hancock, and called on Ambac to perform on the agreement. Hoosier filed suit before Ambac could perform, and the district court granted a temporary restraining order and preliminary injunction, finding that New York law allows temporary commercial impracticability.

On appeal, the *Hoosier* court focused its examination of the district court’s holding on whether Hoosier had a “plausible theory on the merits . . . to justify exposing John Hancock to financial risks until the district court can decide the merits.” The court rejected Hoosier’s first argument, accepted by the district court, that the transaction was an abusive tax shelter. The court rejected this argument because “[w]hether or not the contract lawfully transfers tax benefits, there is nothing wrong with, or illegal about, the contract itself; only the claim of tax benefits from the contract would be problematic.”

Next, the court found that, even / continued page 18

## Temporary Commerical Impracticability

*continued from page 17*

though New York does not recognize temporary commercial impracticability, Hoosier may have a plausible argument for impossibility. In contrast with temporary commercial impracticability, an impossibility defense requires a showing that “the new event ‘could not have been foreseen or guarded against’ in the contract.” The court began its analysis by noting that New York law “takes a very dim view of ‘impossibility’ defenses and has never suggested that, when an impossibility defense is unavailable, a ‘temporary commercial impracticability’ defense might serve instead.” While temporary impracticability was unavailable, the court found that the language of the contract left open whether Hoosier had a duty or simply the option to replace Ambac in the transaction. The court concluded that if Hoosier had a duty and could not find any replacement for Ambac then performance of the obligation may have been impossible at that time.

The Seventh Circuit upheld the injunction but went to lengths to note that the district court emphasized that the order was temporary. The court stated “we are confident that the court will not allow ‘temporary’ to drag out in the direction of permanence.” The court made this statement in light of the fact that the longer the injunction continues the more the equities of the situation balance in favor of John Hancock.

### Conclusion

The *Walden* and *Hoosier* decisions reaffirm that the defense of temporary commercial impracticability is not available in New York. While the defense of impossibility is available, it presents a much higher burden, and New York courts have shown reluctance to conclude such burden has been satisfied. Defense counsel need to be keenly aware of the difference between temporary commercial impracticability and impossibility, and plead their defense to satisfy the elements of an impossibility defense. ☺

## Court Dismisses Securities Act Claims Against Countrywide Based On Statute Of Repose

*By Paige M. Willan*

In *Footbridge Ltd. Trust v. Countrywide Fin. Corp.*, No. 10 Civ. 367 (PKC) (S.D.N.Y. 2011), the United States District Court for the Southern District of New York recently dismissed claims brought under Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 on the grounds that the filing of a class action regarding the securities at issue did not toll the statute of repose for claims under that statute. In so holding, the Court determined that the tolling available under the United States Supreme Court decision in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) for statutes of limitation does not apply to the Securities Act’s statute of repose. A statute of repose limits the time during which a specified cause of action exists, whereas a statute of limitation limits the time within which a suit can be brought. Thus, a statute of repose is considered a stricter deadline than a statute of limitation.

### The Footbridge Action

Plaintiffs in the *Footbridge* action were two hedge funds that allegedly purchased residential mortgage-backed securities issued by Countrywide. The securities, CWABS Asset Backed Certificates, Series 2006-SPS1 and CWABS Asset Backed Securities, Series 2006-SPS2, were offered pursuant to registration certificates filed with the Securities and Exchange Commission (SEC) on February 21, 2006 and August 8, 2006. The prospectus supplements detailing these particular series of certificates were registered with the SEC on June 26, 2006 and August 28, 2006. Plaintiffs purchased the SPS1 certificates on June 27, 2006 and the SPS2 certificates on August 29, 2006, September 12, 2006, and October 3, 2006.

Plaintiffs’ complaint alleged that the registration statements and the prospectus supplements for the Countrywide securities that plaintiffs purchased contained false statements and omissions of material fact regarding the quality of the mortgage loans contained in the securitizations and the underwriting guidelines used to issue those loans. Defendants moved for summary judgment.

## The Securities Act of 1933

The Securities Act of 1933 allows investors to bring claims based on false statements in the offering documents of securities offered for sale in interstate commerce. See 15 U.S.C. §§ 77k & 77l. Section 11 establishes a cause of action against directors of the issuer — and those who signed or certified a registration statement, or acted as an underwriter of the relevant security — if the registration statement contains “an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” 15 U.S.C. § 77k. Section 12(a)(2) creates a cause of action against one who offers or sells a security, where the prospectus or any statements in support of the sale contain “an untrue statement of a material fact or omit[] to state a material fact necessary in order to make the statements . . . not misleading.” 15 U.S.C. § 77l(a)(2). Those actions, however, are subject to a “statute of repose,” which places an outer limit on the time that a cause of action exists for violations of those statutes:

In no event shall any such action be brought to enforce a liability created under section 77k or 77l(a)(1) of this title more than three years after the security was bona fide offered to the public, or under section 77l(a)(2) of this title more than three years after the sale. 15 U.S.C. § 77m.

## Application of the Statute of Repose

In analyzing Defendants’ motion for summary judgment, the *Footbridge* Court focused entirely on whether the action was timely. The Court applied the Securities Act’s statute of repose to determine that, without the application of any tolling, the suit against Countrywide would be untimely. The suit was filed more than three years from both the offering date of the securities and the date of sale of the securities, which all took place in 2006. The Court then considered whether the Supreme Court decision in *American Pipe* tolled the running of the statute of repose under the Securities Act, such that Plaintiffs’ claims should be allowed.

## American Pipe Tolling

In *American Pipe*, the Supreme Court considered the application of statutes of limitation under the Sherman Act in connection with a class action filed under Rule 23 of the Federal Rules of Civil Procedure. In that case, the Supreme Court held that the institution of a class action tolled the statute of limi-

tations under the Sherman Act as to the members of that class, at least until an order was entered refusing to certify the class. *American Pipe* tolling has been applied in a variety of contexts to toll the statute of limitations.

## Class Actions Involving Countrywide Securities

Two class actions were filed in California State Court in 2007 regarding residential mortgage-backed securities issued by Countrywide. The first, *Luther v. Countrywide Home Loans Servicing LP*, BC380698 (Cal. Super. Ct.), was filed on November 14, 2007. The second, *Washington State Plumbing & Pipefitting Pension Trust v. Countrywide Fin. Corp.*, BC392571 (Cal. Super. Ct.), was filed on June 12, 2008. The actions were consolidated on October 16, 2008 and dismissed by the California State Superior Court on the basis of the Securities Litigation Uniform Standards Act on January 6, 2010. If the filing of those class actions tolled the statute of repose under the Securities Act, the *Footbridge* Action would be timely.

## American Pipe Tolling Does Not Apply to the Securities Act’s Statute of Repose

The *Footbridge* Court began its tolling analysis by examining the plain language of the Securities Act’s statute of repose. It noted that the language was “absolute,” as it provided that “in no event” could an action be initiated following the running of the statute of repose. The court reasoned that the ordinary meaning of those words “precludes the application of *American Pipe* tolling.”

As a secondary reason for its decision, the court determined that the Securities Act’s statute of repose could not be tolled under *American Pipe*, because equitable tolling is not available for such a statute. Citing the Supreme Court decision in *Lampf, Pleva, Lopkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 363 (1991), the court noted that it is “well settled” that a statute of repose is “not subject to equitable tolling.” The court then moved on to determine whether the tolling created in *American Pipe* was equitable or, as some courts have concluded, statutory or legal.

Noting that the tolling available through *American Pipe* is not explicitly permitted under the Securities Act or any other statute, the court determined that *American Pipe* tolling is not statutory. The court then considered whether the tolling could be a type of legal tolling established by Rule 23. Focusing again on the plain text, the court noted that the rule’s text does not specifically provide for — and the *American Pipe* court did not suggest otherwise — a class action

/ continued page 20

## Claims Against Countrywide

*continued from page 19*

tolling rule. Moreover, the court noted that the Rules Enabling Act, 28 U.S.C. § 2072(b), prevents procedural rules, such as Rule 23, from trumping a statutory enactment, such as the Securities Act's statute of repose.

The court also found support for its conclusion in the text of the *American Pipe* decision itself and other Supreme Court jurisprudence. The court noted that the *American Pipe* court analogized its tolling rule to other equitable tolling doctrines, and that the rule was judicially created and "premised on 'traditional and equitable considerations' of fairness, judicial economy and needless multiplicity of lawsuits." Moreover, the court determined that the Supreme Court itself, based on dicta from opinions examining *American Pipe* tolling, "appears to view" the tolling rule it created as a form of equitable, rather than legal or statutory tolling.

Finally, the court noted the similarity in policy considerations between the tolling of statutes of limitations under *American Pipe* and the tolling of statutes of repose that the *Footbridge* plaintiffs sought. The court noted, however, that "the issue presented is not one of policy but of enforcement of the statute as written. Lawmakers are free to adjust the repose period as they have in the past."

Based on these conclusions, the court granted summary judgment to defendants on all claims, because their complaint was "barred by the running of [the Securities Act's] three-year statute of repose, which is not subject to tolling under *American Pipe*." The court entered judgment in favor of defendants, and the *Footbridge* plaintiffs have appealed.

### Importance of Statutes of Repose

The *Footbridge* decision demonstrates that a litigant seeking to bring a claim under the Securities Act of 1933 should determine not only whether a statute of limitation might apply to its claim, but also whether the Securities Act's statute of repose will eliminate that claim after a specified period of time. Moreover, based on the *Footbridge* decision, the litigant should not rely on the filing of a class action regarding the security in question to preserve its cause of action after the statute of repose has run. Instead, the litigant must file its own action if it believes that the class action will be dismissed. ☺

## Public Risk Disclosures May Not Defeat Auction Rate Securities Claims Based on Private Misrepresentations

*By Robert A. Schwinger and Robert Kirby*

Judge Loretta Preska of the United States District Court for the Southern District of New York recently denied a motion to dismiss federal securities law claims brought by investors in the Auction Rate Securities ("ARS") market against underwriters and managing broker-dealers for ARS. *Dow Corning Corp. v. Merrill Lynch & Co. (In re Merrill Lynch Auction Rate Sec. Litig.)*, Index No. 09-MD-2030, 2011 U.S. Dist. LEXIS 35363 (S.D.N.Y.). The district court concluded that the complaint's allegations that the defendants made a series of "specific misrepresentations to reassure Plaintiffs about ARS after the ARS market began to crumble" were sufficient to state a claim, notwithstanding the defendants' public disclosure of certain risks in the ARS market.

### Background

ARS are long-term variable-rate debt instruments that are traded at periodic auctions, where buy orders are entered at interest rates selected by the bidder. The results of these auctions dictate the interest rates payable on the ARS. The highest bid accepted sets the interest rate for the ARS issuance as a whole (*i.e.*, the "clearing rate"). If, at a particular auction, the buy and sell orders are insufficient to purchase all of the ARS offered for sale, the auction fails. In the event of auction failure, ARS holders are unable to sell the securities that they hold, and the interest rate rises to the "failure rate" until the next auction.

Plaintiff Dow Corning Corporation, on its own behalf and as asset manager for plaintiffs Hemlock Corporation and Devonshire Underwriters Limited, allegedly purchased a total of \$165 million of ARS between 2005 and February 13, 2008, from defendants Merrill Lynch & Company, Inc. and Merrill Lynch, Pierce, Fenner, & Smith Inc. The defendants served as the underwriters and managing broker-dealers for the ARS, and were often the only firms able to submit bids on behalf of others at their ARS auctions. They allegedly also "supported" their own ARS auctions by placing bids for their own account,

which prevented auction failure and set an artificial clearing rate.

The defendants allegedly had exclusive access to information concerning the ARS market, and did not disclose the identity of bidders, the number of bids placed, the rates at which bidders bid, or the total dollar amount of bids placed at their auctions. Defendants did, however, make public disclosures that “they may routinely bid in their own ARS auctions, that their bidding affects clearing rates, that Defendants are not obligated to bid, that the fact an auction clears does not mean there is no liquidity risk involved, and that auctions may fail if Defendants cease bidding.” According to the plaintiffs, by early 2007 the defendants “knew that the ARS market was teetering” and had internally “discussed withdrawing support bids for ARS entirely,” while they “increased their efforts to sell ARS to unwitting investors.”

Thereafter, plaintiffs allegedly questioned the defendants on several occasions concerning conditions in the ARS market and their affect on the liquidity of ARS, only to be reassured by

lation of the Michigan Uniform Securities Act. On April 23, 2010, defendants filed a motion to dismiss the complaint in its entirety for failure to state a claim.

### Complaint States Federal Securities Law Claims

Plaintiffs’ claims under Section 10(b) of the Securities Exchange Act and Rule 10b-5 alleged that the defendants’ reassuring representations concerning the ARS market were fraudulent because defendants failed to disclose that “their bidding alone created the appearance of a liquid market” and that they were at the same time “contemplating ending their support bidding practice.” For these claims to survive a motion to dismiss, plaintiffs were required to allege that the defendants (1) made misstatements or omissions of material fact, (2) with scienter, (3) in connection with the purchase or sale of securities, (4) upon which the plaintiffs reasonably relied, and (5) that the plaintiffs’ reliance was the proximate cause of their injury. The district court concluded that the plaintiffs’ complaint satisfied each of these required elements.

**Judge Preska’s recent decision in the *In re Merrill Lynch Auction Rate Securities Litigation* demonstrates that the challenging pleading standards to state a federal securities fraud claim, in appropriate circumstances, can be overcome by specific allegations of direct misrepresentations to an investor.**

defendants. Specifically, plaintiffs alleged that the defendants represented that “problems in the mortgage-backed securities market did not and would not affect the liquidity of Plaintiffs’ ARS,” that plaintiffs’ investments in ARS were “safe,” and that defendants would “continue to support their products and ensure that the auctions succeeded.” Beginning on February 13, 2008, however, the defendants allegedly stopped supporting their auctions, leading to auction failure and the inability of plaintiffs to sell their ARS from that date forward.

On November 20, 2009, plaintiffs filed their complaint, which was later consolidated into the multidistrict litigation pending before the district court concerning defendants’ alleged misconduct with respect to the ARS market. Plaintiffs’ complaint alleged violations of Section 10(b) of the federal Securities Exchange Act and Rule 10b-5, common law fraud, breach of fiduciary duty, negligent misrepresentation, and vio-

The district court found that the complaint adequately alleged misstatements based on its allegations that “Defendants were the sole repositories of liquidity information” and “when asked about liquidity . . . Defendants did not disclose the ‘true state’ of the ARS market.” In particular, the district court identified five statements allegedly made by defendants in response to plaintiffs’ “questions about liquidity” that contained “untrue or only partially true reasons for ARS market changes when Defendants had specific and exclusive information about ARS demand.” With respect to each of those five statements, plaintiffs’ complaint had “identified the speaker, the date and place of the statements, the substance of the statements, and the reason why they were false or misleading.” According to the district court, “if the fate of Plaintiffs’ investments was exclusively in Defendants’ hands and if Defendants were contemplating / continued page 22

## Public Risk Disclosures

*continued from page 21*

ending their support for those investments or knew that the market was markedly different or impaired, Plaintiffs should have been told these facts in response to their inquiries.”

The district court emphasized that, “[u]nlike other ARS cases in this multidistrict litigation,” this was not a case founded on generic statements about audit risks found in public disclosures. Rather, this case involved allegations of “specific misrepresentations to reassure Plaintiffs about ARS after the ARS market began to crumble.” As a result, it was not dispositive of plaintiffs’ claims that they “were made aware of the general risks involved in ARS investments and the ability of Defendants to place (or not place) support bids.”

The allegations in the complaint also gave rise to an inference of scienter (*i.e.*, an intent to deceive, manipulate, or defraud). The district court explained that the mere desire to earn commissions was a common business motivation and, therefore, insufficient to show an intent to defraud. The district court did find sufficient, however, plaintiffs’ allegations “that Defendants sought to prop up the ARS market temporarily in order to preserve their ability to sell their ARS.” The district court rejected defendants’ argument “that Plaintiffs’ claim that Defendants increased their own inventory of ARS is incompatible with an inference of scienter because doing so knowing the market would fail is ‘economically irrational.’” Although that inference was possible, the competing inference that “Defendants sought to prop up the ARS market temporarily in order to preserve their ability to sell their ARS” was “equally compelling.” The plaintiffs’ allegations “suggest equally either recklessness or a motive and opportunity to commit fraud,” and no more was required to allege scienter.

The reliance element was also satisfied by the plaintiffs’ allegations. The district court noted that “the bulk of Plaintiffs’ claims of misrepresentation sound in omission” and “[r]eliance is presumed in omission cases so long as the facts withheld are material.” Moreover, plaintiffs’ allegations indicate that their reliance was reasonable, because they tried to “exercise at least minimal diligence.” Plaintiffs attempted to conduct due diligence by questioning defendants concerning the ARS market, and “Defendants reassured Plaintiffs rather than warned them.” Given that the defendants allegedly had exclusive access to information concerning the ARS market, the plaintiffs had no further obligation to investigate, no matter how

sophisticated they may have been.

Finally, the plaintiffs adequately alleged an injury caused by defendants’ misrepresentations. Plaintiffs’ allegations of a loss of liquidity and inability to sell their ARS holdings were adequate to establish an economic loss, notwithstanding that plaintiffs have continued to receive interest payments. “Plaintiffs’ continued receipt of interest may reduce the overall damages they can claim,” but “it does not preempt the allegations of economic loss.” The district court was unconvinced by the argument that “broader market phenomena,” not defendants’ misrepresentations, could have been the cause of plaintiffs’ inability to sell their ARS holdings. In the context of a motion to dismiss for failure to state a claim, it is enough to “allege that the risk presented, a lack of liquidity, was precisely the risk concealed by the alleged misrepresentations.” Plaintiffs are not required to plead facts sufficient to exclude all other possible explanations for their injury.

The district court denied defendants’ motion to dismiss with respect to plaintiffs’ claims under Section 10(b) of the Securities Exchange Act and Rule 10b-5.

### Split Decision on State Law Claims

Defendants’ motion also asked the district court to dismiss plaintiffs’ assorted state law claims, with partial success. The district court concluded that plaintiffs’ allegations in support of their federal securities law claims sufficed to make out claims for common law fraud and breach of the Michigan Uniform Securities Act, each of which share similar elements. With respect to plaintiffs’ breach of fiduciary duty and negligent misrepresentation claims, however, the district court granted the defendants’ motion to dismiss for failure to state a claim. A broker-customer relationship ordinarily does not create a fiduciary duty. The existence of a fiduciary duty owed by a broker is even less likely where, as in this case, the customers are sophisticated investors. The plaintiffs’ allegations concerning the nature of their relationship with defendants were “conclusory” and “therefore insufficient to show the existence of [a fiduciary] duty.” The plaintiffs’ failure to allege adequately the existence of a fiduciary relationship was also fatal to its negligent misrepresentation claim, which is only cognizable where “the defendant owes [the plaintiff] a fiduciary duty.” Finally, the district court noted that under New York law plaintiffs’ fiduciary duty and negligent misrepresentation claims would also be barred by that state’s Martin Act, which preempts certain common law tort claims in securities disputes.

## Implications

Judge Preska's recent decision in the *In re Merrill Lynch Auction Rate Securities Litigation* demonstrates that the challenging pleading standards to state a federal securities fraud claim, in appropriate circumstances, can be overcome by specific allegations of direct misrepresentations to an investor. Such allegations may survive a motion to dismiss even in the face of boilerplate public disclosures of potential risks facing investors in that security. ☺

# Merged Bank Awarded Summary Judgment in Lieu of Complaint on Predecessor's Notes and Guarantees

By Kimberly Zafran

A New York trial court recently granted Capital One summary judgment in lieu of a complaint for payment due under promissory notes and related guarantees issued in favor of its predecessor bank, North Fork. *Capitol (sic.) One, N.A. v. Alarm Warehouse, LLC*, 37900-2010, 2011 WL 1601572 (Suffolk Co. 2011). In rejecting the defense argument that Capitol One failed to submit an assignment of the notes and guarantees to it, the court relied on Section 602 of the New York Banking Law which provides that a merged financial institution is considered the same legal entity as each of its predecessor institutions.

## Background

In 2008, North Fork Bank was merged into Capital One. Thereafter, Capital One, as North Fork's successor, brought a motion for summary judgment in lieu of complaint pursuant to Section 3213 of the New York Civil Practice Law and Rules against Alarm Warehouse LLC for payment on two promissory notes made in favor of North Fork in 2007 and 2009, respectively. The motion was also brought against Peter Siegel and Jonathan Scott Siegel who signed guarantees in 2007 as guarantors of the notes. Capital One sought recovery of almost \$800,000 due plus interest.

## The Parties' Arguments

The defendants opposed Capital One's motion on two grounds. First, the defendants asserted that Capital One lacked standing as it failed to show any written assignment of the notes or guarantees from North Fork to Capital One. The defendants emphasized the need for a plaintiff to establish on a motion for summary judgment that there are no issues of material fact and that it had failed to prove that it was the owner and holder of the notes and guarantee at issue. Second, defendants argued that the 2007 guarantees did not extend to the 2009 note, despite the fact that it covered the 2007 note obligations and any other obligations "incurred in the future." They argued that extending the 2007 note would be invalid under New York law because past consideration cannot support a new contractual obligation. The guarantors noted that New York General Obligations Law Section 5-1105 is the only exception to this rule regarding past consideration. It provides:

"A promise in writing and signed by the promisor or by his agent shall not be denied effect as a valid contractual obligation on the ground that consideration for the promise is past or executed, if the consideration is expressed in the writing and is proved to have been given or performed and would be valid consideration but for the time when it was given or performed."

Citing *Umscheid v. Simnacher*, 106 A.D.2d 380, 482 N.Y.S.2d 295 (2d Dep't 1984), defendants argued that, for this exception to apply, the relevant writing must promise to pay a sum certain at a date certain, and must express the consideration for the promise. The 2007 guarantees at issue did not contain this specific language.

Capital One replied to defendants' arguments by first pointing to Section 602 of the New York Banking Law which renders a merged financial institution (Capital One, N.A.) the same entity as the previous institution (North Fork Bank), and further that Capital One is deemed to have stepped into North Fork Bank's shoes in any contractual rights that took effect before the merger. Capital One also responded to defendants' contention that it had failed to establish how Capital One became the holder of the notes and guarantees by pointing to the affidavit of its vice president which stated that Capital One was the successor by merger to North Fork Bank. In addition, Capital One argued that the New York law rendering past consideration as insufficient to support a promise, and the exception provided in New York General

/ continued page 24

## Summary Judgment

continued from page 23

Obligations Law Section 5-1105, were inapplicable because such specificity is required where the only consideration for the promise is past consideration, whereas the guarantees at issue here guaranteed future obligations as well. Capital One argued that a guarantee given in consideration of future extensions of credit is enforceable.

### The Court's Reasoning

New York's procedural law permits a party to bring a motion for summary judgment without first filing a complaint when the claim is based on an instrument for the payment of money and where the plaintiff can establish failure of the debtor to make payment as required by the instrument. Thus, as a threshold matter, the court found that it was procedurally proper for Capital One to bring this motion as the notes and the guarantees were in fact instruments for the payment of money only.

The court found that the no written assignment defense lacked merit. Section 602 of the New York Banking Law provides that "the receiving corporation is the same entity as the merged corporation and is considered to have been actually named in any document which took effect prior to the merger." *Id.* at \*1, citing *Landino v. Bank of America*, 52 A.D.3d 571, 861 N.Y.S.2d 683 (2d Dep't 2008); *Barclay's Bank of New York, N.A. v. Smitty's Ranch, Inc.*, 122 A.D.2d 323, 504 N.Y.S.2d 295 (3d Dep't 1986). Capital One's vice president's affidavit attesting to the fact that plaintiff is the successor by merger to North Fork demonstrated its entitlement under the New York Banking Law to bring this motion just as North Fork would have been entitled before the merger. Additionally, the court agreed with the plaintiff that the 2007 guarantees were given in consideration of both past and future extensions of credit, and thus were enforceable under New York General Obligations Law Section 5-1105 and applied to the 2009 note.

The court concluded that the plaintiff was entitled to summary judgment in lieu of complaint pursuant to CPLR Section 3213 with pre-judgment interest as requested. ☺

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