

# Financial Services Litigation

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NEWSWIRE

## Bank Potentially Liable for Terrorist Attacks

By Robert A. Schwinger and Andrea Voelker

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A New York State trial court recently held that claims of terrorist attacks victims based on Israeli law could proceed against the bank that allegedly had knowingly executed money transfers to the terrorist groups responsible for the attacks. *Keren Elmaliach v. Bank of China Ltd.*, No. 102026/09 (N.Y. Co. 2011) ("*Elmaliach*"). Specifically, the court found that, despite banks not having a general duty to protect non-customers from the intentional wrongs of its customers, defendant Bank of China Ltd. ("Bank of China") could be liable for not taking action where it allegedly had actual knowledge that it was assisting in the funding of terrorist attacks. The court also found that dismissal of the case was not appropriate on the grounds of *forum non conveniens*, as Bank of China was conducting discovery in New York State in connection with a similar pending case.

### Background

This case started as two separate suits with nearly identical factual allegations and causes of action that were consolidated by the court. Both complaints concern terrorist attacks perpetrated in 2006 and 2007 by the terrorist groups Hamas and Palestine Islamic Jihad ("PIJ"), and were brought on behalf of the victims of the attacks.

Both Hamas and PIJ have been designated as Foreign Terrorist Organizations by the United States since 1997, and as Specially Designated Global Terrorists since 2001. As a consequence, both organizations are "subject to strict economic sanctions," which are enforced by "[n]early all banks and financial institutions around the world," and are intended to severely limit both Hamas' and PIJ's ability to conduct banking activity that can fund terrorist activities. Bank of China allegedly began providing banking services to Hamas and PIJ in 2003, and executed several wire

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## Liable for Terrorist Attacks

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transfers totaling millions of dollars by and through Bank of China's branches in the United States. Most of the transfers were allegedly sent to an account belonging to Said al-Shurafa ("Shurafa"), a senior operative in both Hamas and PIL, who transferred money to Hamas and PIL in Israel "for the purpose of planning, preparing and executing terrorist attacks."

The complaint alleged that Bank of China's participation in the wire transfers violated Israeli law and "was the proximate cause of their injuries." Specifically, the plaintiffs alleged that during a 2005 meeting between the Prime Minister of the State of Israel, China's Ministry of Public Security and China's central bank, Israel officials told the Chinese officials that the Bank of China wire transfers were being used to perpetuate

terrorist organizations. For example, in *Licci v. American Express Bank Ltd.*, 704 F. Supp. 2d 403 (S.D.N.Y. 2010) ("*Licci*"), the plaintiffs alleged that American Express Bank Ltd. was negligent under Israeli law because it "effected millions of dollars in wire transfers" for the Lebanese Shahid (Martyrs) Foundation, which is alleged to be the financial arm of Hizbollah. The court dismissed the action, reasoning that the plaintiffs had not pled any factual allegations to suggest that American Express "had any ties to Hizbollah, or that they knew or had reason to believe that the monies at issue would be used to carry out terrorist attacks on civilian targets." Absent such knowledge, banks are not negligently liable where they benefit "in some general, nondescript manner" from "routine banking services."

The second related action, *Wultz v. Islamic Republic of Iran*, 755 F. Supp. 1 (D.D.C. 2010) ("*Wultz*"), involved an American citizen who was killed in a PIJ suicide bombing in Israel that also

**While banks generally do not have a duty to protect non-customers from the intentional torts of their customers, the court in *Elmaliach* took the view that a bank may be liable for not taking action where it has actual knowledge that it is funding such a wrong.**

the attacks, imputing actual knowledge to Bank of China. The plaintiffs also asserted that Bank of China "knew or should have known" that the wire transfers were funding terrorist attacks prior to the 2005 meeting, because "the transfers were made in cash, [] the funds were withdrawn by Shurafa within a day of being received, [and] the transfers were large . . ." The plaintiffs alleged that banks recognize that these practices are indicative of illegal activity and that they are "under an obligation to monitor, report and refuse to execute such suspicious and irregular banking transactions."

### Related Litigation

Counsel for plaintiffs filed two other substantially similar lawsuits on behalf of other Israeli terrorist victims against other financial institutions that similarly provided wire transfers to

killed six of the decedents in the *Elmaliach* case. The court in *Wultz* denied a motion to dismiss the case brought by Bank of China, a defendant in the *Wultz* case, reasoning that the plaintiffs' allegations "were sufficient to give rise to an inference that the bank actually knew it was providing financial services to a terrorist organization." The court in *Wultz* also found that the plaintiffs had adequately pled causation, because the "plaintiffs' injuries were reasonably foreseeable to the bank," and distinguished the case from *Licci* on the ground that the defendant in *Licci* was not alleged to have actual knowledge of the bank's terrorist activities. On a motion by Bank of China, the *Wultz* court later severed and transferred the claims against Bank of China to the Southern District of New York, where the case is in the discovery phase.

## The Claims and Defenses

The complaints in *Elmaliach* alleged two causes of action. The first cause of action was brought pursuant to Sections 35 and 36 of Israel's Civil Wrongs Ordinance "which create a civil wrong of negligence," and imposes liability on a person "who injures others by committing acts (or refraining from action) under circumstances under which a reasonable person would have done otherwise." The second cause of action was brought under Section 63 of Israel's Civil Wrongs Ordinance, which imposes liability where a person violates an "enactment" that is "intended for the benefit or protection of another person." To support the "enactment" requirement of Section 63, plaintiffs alleged that Bank of China violated a number of Israeli laws that "criminally prohibit the provision of material support to terrorist organizations such as Hamas and PIJ."

Specifically, the plaintiffs alleged that Bank of China's participation in the wire transfers to Hamas and PIJ "was the proximate cause of their injuries," and carried out with actual knowledge that the wire transfers used by the terror organizations were funding terrorist attacks. Bank of China moved to dismiss the complaints for failure to state a claim or, in the alternative, on the grounds of *forum non conveniens*.

## The Court's Ruling

The court first noted that, even though the *Wultz* decision by a federal district court was not binding on it, Bank of China had not presented a sufficient argument as to why it should not adopt the reasoning and conclusions of the *Wultz* court. Despite this, the court stated that it had conducted its own *de novo* review of the applicable law and found that *Wultz* was correctly decided. The court agreed with the *Wultz* court's finding that Bank of China's actual knowledge of its customer's terrorist activities distinguished it from *Licci*, "and takes it outside the usual rule that 'banks do not owe non-customers a duty to protect them from the intentional torts committed by their customers.'" The court stated that, because on a motion to dismiss it was required to accept the facts alleged in the complaint as true, it was immaterial that Bank of China denied having actual knowledge and "denigrat[ed] the quality of the evidence supporting the allegation."

The court stated that it agreed with Bank of China's contention that, prior to the 2005 meeting, the "red flags" alleged by plaintiff "would, at best, impute constructive knowledge" to Bank of China and, citing *In re Agape Litig.*, 681 F. Supp. 2d 352, 364 (E.D.N.Y. 2010), this would not be sufficient for liability. As

such, the court found that, insofar as one of the attacks alleged in the complaint occurred before Bank of China allegedly had actual knowledge, these claims may be subject to dismissal at a later date. The court stated, however, that dismissal would not be appropriate until discovery was completed concerning Bank of China's knowledge of Shurafa's terrorist activities.

Lastly, the court rejected Bank of China's *forum non conveniens* argument. Citing *Islamic Republic of Iran v. Pahlavi*, 62 N.Y.2d 474, 479 (1984), the court stated that the relevant factors are the potential hardship to the defendant, the unavailability of an alternative forum, the residence of the parties, and whether "the transaction out of which the cause of action arose occurred primarily in a foreign jurisdiction." "Generally, unless the balance is strongly in favor of the defendant, the plaintiff's choice of forums should rarely be disturbed." The court held that Bank of China did not meet its burden in showing that New York was an inconvenient forum as it has three branches in New York, and noted that where a party is a "multinational corporation[]" with ample resources, any hardship in bringing documents or witnesses to New York is generally minimal." Citing *Georgia-Pacific Corp. v. Multimark's Intl.*, 265 A.D.2d 109 (N.Y. 1st Dep't 2000), the court also found that the potential use of a New York banking facility to effectuate the wire transfers provided for a "sufficient nexus to the state." Lastly, citing *Rostuca Holdings v. Polo*, 246 A.D.2d 475 (N.Y. 1st Dep't 1998), the court held that New York was an appropriate forum because Bank of China was already conducting discovery in New York in the *Wultz* action.

## Conclusion

While banks generally do not have a duty to protect non-customers from the intentional torts of their customers, the court in *Elmaliach* took the view that a bank may be liable for not taking action where it has actual knowledge that it is funding such a wrong. Accordingly, financial institutions should be on notice that, if they provide financial services to individuals or groups who partake in terrorist activities, they may be amenable to claims, including those based on foreign law. To reduce the risk of liability, financial institutions should be conscious of who it provides banking services to, and should take warnings seriously if approached concerning potential terrorism-related transactions. ☺

# Bank that Allegedly Aided Madoff Avoids RICO Claim

By Gerald D. Silver and Caroline Pignatelli

Addressing an issue of first impression in the Second Circuit, the court in *MLSMK Investment Company v. JP Morgan Chase & Co.*, 2011 WL 2640579 (2d Cir. 2011), recently held that the plaintiff was barred by Section 107 of the Private Securities Litigation Reform Act (the “PSLRA”), 18 U.S.C. § 1964(c), from asserting a civil Racketeering Influenced and Corrupt Organizations Act (“RICO”) claim against a bank that allegedly aided the Ponzi scheme perpetrated by Bernard L. Madoff (“Madoff”). The court found that allegations of securities fraud, upon which plaintiff based its predicate act allegation to support its RICO claim, was insufficient even though the plaintiff was legally precluded from bringing a private securities claim against the bank.

## Facts & Procedural History

Plaintiff MLSMK Investment Company (“MLSMK”) allegedly invested \$12.8 million with Madoff’s investment company between October and December 2008. Defendants JP Morgan Chase & Co. and JP Morgan Chase Bank, N.A. (collectively, “JPMC”) allegedly were trading partners with Madoff’s market-making business and the bank where Madoff’s investment company’s account was maintained. MLSMK allegedly lost its entire investment on December 11, 2008, when Madoff’s assets were seized.

On April 23, 2009, plaintiff filed suit in the United States District Court for the Southern District of New York against JPMC alleging New York state law claims for aiding and abetting breach of fiduciary duty, commercial bad faith and negligence. Plaintiff also asserted a federal claim that JPMC had conspired with Madoff in violation of RICO, and sought treble damages in connection with its RICO claim. In support of its claims, the complaint alleged that in late Summer 2008, JPMC became suspicious of Madoff and undertook a due diligence investigation of Madoff’s business activities which revealed that “Madoff’s investment business was a thoroughly fraudulent enterprise.” The complaint further alleged that from about September 2008 to December 2008 JPMC conspired to violate RICO by “knowingly and purposely conspir[ing] with Madoff to further Madoff’s racketeering enterprise by providing Madoff with banking services that were integral to the functioning of

the racketeering enterprise and by engaging in various RICO predicate acts, including numerous interstate wire communications, for which the defendants were paid substantial fees . . . derived entirely from Madoff’s racketeering enterprise.”

JPMC moved to dismiss the entire complaint under Rule 12(b)(6) of the Federal Rules of Civil Procedure. Specifically, JPMC argued that plaintiff has not adequately plead the required elements of the state law claims, and that the RICO claim was barred by Section 107 of the PSLRA, 18 U.S.C. § 1964(c) (the “RICO Amendment”). The district court dismissed the complaint in its entirety. With respect to the RICO claim, the district court concluded that plaintiff had failed to plead adequately the defendants’ requisite state of mind.

Plaintiff appealed the district court’s decision to the Second Circuit Court of Appeals. By summary order dated June 6, 2011, *MLSMK Inv. Co. v. JP Morgan Chase & Co.*, No. 10-3040-cv, 2011 WL 2176152 (2d Cir. June 6, 2011), the Second Circuit affirmed the District Court’s dismissal of the state law claims. In a July 7, 2011 decision, the Second Circuit addressed plaintiff’s RICO claim.

## Discussion

The legal issue in dispute in connection with the RICO claim was the scope of the RICO Amendment’s bar of civil RICO claims based upon allegations of securities fraud. The RICO Amendment provides that “no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962.” 18 U.S.C. § 1964(c). The Second Circuit explained that, prior to the RICO Amendment, plaintiffs “regularly” elevated claims for securities violations based upon fraud to RICO violations to take advantage of the treble damages provided for RICO violations (citing *Bald Eagle Area Sch. Dist. v. Keystone Fin., Inc.*, 189 F.3d 321, 327 (3d Cir. 1999)). The court further explained that the RICO Amendment “changed the use of that tactic” by barring plaintiffs from bringing civil RICO claims based upon allegations of securities fraud.

The court addressed the issue of whether an exception exists to the RICO Amendment bar “where, as here, the plaintiff cannot bring a securities fraud claim against the defendant because the plaintiff alleges only an aiding and abetting claim, which cannot serve as a basis for a private right of action.” JPMC argued that the bar applies to “claims based on conduct that could be actionable under the securities laws even when the [particular] plaintiff . . . cannot bring a cause of action under the securities laws,” whereas the plaintiff argued that

the viability of a RICO claim turns on the claims available against the defendant. The court observed that, while the Second Circuit had not previously addressed the issue, there was inconsistency among the district court judges within the Second Circuit. Specifically, the court stated that at least three district court decisions in the Second Circuit had accepted the argument advanced by JPMC, whereas at least two district court decisions in the Second Circuit had interpreted the RICO Amendment bar more narrowly.

In support of JPMC's arguments, the Second Circuit pointed to the district court cases of *Fezzani v. Bear Stearns & Co.*, 2005 WL 500377, 2005 U.S. Dist. LEXIS 3266 (S.D.N.Y. Mar. 2, 2005), *Thomas H. Lee Equity Fund V, L.P. v. Mayer Brown, Rowe & Maw LLP*, 612 F. Supp. 2d 267 (S.D.N.Y. 2009), and *Cohain v.*

'so long as [plaintiffs] are pursuing aiders and abettors[, ]they may proceed under RICO' because their securities claims are not actionable—is 'treacherous.'" Consistent with *Fezzani*, the Second Circuit further explained that, in *Thomas H. Lee* the court noted that language of the RICO Amendment does not support the argument that "for a RICO claim to be barred, the plaintiff who sues under RICO must be able to sue under securities laws, or that the conduct 'actionable as securities fraud' on which the plaintiff relies to establish the RICO violation must be that of the defendant." Finally, the *Thomas H. Lee* court seemed to suggest that the narrower interpretation of the RICO Amendment would be inconsistent with Congressional intent. The Second Circuit observed that the *Thomas H. Lee* court had concluded:

**The court found that allegations of securities fraud, upon which plaintiff based its predicate act allegation to support its RICO claim, was insufficient even though the plaintiff was legally precluded from bringing a private securities claim against the bank.**

*Klimley*, 2010 WL 3701362, 2010 U.S. Dist. LEXIS 98870 (S.D.N.Y. Sept. 20, 2010). The court explained that the *Fezzani* court rejected, as inconsistent with Congress's purpose, the particularly narrow interpretation of the RICO Amendment which would allow civil RICO claims based upon aiding and abetting securities fraud. The *Fezzani* court also specifically rejected MLSMK's argument made in this case that plaintiffs should be able to pursue RICO claims against the aider and abettor because the securities laws do not create a provide cause of action for aiding and abetting securities fraud. The court further explained that the rationale for the *Fezzani* court decision was the court's concern that "if it were to accept the plaintiffs' interpretation, a plaintiff could too easily manipulate a complaint to skirt the RICO Amendment's limitations."

The Second Circuit explained that the district court in *Thomas H. Lee* adopted the reasoning of *Fezzani* determining that an interpretation of the RICO Amendment "under which

It would be strange indeed if Congress, in a statute that otherwise bars private causes of action under RICO for predicate acts that describe conduct actionable as securities fraud, nevertheless chose to allow enhanced RICO remedies—treble damages and attorneys' fees—against only the very parties that Congress simultaneously made immune from private suit under the securities laws. The better interpretation—and the one supported by the plain meaning of § 107 [of the PSLRA]—is that the RICO Amendment bars claims based on conduct that could be actionable under the securities laws even when the plaintiff, himself, cannot bring a cause of action under the securities laws.

The Second Circuit noted that the district court in *Cohain* similarly adopted the interpretation of the RICO Amendment set forth in *Thomas H. Lee* and *Fezzani*. / continued page 6

## Bank Avoids RICO Claim

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In contrast, in support of plaintiff's more narrow interpretation of the RICO Amendment, the Second Circuit pointed to *OSRecovery, Inc. v. One Groupe Int'l Inc.*, 354 F. Supp. 2d 357 (S.D.N.Y. 2005), and *Renner v. Chase Manhattan Bank*, 1999 WL 47239, 1999 U.S. Dist. LEXIS 978 (S.D.N.Y. Feb. 3, 1999). The court explained that the district court in *OSRecovery* interpreted the RICO Amendment to bar only RICO claims based on predicate acts of securities fraud that the plaintiffs could have pursued as securities claims against the defendant. The Second Circuit further explained that the *OSRecovery* court thought the relevant question under the RICO Amendment to be whether the specific defendant's alleged conduct is actionable under the securities laws. Therefore, the *OSRecovery* court concluded that because there is no private right of action for aid-

cumstances where the plaintiffs pled fraud and securities claims in the alternative, in contrast to this case where the plaintiff pleaded only a civil RICO claim. Although the Second Circuit acknowledged the factual difference in the cases, it explained that the decisions were not limited to concerns about gamesmanship in pleadings and analyzed the meaning of the statutory language independently from the specific facts of the cases before them. Further, the court was not swayed by plaintiff's reliance on *OSRecovery*. The court noted that plaintiff did not seem to consider JPMC's interpretation of the RICO Amendment, which was accepted by the district court in *Thomas H. Lee* and *Fezzani*, nor "that it was Congress's intention that the applicability of the RICO amendment to a plaintiff's civil RICO claim would not depend on the plaintiff's ability to bring a private securities law action against a particular defendant."

**In *MLSMK Investment*, the Second Circuit settled a simmering disagreement within the Circuit about whether the RICO Amendment bars a plaintiff from asserting a civil RICO claim premised upon predicate acts of securities fraud, including mail or wire fraud, even where the plaintiff could not bring a private securities law claim against the defendant.**

ing and abetting under the securities laws, the RICO Amendment does not bar such claims. The Second Circuit noted that *Remmer* similarly determined that the RICO Amendment did not bar the RICO claim because the plaintiff's aiding and abetting claim did not provide a valid basis for a securities claim and would not have been actionable under the securities laws.

Ultimately, the Second Circuit agreed with JPMC that the reasoning of the district courts in *Fezzani* and *Thomas H. Lee* is persuasive and concluded that the RICO Amendment bars civil RICO claims alleging predicate acts of securities fraud, including aiding and abetting securities fraud, even where a plaintiff cannot pursue a securities fraud claim against the defendant. The court rejected plaintiff's attempt to distinguish *Thomas H. Lee* and *Fezzani* on the grounds that those cases involved cir-

Additionally, the Second Circuit explained that the plain language of the RICO Amendment "does not require that the same plaintiff who sues under RICO must be the one who can sue under securities laws; its wording . . . does not make such a connection" (quoting *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp. 2d 511, 620 (S.D. Tex. 2003)). The court further agreed that the RICO Amendment is worded broadly and does not indicate that Congress intended it to be applied in the limited manner that plaintiff urged.

Next, although the Second Circuit found the language of the RICO Amendment to be unambiguous, it noted that the legislative history of the RICO Amendment supported its holding. Specifically, the court explained that the Conference Committee Report provides that Congress intended that the section would eliminate securities fraud as a predicate offense

in a civil RICO action (*citing* H.R. Rep. 104–369, at 47 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 746.). The court noted further that the Committee explained that the purpose of the RICO Amendment was to remove as a predicate act of racketeering *any conduct* that would have been actionable as fraud in the purchase or sale of securities as racketeering activity under civil RICO (*citing id.*; accord S. Rep. 104–98, at 19, 1995 U.S.C.C.A.N. at 698). The court explained that “Congress did not say that it was removing *any claim* that would have been actionable” rather “[i]ts focus was on the behavior alleged to satisfy RICO’s predicate-act requirement.” The court further explained that the Senate Report made clear that Congress was aware that the RICO Amendment would bar some claims, including aiding and abetting securities law violations. Finally, the court commented that its decision is consistent with analogous cases in other circuits.

## Conclusion

In *MLSMK Investment*, the Second Circuit settled a simmering disagreement within the Circuit about whether the RICO Amendment bars a plaintiff from asserting a civil RICO claim premised upon predicate acts of securities fraud, including mail or wire fraud, even where the plaintiff could not bring a private securities law claim against the defendant. In ruling that it does, the court affirmed the judgment of the district court dismissing the RICO claim against JPMC. ☺

# Public Side/Private Side Wall Helps Defeat Breach of Loyalty Claim

By Thomas J. Hall

A New York federal court recently ruled that an information barrier in place between the “public” and “private” sides at JPMorgan Chase Bank (“JPMC”) was adequate to prevent public trust group personnel from obtaining material non-public information from JPMC’s private investment business. As such, the court found that a claim that JPMC breached its duty of loyalty by investing its client’s assets in notes of a company to which its private side extended billions in financing lacked merit. The court found the existence of “wall straddlers” who were aware of transactions on both sides of the wall, did not

change this outcome as any such information passed was not material to JPMC’s investment decisions for its clients. *Board of Trustees of the AFTRA Retirement Fund v. JPM Chase Bank, N.A.*, 09 Civ. 686 (SAS) (S.D.N.Y. Aug. 2011).

## Information Barriers

Since the passage of the Federal Reserve Act in 1913, federal law has permitted national banks to manage and invest trust accounts while at the same time engaging in commercial lending for their own account. Thus, a bank in its trust management function can invest clients’ funds in securities of a corporation while, at the same time, the bank is a lender to that corporation — provided that an information barrier, or Chinese wall, is in place between the two functions to prevent the flow of material, nonpublic information from the commercial department to the trust department. This permissive approach carries over to a variety of federal laws and regulations. For example, the Office of the Comptroller of the Currency (“OCC”) permits the commercial arm of a national bank to make secured loans directly to a fiduciary client. 12 C.F.R. § 9.12(c). The Federal Deposit Insurance Corporation also permits the simultaneous investment of fiduciary assets and commercial bank lending with respect to the same issuer, so long as an information wall is in place. Likewise, the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 1851(d)(1), does not contemplate the disaggregation of banks’ fiduciary asset management and corporate finance functions.

OCC regulations require that national banks exercising fiduciary powers, for example by investing for their clients funds, adopt “[m]ethods for ensuring that fiduciary officers and employees do not use material inside information in connection with any decision or recommendation to purchase or sell any security.” The OCC thus requires that a wall be established to “prevent the passage of material inside information between a bank’s fiduciary department and its commercial department in violation of securities laws and regulations, as well as fiduciary standards.” 12 C.F.R. § 9.5(b)-(c).

## Background

JPMC’s securities lending group, part of the public side of JPMC’s business, manages the accounts of various clients, including the assets of ERISA plans. In June 2007, acting in this fiduciary capacity, JPMC allegedly purchased for certain securities lending clients, using their cash collateral, \$500 million in the June 2009 Medium Term Notes (the / continued page 8

## Public Side/Private Side

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“Notes”) of SIGMA Finance, Inc. (“SIGMA”), a structured finance vehicle. Although SIGMA secured those notes with a floating first priority lien over its assets, SIGMA was contractually entitled to grant superior interests on specific assets to other lenders — thereby making such assets potentially unavailable to support the notes.

Shortly after JPMC’s securities lending group had invested its clients’ funds in SIGMA’s notes, JPMC’s private side investment bank allegedly extended billions of dollars of repo financing to SIGMA. A repo is a form of financing structured as a sale of securities with a simultaneous agreement to repurchase those securities at a later date, thus in effect making the repo

about six cents on the dollar.

### The Lawsuit

Following SIGMA’s collapse, a putative class action suit was brought asserting claims on behalf of JPMC’s securities lending clients whose cash collateral JPMC had invested in the SIGMA notes. The claims included breach of fiduciary duty, breach of loyalty and mismanagement of assets. The class action members governed by ERISA (*i.e.*, member of ERISA plans whose funds were invested in the SIGMA notes) brought these claims pursuant to ERISA, whereas class members not covered by ERISA (non-ERISA plan investors) asserted analogous claims under New York common law. Thereafter, the court certified the class.

**Information barriers are an important aspect of compliance in today’s financial institutions. While the existence of a wall here may not have been the dispositive factor in dismissing the breach of loyalty claim, it clearly was an important element of the court’s reasoning.**

a loan in the amount of the sale proceeds collateralized by the security. Specifically, between February and August 2008, JPMC entered into four agreements extending SIGMA an aggregate of \$8.4 billion in repo financing. In connection with such loans, JPMC allegedly “cherry picked” SIGMA’s assets used to secure that financing, securing the best assets in SIGMA’s portfolio as security for its financings, thereby making those assets unavailable as security for the SIGMA notes.

SIGMA collapsed in September 2008, causing considerable losses to JPMC’s clients. On September 30, 2008, JPMC issued notices of default to SIGMA under its repo agreements. A day later, SIGMA entered receivership, and the receivers later held an auction sale of all of SIGMA’s assets. While JPMC’s investment side allegedly reaped substantial profits from its SIGMA repo loans, the anticipated losses to SIGMA’s noteholders, including JPMC’s securities lending clients, were substantial with an expected recovery of only

The parties cross-moved for partial summary judgment on plaintiffs’ claim that JPMC breached its duty of loyalty by investing its fiduciary clients’ cash collateral in the SIGMA notes while, at around the same time, JPMC extended billions of dollars of repo financing to SIGMA. Plaintiffs further alleged that, as part of its duty of loyalty, JPMC had a duty to disclose to them, and failed to, its role as a repo lender to SIGMA. The plaintiffs alleged that, as repo lender, JPMC “reaped nearly \$2 billion of profits for itself while leaving the class notes virtually worthless.” In response, JPMC argued, among other things, that the information barrier between its securities lending and commercial segments effectively prevented any conflict of interest. The motions did not address, and thus the court did not decide, the viability of plaintiffs’ claim that JPMC failed to prudently manage their assets.

## The Court's Analysis

The court ruled for JPMC and dismissed the breach of loyalty claim.

The court initially observed that a fiduciary, whether under ERISA or common law, is charged with a duty of loyalty pursuant to which it is obligated to give its beneficiary its undivided loyalty, free from any conflicting personal interests. As such, ERISA identifies as a prohibited transaction the fiduciary dealing with its clients' assets in its own interest or for its own account. The court further observed that an ERISA fiduciary has an affirmative duty to inform its clients of information that the fiduciary knows might be harmful to its clients. This includes disclosing a material conflict of interest that may render suspect the advice given by the fiduciary acting in a fiduciary capacity.

The court found, however, that, in extending repo financing to SIGMA, JPMC was not acting in its fiduciary capacity and, thus, no conflict of interest existed. While JPMC acted in a fiduciary capacity when lending out plaintiffs' securities and investing their collateral in the SIGMA notes, JPMC's private side was not acting in that fiduciary capacity in the repo financings. The court found that two Court of Appeals decisions, *Ershick v. United Mo. Bank of Kan. City, M.A.*, 948 F.2d 660 (10th Cir. 1991), and *Friend v. Sunwise Anwa Bank of Cal.*, 35 F.3d 466, 469 (9th Cir. 1994), provided strong support for JPMC's argument that it did not violate its duty of loyalty merely because it acted simultaneously as an investment manager and a secured lender. The court noted that, under this precedent, action by a bank's commercial loan department is not taken in its fiduciary capacity as a trustee. Moreover, these courts found that even direct communications between a bank's commercial department and its trust department about the fact that the commercial side extended secure financing and the fact that the bank served as trustee does not convert the commercial department's actions into actions taken in a fiduciary capacity. Finding no conflict of interest, the court also found that JPMC had no duty to disclose its alleged conflicted status.

The plaintiffs submitted evidence that some information concerning SIGMA had in fact crossed the wall between the public trust group and the private investment bank group. Although JPMC's securities lending personnel were never told by the private side of the bank that JPMC was providing repo financing to SIGMA, several heard rumors in the market place that JPMC was a SIGMA repo lender. Moreover, JPMC's CEO

Jamie Dimon and other high ranking officials of JPMC's investment bank allegedly were aware that the securities lending held SIGMA notes for its clients. The court found this evidence unpersuasive. The court stated that a wall need not be an absolute barrier to all information, but rather is intended to prevent the bank's use of significant non-public information in making investment decisions. JPMC's expert testified that JPMC's status as a repo financier of SIGMA was not material nonpublic information. The court stated:

Preventing banks from aligning their private-and public-side incentives, but then penalizing them when it turns out-or their private side discovers - that their fiduciary clients' money is invested in the same assets in which their public side holds a priority interest, would effectively penalize them for complying with the law.

Separately, the court found a lack of causation between plaintiffs' losses and the alleged breach of loyalty. The court observed that the "notes were not paid because the market tumbled, not because JPMC loaned over \$8 billion to SIGMA at its request." The court added that plaintiffs failed to establish that JPMC would not have extended repo financing or would have prevented SIGMA's bankruptcy if JPMC's security lending department had not served as plaintiffs' fiduciary. The court further found that there was no evidence that JPMC's involvement as a repo lender to SIGMA influenced its public side's management of clients' assets, or that its failure to disclose its status as a repo lender was somehow motivated by the desire to protect itself to the detriment of its fiduciary clients.

## Conclusion

Information barriers are an important aspect of compliance in today's financial institutions. While the existence of a wall here may not have been the dispositive factor in dismissing the breach of loyalty claim, it clearly was an important element of the court's reasoning. This decision thus reinforces the importance of honoring information barriers imposed by public side-private side walls so as to reduce potential liability risks. ☺

# Enron's Prematurity Redemptions of Commercial Paper are not Avoidable in Bankruptcy

By Scott S. Balber and Marcelo Blackburn

The U.S. Court of Appeals for the Second Circuit recently held that prematurity redemptions of commercial paper made by Enron Corp. shortly before it filed for bankruptcy were protected from avoidance by 11 U.S.C. § 546(e)'s safe harbor for securities transaction settlement payments. *In re Enron Creditors Recovery Corp. v. Alfa*, No. 09-5122-bk (2d Cir. June 28, 2011). In so doing, the Second Circuit resolved a clash between the Bankruptcy Code's interest in avoiding preferential debt repayment and the securities industry's interest in preserving transaction finality. The Second Circuit's decision, which addressed a question of first impression in the circuit courts, liberally construes Section 546(e)'s safe harbor to preserve the finality of transactions involving tradable commercial paper and may provide a basis to further extend this safe harbor to encompass other debt securities.

## Enron's Prematurity Redemptions of Commercial Paper

Rumors of Enron's imminent collapse began to circulate in late 2001 after the resignation of its CEO, the announcement of approximately \$600 million in third-quarter losses and the correction of four years of financial statements. In what appears to have been a last ditch attempt to quell market speculation about the company's viability, and in response to what Enron later claimed was coercion by creditors, Enron embarked on a massive program to redeem its commercial paper. Between October 25, 2001 and November 6, 2001, Enron drew down its credit lines to retire more than \$1.1 billion of its unsecured commercial paper prior to the paper's maturity. Enron redeemed the paper at the accrued par value, which was calculated as the purchase price plus accrued interest, an amount that was well above the price at which the paper had been trading. The redemptions were executed through broker-dealers and the commercial paper was extinguished from the bookkeeping entries of Enron's clearing agent, the Depository Trust Company, without Enron taking title to it. Enron subsequently filed for Chapter 11 bankruptcy on December 2, 2001.

## The Bankruptcy and District Court Proceedings

Approximately two years later, Enron (Enron Corp. and the reorganized Enron Creditors Recovery Corp. are collectively referred to herein as "Enron") initiated adversary proceedings against hundreds of financial institutions from which it had redeemed commercial paper. Enron sought to avoid and recover the redemption payments pursuant to 11 U.S.C. § 547(b) on the grounds that they were (1) made on account of an antecedent debt within 90 days prior to bankruptcy and (2) constructively fraudulent transfers under 11 U.S.C. § 548(a)(1)(B), because the redemption price exceeded the commercial paper's fair market value.

The defendant financial institutions moved to dismiss Enron's complaint on the basis that the redemptions were settlement payments protected from avoidance by 11 U.S.C. § 546(e)'s safe harbor. Section 546(e) provides that "the trustee may not avoid a transfer that is a . . . settlement payment, as defined in section . . . 741 of this title." Section 741(8), in turn, defines a settlement payment as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

The Bankruptcy Court denied the defendants' motion to dismiss and held that the Section 546(e) safe harbor did not apply to Enron's redemptions for two reasons. First, it interpreted the phrase "commonly used in the securities trade" in Section 741(8)'s definition of a settlement payment to modify all the terms in the preceding definition, and thus to limit settlement payments to payments that are commonly used in the securities industry. Accordingly, it concluded that evidence was necessary to determine whether Enron's redemption payments were "commonly used" or were extraordinary and resulted from coercion by the noteholders. *In re Enron Corp.*, 325 B.R. 67, 685-86 and n.7 (Bankr. S.D.N.Y. 2005). Second, the Bankruptcy Court concluded that whether Enron's redemptions constituted settlement payments depended on whether the redemption payments were made to retire debt or to purchase commercial paper, which was a question of fact.

Most of the defendant financial institutions settled with Enron after the Bankruptcy Court denied their motion to dismiss. Three institutions, however, Alfa, S.A.B. de C.V. ("Alfa"), ING Balanced Portfolio, Inc. and ING VP Bond Portfolio, Inc. (the two ING entities, "ING"), did not. After discovery, Alfa and ING moved for summary judgment based on Section 546(e)'s safe

harbor. The Bankruptcy Court denied their motions in a decision that held that the safe harbor for settlement payments did not apply to payments made to retire debt, as opposed to payments made to purchase or sell securities. The Bankruptcy Court also emphasized the unusual nature of the payments. *In re Enron Creditors Recovery Corp.*, 407 B.R. 17, 45 (Bankr. S.D.N.Y. 2009).

Alfa and ING were granted leave to pursue an interlocutory appeal to the District Court, which reversed the Bankruptcy Court's decision on the grounds that (1) the definition of "settlement payment" was not limited to "commonly used" payments and (2) the fact that Enron's redemption did not involve a purchase, or acquisition of title to the commercial paper, was not dispositive. *In re Enron Creditors Recovery Corp.*, 422 B.R. 423, 424 (S.D.N.Y. 2009). Enron appealed the District Court's decision to the Second Circuit.

what circularly defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." The Court noted that, under the last antecedent rule of construction, a limiting clause or phrase should ordinarily be read to modify only the noun or phrase that it immediately follows. As a result, the phrase "commonly used in the securities trade" should be read to modify only the immediately preceding phrase "any other similar payment," and not the entire definition of a settlement payment. Enron had invoked another rule of construction in which a modifier set off from a series of antecedents by a comma should be read to apply to each of those antecedents. The court reasoned, however, that the absence of a comma immediately before the clause "commonly used in the securities trade" ren-

**It remains to be seen, however, whether the Second Circuit's opinion will be the last word on the issue. The other circuit courts have yet to address the question, and Judge Koeltl's dissent illustrates the competing argument for limiting the safe harbor to purchases or sales of securities.**

### The Second Circuit's Decision

On appeal, Enron offered three reasons for excluding its pre-maturity redemptions of commercial paper from Section 546(e)'s safe harbor: (1) the safe harbor applied only to payments that were "commonly used in the securities trade," (2) the redemption payments were not settlement payments because they did not involve the purchase or sale of commercial paper, and (3) the redemption payments did not implicate the purpose of the statute.

In a 2-1 opinion, the Second Circuit rejected all of Enron's arguments. The court first analyzed Enron's proposed limitation of settlement payments to payments "commonly used in the securities trade" in light of the statute's grammatical structure and concluded that the lack of a comma precluded Enron's interpretation. The court observed that Section 741(8) some-

dered Enron's proposed rule inapplicable.

Enron's argument that the redemption payments were not settlement payments because they involved the retirement of debt and not the purchase of commercial paper was also unavailing. Enron had relied on the Second Circuit's decision in *SEC v. Sterling Precision Corp.*, 393 F.2d 214 (2d Cir. 1968), which held that a "redemption" did not constitute a "purchase" under the Investment Company Act. But the Second Circuit concluded that whether the redemption constituted a purchase was beside the point, as there was nothing in the Bankruptcy Code requiring that a settlement payment involve either a purchase or a sale. The Second Circuit also rejected Enron's argument that applying the safe harbor to Enron's redemption of commercial paper was inconsistent with well-established case law allowing the avoidance of preferen-

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## Enron's Prematurity Redemptions

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tial debt payments. The court distinguished these precedents on the grounds that Enron's redemptions involved widely-issued debt securities and not the ordinary non-tradable loans that had been the subject of prior avoidance case law.

Finally, the court rejected Enron's argument that its redemptions should be excluded from Section 546(e)'s safe harbor because no financial intermediary had taken a beneficial interest in the securities during the transaction, and thus that avoidance of such transactions would not pose the systemic risk to the securities industry that had motivated Congressional enactment of the safe harbor. The court instead agreed with decisions by three other circuit courts, which had held that undoing transactions would substantially affect the stability of the financial markets even in the absence of a beneficial interest held by a financial intermediary.

The court's decision was not unanimous. In a thorough dissent that touched on industry usage of the term "securities transaction" and the legislative history of Section 546(e), Judge Koeltl (sitting by designation) argued that a "settlement payment" required the purchase or sale of a security, which had not occurred in Enron's redemptions.

### Conclusion

The Second Circuit's decision, and the broad effect it gives to Section 546(e)'s safe harbor, is an important and welcome one for the securities industry. Notably, both the SEC and the Securities Industry and Financial Markets Association, a trade group representing the interest of securities firms, banks and asset managers, had filed amicus briefs in support of Alfa and ING's arguments that the safe harbor applied to redemptions of commercial paper. It remains to be seen, however, whether the Second Circuit's opinion will be the last word on the issue. The other circuit courts have yet to address the question, and Judge Koeltl's dissent illustrates the competing argument for limiting the safe harbor to purchases or sales of securities. Ultimately, a final resolution of the tension between a broad construction of Section 546(e)'s safe harbor and the Bankruptcy Code's interest in avoiding preferential debt repayment may require a decision by the U.S. Supreme Court. ☺

## Securities Fraud Claims Arising from Lehman Collapse Survive Dismissal

*By Thomas J. McCormack and Robert Kirby*

Judge Lewis A. Kaplan of the United States District Court for the Southern District of New York recently granted in part and denied in part a motion to dismiss federal securities law claims brought on behalf of a putative class of purchasers of securities issued by Lehman Brothers Holdings Inc. ("Lehman") prior to its September 2008 collapse. *In re Lehman Bros. Sec. Litig. and ERISA Litig.*, Case No. 09-MD-2017, 2011 U.S. Dist. LEXIS 82119 (S.D.N.Y. 2011). The district court concluded that the complaint stated claims arising from alleged misstatements concerning Lehman's net leverage ratio, which had allegedly been "reduced artificially," thereby misleading investors concerning Lehman's "ability to absorb any losses sustained by its riskiest assets."

### Background

Plaintiffs are a putative class of individuals, pension funds and companies that purchased the more than \$31 billion in Lehman debt and equity securities issued pursuant to a shelf registration statement and base prospectus dated May 30, 2006, and various supplements thereto. Plaintiffs seek to recover for their losses from Lehman's former officers and directors, Lehman's outside auditor, and the 51 entities that underwrote the offerings in which the securities at issue were purchased. Plaintiffs' complaint, as amended April 23, 2010, in the wake of the issuance of a nine-volume report by the court-appointed examiner in the Lehman bankruptcy proceeding, alleges violations of the Securities Act of 1933 and Section 10(b)(5) and other provisions of the Securities Exchange Act of 1934 arising from false and misleading statements allegedly contained in Lehman's offering materials and financial statements. The complaint alleges that those misleading statements concerned, among other things, Lehman's accounting treatment of so-called "Repo 105" transactions and their effect on Lehman's reported net leverage (*i.e.*, the ratio of its net assets to tangible equity capital).

A repurchase agreement (also known as a "repo") is a two-step transaction used to obtain short term funding. In the first step, the borrower transfers specified securities to the counter-

party in exchange for a cash payment, with an agreement to later reacquire the transferred securities. In the second step, the borrower repays the original cash payment plus interest and the counter party returns the securities. According to the complaint, Lehman would ordinarily account for repo transactions as financings, with the collateral (*i.e.*, the transferred securities) remaining on Lehman's balance sheet as assets.

Repo 105 was a type of repo transaction that, according to the complaint, Lehman repeatedly used "near the ends of its quarterly reporting periods solely to lower its net leverage" to "present Lehman as being in a stronger financial position than it actually was." Unlike with respect to an "ordinary" repo transaction, the collateral transferred by Lehman in a Repo 105 transaction was treated for accounting purposes "as though it actually had been sold and therefore removed from Lehman's balance sheet." This treatment allegedly artificially decreased

### Complaint States Claims of Material Misstatements

To survive a motion to dismiss, plaintiffs claims under Section 10(b)(5) of the Exchange Act needed to allege adequately that the defendants "in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that the [plaintiffs'] reliance on the [defendants'] action caused injury to the plaintiff." The district court concluded that the allegations in the complaint were sufficient to state a claim against Lehman's former officers under this standard.

The district court found that the complaint adequately alleged misstatements including, among others, misstatements based on Lehman's "use of and accounting for Repo 105 transactions and their effect on net leverage." Lehman's offering materials and financial statements stated "(1) Lehman's

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Lehman's net leverage ratio because "it reduced net assets by the 'sale' of the 'collateral'" and, moreover, the cash received from a Repo 105 transaction was used to pay down other liabilities. Lehman allegedly would execute the second step of the Repo 105 transaction within days after the quarter closed, reacquiring the collateral and thereby "returning its net leverage to the pre-Repo 105 level." Plaintiffs allege that, as a result of this process, Lehman's statements of its quarter-ending net leverage ratios were "false and materially misleading" because they failed to disclose that "the ratio had been reduced artificially by the Repo 105 transactions."

Defendants moved to dismiss the complaint in its entirety for failure to stay a claim upon which relief may be granted.

net leverage and amount of securities it sold under agreements to repurchase as of the end of each quarter, (2) that Lehman prepared its financial statements in accordance with GAAP, and (3) that Lehman treated securities sold under repurchase agreements as financings." Moreover, during investor conference calls certain of Lehman's executives allegedly represented that its net leverage reduction came in large part from a "reduction of assets across the Firm." According to plaintiffs, these statements were false and misleading because Lehman "failed to disclose its use of Repo 105 transactions and its temporary effect of reducing Lehman's net leverage" and thereby "presented a misleading picture of the company in violation of GAAP."

The district court concluded that the "repetitive, temporary, and undisclosed reduction of net lever- / continued page 14

## Securities Fraud Claims

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age at the end of each quarter is sufficient to make out a claim that the Offering Materials and oral statements about net leverage violated the overriding GAAP requirement to present the financial condition of the company accurately, assuming the changes in net leverage that resulted from the Repo 105 transactions were material.” Moreover, whether the changes in net leverage were material is a “fact-specific inquiry” that should not be decided at this stage of the litigation “unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.” This was not such a case. The district court rejected defendants’ contention that the changes in net leverage due to the Repo 105 transactions were immaterial as a

the end of each reporting period, in amounts that increased as the economic crisis intensified, to affect a financial metric that allegedly was material to investors, credit rating agencies, and analysts support a strong inference that [Lehman’s officers] knew, or were reckless in not knowing, that use of the Repo 105 transactions and the manner in which they were accounted for painted a misleading picture of the company’s finances.”

Finally, the plaintiffs adequately alleged an injury caused by these misrepresentations. The district court rejected defendants’ argument that the decline in Lehman’s stock price and its ultimate collapse were caused not by any of the misrepresentations alleged in the complaint but instead by “market-wide phenomenon,” namely the “crisis in the subprime market that spread to the rest of the real estate market” and led to the

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matter of law because Lehman’s offering materials contained cautionary language that the overall size of Lehman’s balance sheet would “fluctuate from time to time and might be higher than the year-end or quarter-end amounts.” Though this was, in the district court’s view, the defendants’ “strongest argument” concerning materiality, it was unavailing because the cautionary language “was not sufficiently specific or prominent to support a conclusion as a matter of law that no reasonable investor would have found it important to know that Lehman engaged in transactions, the effect of which was to reduce temporarily its net leverage at the end of each reporting period.”

The complaint also gave rise to an inference of scienter (*i.e.*, an intent to deceive, manipulate, or defraud) with respect to its alleged material misstatements. Specifically, the complaint’s allegations that Repo 105 transactions “were used at

“collapse of the financial markets generally.” As an initial matter, plaintiffs were not required to allege that their entire loss was caused by the defendants’ misstatements. Furthermore, even though it could “be said with some assurance that Lehman, given the assets it held, would have been in trouble in any case, it is entirely plausible to conclude . . . from the facts alleged in the [complaint] that the misleading picture that Lehman portrayed played a material part in keeping its stock higher during the class period than it otherwise would have been.” As such, “plaintiffs are entitled to an opportunity to attempt to prove that some ascertainable amount of the losses they suffered was attributable to th[is] allegedly false picture of relative security.”

The complaint’s related claims under the Security Act against the former officers and directors of Lehman and the underwriters were also deemed adequate to survive the

motion to dismiss. The Securities Act claims were “based principally on the same categories of alleged misstatements and omissions” relied upon in support of the complaint’s Exchange Act claims and, accordingly, the complaint “alleges misstatements and omissions sufficiently under the Securities Act to the same extent that it does so under the Exchange Act.”

### Complaint also States Claims Against Auditors

The district court also found the allegations in the complaint adequate to state a claim under Section 10(b)(5) of the Exchange Act against Ernst & Young, Lehman’s outside auditor during the relevant period. The complaint alleged in part that opinions issued by Ernst & Young that Lehman’s financial statements were in compliance with U.S. generally accepted accounting principles (“GAAP”) were materially false and misleading because those financial statements in fact did not comply with GAAP.

The district court first clarified that Ernst & Young’s opinions indicated only its belief that Lehman’s financial statements were in compliance with GAAP and, accordingly, allegations that Lehman “violated GAAP in preparing its financial statements are not sufficient, in and of themselves, to state a claim that an auditor’s opinion of GAAP compliance is a factual misstatement.” The complaint must also “set forth facts sufficient to warrant a finding that the auditor did not actually hold the opinion it expressed or that it knew that it had no reasonable basis for holding it.” Here, the district court found that plaintiffs had “sufficiently alleged that [Ernst & Young] knew enough about Lehman’s use of Repo 105s to ‘window-dress’ its period-end balance sheets to permit a finding that [Ernst & Young] had no reasonable basis for believing that those balance sheets fairly presented the financial condition of Lehman.”

This finding relied in large part on allegations concerning an interview that Ernst & Young had conducted with Matthew Lee, a Lehman senior vice president, on June 12, 2008. According to the complaint, Lee told Ernst & Young during that interview “that Lehman moved \$50 billion of inventory off its balance sheet at quarter-end through Repo 105 transactions and that these assets returned to the balance sheet about a week later.” If these allegations are true, then Ernst & Young “arguably was on notice by June 2008 that Lehman had used Repo 105s to portray its net leverage more favorably than its financial position warranted, a circumstance that could well have resulted in the published balance sheet for that quarter being inconsistent with GAAP’s overall requirement of fair presentation.”

### Conclusion

Judge Kaplan’s recent decision to allow several federal securities claims to move forward in the sprawling, multi-district *In re Lehman Bros. Securities Litigation and ERISA Litigation* is a reminder of the continued potential exposure of financial institutions and their auditors to liability for losses suffered by investors in the wake of the 2008 financial crisis (and any future financial crises). With the added benefit of hindsight, investors may in some circumstances be able to allege sufficient facts to survive a motion to dismiss, even under the heightened pleading standards that govern federal securities claims. ☺

## New York Appellate Court Rejects Validity of Loan Assignments by MERS

By Jonathan Cross and Stacey Trimmer

The New York Appellate Division, Second Department, has held that a lender does not have standing to commence a foreclosure action when the lender’s assignor was listed in the underlying mortgage instruments as a nominee and mortgagee for the purpose of recording, but never actually held the underlying notes. *Bank of New York v. Silverberg*, 926 N.Y.S.2d 532 (2d Dep’t 2011). The court’s decision casts doubt on the validity of loan assignments executed by the Mortgage Electronic Registration System (“MERS”), and has significant ramifications for the foreclosure process in New York, suggesting that foreclosing lenders may have to present substantially more robust documentation concerning the mortgage note’s history of assignment and transfer.

### The Mortgage Agreements

In October 2006, Countrywide Home Loans, Inc. (“Countrywide”) allegedly loaned \$450,000 to Stephen and Frederica Silverberg (“defendants”) to purchase residential real property. The mortgage named MERS as the mortgagee for purposes of recording, but stated that the underlying promissory note was in favor of Countrywide. The mortgage stated: “MERS holds only legal title to the rights granted by the [defendants] . . . but, if necessary to comply with law or custom,” MERS had the right to foreclose / continued page 16

## Validity of Loan Assignments

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and “to take any action required of [Countrywide].” Subsequently, in April 2007, the defendants allegedly signed a second mortgage on the same property, which again named MERS as the nominee and mortgagee of Countrywide, and executed a promissory note in Countrywide’s favor. The promissory note provided that Countrywide “may transfer this Note.”

In April 2007, the defendants signed a consolidation agreement which merged the two prior notes and mortgages into one loan obligation, once more naming MERS as nominee and mortgagee of Countrywide. While the consolidation agreement named Countrywide as the lender and note holder,

MERS and Countrywide did not transfer or endorse the notes described in the consolidation agreement to plaintiff, in violation of the Uniform Commercial Code; (ii) MERS never had authority to assign the mortgages; (iii) the mortgages and notes were unenforceable because they were bifurcated; and (iv) the trial court should not have considered the “corrected assignment of mortgage” because it was not authenticated.

### Role of MERS

The Appellate Division first described the role of MERS in the mortgage process. Real estate mortgage participants created MERS in the 1990’s to “track ownership interests in residential mortgages.” MERS members subscribe to the MERS system for electronic processing and tracking of ownership and transfers of mortgages. As part of membership, members agree to

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Countrywide was not a party to this agreement. All of these agreements were recorded in the Suffolk County, New York Clerk’s office. In December 2007, the defendants allegedly defaulted on the consolidation agreement. On April 30, 2008, MERS assigned the consolidation agreement to the Bank of New York (“BoNY”), as trustee for a mortgage securitization vehicle, through a “corrected assignment of mortgage.”

### Foreclosure Action

On May 6, 2008, BoNY brought a foreclosure action against defendants. The defendants moved to dismiss the complaint for lack of standing. The trial court denied the motion to dismiss because MERS assigned the mortgages, as nominee of Countrywide, to BoNY before the foreclosure action commenced. The defendants appealed this decision and set forth several arguments as to the plaintiff’s lack of standing: (i)

appoint MERS as an agent for all mortgages registered with MERS. Further, in local county recording offices MERS is named the mortgagee of record. With the creation of MERS, banks were able to transfer mortgage interests more expeditiously and avoid the expense and inefficiency of recording each time a transfer occurs.

### The Court’s Analysis

The Appellate Division presented the issue in the case as “whether MERS, as nominee and mortgagee for purposes of recording, can assign the right to foreclose upon a mortgage to a plaintiff in a foreclosure action absent MERS’s right to, or possession of, the actual underlying promissory note.” Generally, “in a mortgage foreclosure action, a plaintiff has standing where it is both the holder or assignee of the subject mortgage and the holder or assignee of the underlying note at

the time the action is commenced.” The court noted that while a mortgage typically follows the assignment of a promissory note, the reverse is not true. A transfer of a mortgage does not automatically transfer the note, and the underlying debt will be a nullity if not transferred along with the mortgage.

First, the court rejected the defendants’ argument that BoNY did not own the notes and mortgages based on the failure to provide proof of recording the corrected assignment, because an assignment need not be in writing; physical delivery will also effectuate an assignment. The court then found, however, that the consolidation agreement did not give MERS authority to assign the notes. Specifically, “as ‘nominee,’ MERS’ authority was limited to only those powers which were specifically conferred to it and authorized by the lender . . . . Hence, although the consolidation agreement gave MERS the right to assign the mortgages themselves, it did not specifically give MERS the right to assign the underlying notes.” The court determined that assignment of the notes was beyond MERS’ authority as nominee. Moreover, the record failed to show that the notes were physically delivered to MERS. Thus, because BoNY “merely stepped into the shoes of MERS,” BoNY had an interest only in the mortgages — not the notes — leaving BoNY without the power to foreclose.

Furthermore, the court commented that its earlier decision in *MERS v. Coakley*, 41 N.Y.S.2d 622 (2d Dep’t 2007), holding that MERS’ standing to foreclose is limited to circumstances where MERS actually holds the note before a foreclosure action is commenced. In the *BoNY* case, MERS never held the note, and thus the court found that *Coakley* did not apply. Even though BoNY contended that the language in the first and second mortgages gave MERS the right to foreclose, the consolidation agreement superseded those mortgages. Either way, broad language “cannot overcome the requirement that the foreclosing party be both the holder or assignee of the subject mortgage, and the holder or assignee of the underlying note, at the time the action is commenced.”

The court concluded that the corrected assignment was a nullity as MERS was never the lawful holder or assignee of the notes described in the consolidation agreement, and therefore did not have authority to assign the power to foreclose to plaintiff. Thus, plaintiff did not have standing to foreclose and the court granted defendants’ motion to dismiss.

## Conclusion

The Appellate Division’s *Silverberg* decision may have broad implications for New York foreclosure practice. The decision

suggests that, before commencing foreclosure proceedings, lenders must pay more careful attention to the documentation demonstrating that the entity bringing foreclosure proceedings holds the note and the mortgage in question. Where this documentation is arguably deficient, such deficiencies may often be curable, but where prior lenders in the chain of assignment have ceased to exist, or refuse to cooperate to remedy possible documentary deficiencies, the Appellate Division approach may significantly complicate efforts to foreclose on real property.

Other New York courts have upheld note assignments executed by MERS, and the *Silverberg* decision adds to a substantial body of conflicting authority regarding the question of MERS’ standing to bring foreclosure proceedings, and to assign mortgages and notes to entities that subsequently bring such proceedings. Compare *In re Agard*, 44 B.R. 231 (Bank. E.D.N.Y. 2011) (concluding that MERS lacks authority to assign mortgage notes) and *LaSalle Bank N.A. v. Bouloute*, 28 Misc. 3d 1227A (N.Y. Kings Co. 2010) (holding that a MERS assignee lacked standing to foreclose because MERS had limited agency powers) with *Bank of New York v. Sachar*, No. 0380904/2009 (N.Y. Bronx Co. 2011) (finding that MERS had broad power to assign mortgage and assignee took physical delivery of the note) and *U.S. Bank v. Flynn*, 27 Misc. 3d 802 (N.Y. Suffolk Co. 2010) (upholding MERS assignment of mortgage and note). Until the New York Court of Appeal, New York’s highest court, rules on these issues, the state of the law in New York concerning foreclosure standing is likely to remain unsettled. ☺

## New York Federal Courts Split on Mortgage-Backed Securities Class Action Certifications

By Scott S. Balber and Michael Samalin

A conflict has emerged in a trio of class certification rulings filed this year in the United States District Court for the Southern District of New York. Three cases with similar facts and theories split two-to-one in favor of granting class certification to mortgage-backed securities (“MBS”) investors. The courts differed on the quality of / continued page 18

## Mortgage-Backed Securities

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evidence defendants must put forward to raise the certification-defeating question of whether some portion of the proposed class knew about purported misrepresentations.

Before the last of these decisions, MBS litigants had cause to believe there was a general trend away from class certification in these cases. In 2006, the Second Circuit Court of Appeals had de-certified a securities class and tightened the standards for certification. *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006) (“*IPO*”). In January 2011, the first Southern District decision in an MBS investor class action denied certification. Numerous individual MBS case filings followed, as well as the Supreme Court’s well publicized decision de-certifying a class in the Wal-Mart employment discrimination case. *Wal-*

under Section 11 of the Securities Act of 1933, for alleged misrepresentations in offering documents. Section 11 claims may be defeated with proof that purchasers were aware of the falsity of the representations or of the purported omissions at the time of the sale. Where plaintiffs within a proposed class differed in their knowledge, a court may find that individual knowledge determinations must be made and that such determinations will predominate over class issues. The Southern District split centered on this point.

### The Second Circuit De-Certification Precedent

The significant precedent for these three cases was the Second Circuit decision in *IPO*. That case turned on the same issue faced by the three subsequent Southern District cases.

*IPO* concerned alleged schemes, undisclosed in registration statements and offering documents, by which underwriters

**These three Southern District cases dealt with very similar facts and differed somewhat on the quality of their evidentiary submissions, but they also appear to differ in their interpretation of the applicable standard.**

*Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (“*Wal-Mart*”).

The two most recent Southern District cases, however, may have shifted the current back in plaintiffs’ favor. The conflict is now headed toward a possible resolution by the United States Court of Appeals for the Second Circuit.

### Class Action Certification Standard

A federal court considering a class certification motion must first determine whether the claims meet four threshold requirements commonly referred to as numerosity, commonality, typicality and adequacy. If these threshold requirements are satisfied, as they were in each of the three Southern District cases, the court may then certify a class if questions of law common to the class predominate over individual issues, and if a class action would be superior to other available methods of adjudication.

All three Southern District cases involved claims brought

increased their profits from initial public offerings. The underwriters allegedly required investors who wished to receive an allocation of shares in an offering to agree to buy additional shares in the secondary market. Plaintiff investors who had made such purchases brought claims under Section 11 for failure to disclose the scheme in registration statements. Plaintiffs pleaded that potential class members did not know about the scheme when they purchased. According to the Second Circuit, however, the pleadings themselves established the contrary as the plaintiffs had alleged an “industry-wide understanding” that the scheme existed. The scheme, as alleged, actually required the investors to know of it in advance because the investors had to agree to make aftermarket purchases before they would get an allocation to buy. Furthermore, discovery showed that cable news programs, Barron’s newspaper and even an SEC Staff Bulletin had discussed the aftermarket purchase requirements. The court

concluded that “the broad extent of knowledge of the scheme throughout the community of market participants and watchers ... would precipitate individual inquiries as to the knowledge of each member of the class,” defeating class certification. The Second Circuit did not elaborate, however, on how specific that knowledge must be.

## Factual Background of the Three Southern District Cases

All three Southern District cases involved series of pass-through certificates that permit holders to collect principal and interest payments from a pool of residential home equity loans that are secured by mortgages. Two factors largely determine the certificates’ ultimate value, the ability of the underlying borrowers to make their payments, and the market price of the collateral. Defendants in these cases generally purchased the home equity loans from originators, deposited the loans into trusts, and securitized the cash flows through the certificates. Defendants then sold the certificates to investors in registered offerings. Within months after each of the offerings, the complaints alleged, delinquency and default rates on the underlying home equity loans began to rise, impeding cash flows and degrading the value of the certificates. Plaintiffs have attributed their losses to loan originators who failed to assess borrower credit or the fair value of the mortgaged properties, practices that plaintiffs claim “flagrantly violated underwriting guidelines” set forth in the relevant offering documents.

## One Southern District Court Denies Class Certification

The first of the three Southern District class certification decisions was *New Jersey Carpenters Health Fund, v. Residential Capital, LLC*, 272 F.R.D. 160 (S.D.N.Y. Jan. 18, 2011) (“*Residential Capital*”). In the case, investors in mortgage-backed pass-through certificates brought a purported class action against underwriters alleging that the offering documents falsely represented the underwriting standards used in residential home loan originations. The court found that the threshold requirements supporting class certification were met, and moved on to consider whether issues that could be determined for the class as a whole predominated. As in *IPO*, the critical issue was knowledge.

In his decision, Judge Harold Baer Jr., detailed the evidence that one plaintiff’s investment advisor, Western Asset Management Company (“WAMCO”), had knowledge about

lowered underwriting standards in the MBS market. A WAMCO representative testified that its analysts regularly met with mortgage originators, including the largest originator with respect to the certificates at issue, for the purpose of discussing their origination standards and field practices. According to the court, WAMCO’s witness testified that they had been closely following the deterioration in underwriting standards for years, and knew of the heightened risks. The court observed that many of the other putative class members were also “steeped in the mortgage-backed securities market.” On this basis, the court concluded that individual issues concerning knowledge would predominate over common issues, and denied certification to the proposed class.

## A Southern District Decision Favors Certification

In June 2011, Judge Jed S. Rakoff certified a class of MBS investors in *Public Employees’ Retirement System of Mississippi v. Merrill Lynch & Co., Inc.*, 08 Civ. 10841 (S.D.N.Y. Aug. 22, 2011) (“*Miss.PERS*”) (Judge Rakoff issued his written opinion in August). The case concerns pass-through certificates originally valued at around \$16.5 billion, that allegedly fell in value after delinquency and default rates in its underlying loan pool rose in 2007. Relying on *Residential Capital* and *IPO*, defendants provided evidence suggesting that sufficient information was available at the time of the offerings for sophisticated plaintiffs to have learned of the deteriorating underwriting standards in the MBS market.

Defendants pointed to statements in newspapers and reports that implied that certain plaintiffs were suspicious about mortgage origination practices generally. In one such statement, a PIMCO executive allegedly told the Wall Street Journal that he “assume[d] that appraisals [in the MBS market were] a little lofty.” Defendants also submitted evidence that certain plaintiffs were experts in, and had independently profited from, mortgage-backed securities, or had conducted “old-fashioned shoe-leather research” into the “degradation of underwriting standards.” Evidence of similar quality had been persuasive for defendants in *Residential Capital*. Here, the court found the evidence “generic” and “weak at best,” concluding that a “broad indictment of the housing market as a whole” did not suggest knowledge of the particular conduct at issue in the case.

As if to highlight the two courts’ different approaches to the evidence, where the *Residential Capital* court had cited the WAMCO testimony that showed the firm’s knowledge of weak industry standards, the *Miss.PERS* court / continued page 20

## Mortgage-Backed Securities

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cited WAMCO testimony denying knowledge of specific false statements in the offering documents at issue. The court distinguished *IPO*, noting that in this case, there was no evidence of industry-wide knowledge or of plaintiffs participating in the scheme.

### The Supreme Court's *Wal-Mart* Decision Has Little Impact

Following the *Miss.PERS* decision, the United States Supreme Court decided *Wal-Mart*. At the time, MBS defendants may have hoped they had received a new weapon against class certification.

In *Wal-Mart*, three named plaintiffs sought to represent a class of up to 1.5 million women who alleged that they had suffered discrimination in promotion decisions and pay while employed at Wal-Mart. The Supreme Court observed that the employment decisions at issue were made by individual managers without corporate oversight, and that plaintiffs had failed to provide a credible general theory of discrimination. Because finding at least one common question to bind the class is a threshold requirement, the Court denied class certification.

In the context of securities litigation, however, it seems doubtful that *Wal-Mart* will serve as a significant impediment to class certifications. Judge Rakoff crisply distinguished the case when he issued his written opinion, holding that it had “little to no bearing” on his decision in *Miss.PERS*. Judge Rakoff explained that *Wal-Mart* turned on the threshold issue of commonality, a requirement that is easily met in securities cases where many common issues surround the content of the offering documents.

### A Second Southern District Court Certifies a Class

On August 16, 2011, Judge Paul A. Crotty issued the third Southern District MBS class certification ruling of the year, *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc.*, No. 08 Civ. 5653 (S.D.N.Y. Aug. 16, 2011) (“*DLJ Mortgage*”). In that case, Lead Plaintiff New Jersey Carpenters Health Fund brought suit, alleging violations of Section 11 of the Securities Act by defendants in the sale of \$2.39 billion of pass-through certificates.

Looking to *IPO* and *Residential Capital*, defendants argued

that “sufficient information was publicly available” to raise the inference that sophisticated plaintiffs may have known about the troubles in the subprime market. Defendants pointed to “rising delinquency and default rates, three trustee reports which discussed the delinquency rates of the collateral pool, and news reports” regarding one loan originator’s practices.

In its ruling, the court distinguished *IPO* and *Residential Capital*, concluding that the evidence adduced here by defendants did not rise to the same level. In those cases, the court explained, there was explicit testimonial and documentary evidence suggesting knowledge by particular class members. Here, the evidence did not relate to the certificates at issue, and the mere fact that some members of the plaintiff class were sophisticated financial institutions could not defeat class certification.

### Conclusion

These three Southern District cases dealt with very similar facts and differed somewhat on the quality of their evidentiary submissions, but they also appear to differ in their interpretation of the applicable standard. The *Residential Capital* court found that evidence of some plaintiffs’ expertise in the MBS industry was sufficient to raise the knowledge question and defeat class certification. The *Miss.PERS* and *DLJ Mortgage* courts insisted on a showing that plaintiffs had specific knowledge going to the offering at issue. The Second Circuit has now accepted an interlocutory appeal in the *Residential Capital* case, the outcome of which will likely shed further light on the level of knowledge required to defeat class action certification in MBS cases. ☺

## Madoff Trustee has no Standing to Bring Common Law Claims on Behalf of Madoff Customers

*By Thomas J. Hall and Paige M. Willan*

The trustee of Bernard L. Madoff Investment Securities, LLC (“BLMIS”), Irving Picard, recently suffered a severe setback in his efforts to recover money on behalf of investors in BLMIS at the expense of the banks and other financial firms that pro-

vided services to BLMIS. In *Picard v. HSBC Bank PLC*, No. 11 Civ. 763 (JSR) (S.D.N.Y.), and *Picard v. Alpha Prime Fund Ltd.*, No. 11 Civ. 836 (S.D.N.Y.), Judge Jed S. Rakoff of the United States District Court for the Southern District of New York determined that Picard lacked standing to bring common law claims arising from the Madoff fraud on behalf of BLMIS's customers. This decision essentially eliminates Picard's standing to pursue claims that effectively belong to BLMIS customers arising from third parties' alleged participation in the Madoff fraud.

### Picard's Claims Against BLMIS's Bankers

In these two actions, Picard brought a number of fraudulent conveyance claims and several common law claims against HSBC and other financial institutions. The common law claims included unjust enrichment, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty. Picard based these claims on allegations that HSBC served as a banker and a

allowing the fraudulent conveyance claims to go forward. In that opinion, the court held that Picard does not have standing to bring claims against third parties on behalf of the creditors of BLMIS. The court initially reasoned that Picard's powers as trustee of BLMIS arise from the Bankruptcy Code and the Securities Investor Protection Act ("SIPA"), which collectively establish the procedure for the liquidation of a securities brokerage. The court then analyzed the Bankruptcy Code and SIPA and determined that neither authorizes a trustee to bring claims on behalf of the customers of a brokerage firm that is being liquidated. Instead, the court found that the Bankruptcy Code and SIPA allow a trustee to bring claims solely on behalf of the estate — in this case, on behalf of BLMIS itself.

Picard made various arguments in support of his contention that either SIPA or the Bankruptcy Code implicitly permits him to bring such common law causes of action on behalf of BLMIS customers.

**Under Judge Rakoff's analysis, the trustee is not authorized under either SIPA or the Bankruptcy Code to pursue claims on behalf of the customers or creditors of a debtor.**

conduit for BLMIS investments and, in so doing, failed to investigate BLMIS adequately, despite being aware of myriad red flags and indicia of fraud.

Picard initially brought these claims in the Bankruptcy Court for the Southern District of New York, but in an earlier decision Judge Rakoff ordered that the case be withdrawn from the Bankruptcy Court, finding that it presented substantial, unresolved issues of federal non-bankruptcy law. Subsequently, HSBC and a couple other defendants moved to dismiss Picard's claims for, among other things, lack of standing.

### Picard Lacks Standing

On July 28, 2011, the court issued an opinion dismissing the common law claims that Picard brought against HSBC, but

First, Picard argued that a SIPA provision allowing the SIPA Trustee to "report to the court any . . . fraud, misconduct, mismanagement, and irregularities, and any causes of action available to the estate" permitted him to bring suit for the enumerated types of misconduct (fraud, misconduct, etc.) on behalf of the brokerage's customers. The court found, however, that the provision merely means that the SIPA Trustee must report such information to the court, and thereby to the public. The court concluded that finding that such language permitted Picard to commence a suit that is not otherwise authorized by statute would "go[] far beyond any accepted legal principle defining implied rights of action."

Next, Picard argued that, since the Trustee may recover customer property, which is defined as, / continued page 22

## Madoff Trustee

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among other things “other property of the debtor,” SIPA implicitly gives him the right to bring claims on behalf of the customers of the estate. This is so, the Trustee contended, either because the causes of action are themselves customer property or because the damages that result from the claims are properly customer property. The court rejected both of those arguments. With respect to the first argument, the court found that the argument was a “classic example of bootstrapping” as the fact that a recovery might be customer property did not provide the Trustee with standing to bring the claim in the first instance. The second argument, on the other hand, merely involved a far too broad construction of the term “customer property.”

In addition to his SIPA arguments, the Trustee also contended that he was authorized to bring common law claims on behalf of BLMIS’s customers as the bailee of the customers’ property. The court indicated that it saw “no warrant for inferring that some law other than SIPA, such as the common law, can vest a SIPA trustee with powers that are broader than the powers afforded an ordinary bankruptcy trustee under Title 11 or otherwise expressly provided for in SIPA itself.” The court went on to note that, even if the common law could establish such rights, the law of bailment did not establish them here. As an initial matter, it found that Picard could not be considered a bailee of BLMIS’s customers, because he is not seeking to return recovered bailments to individual investors, but rather to distribute customer property recovered pro rata to all customers. And even if that were not the case, the court noted that New York law establishes that no bailment exists where the bailee is a thief — and here Madoff, the original transferee of the property, was a confessed thief.

In addition to his SIPA arguments and his bailment theory, Picard claimed that he had the right to pursue the relevant common law claims as a subrogee of BLMIS customer claims, because the Securities Investor Protection Corporation (“SIPC”) has assigned Picard its subrogation right for the \$800 million it advanced to BLMIS customers. But SIPA is clear that those subrogation claims are limited to net equity claims against the debtor estate. As such, SIPC cannot recover until BLMIS’s customers are made whole. As the customers have not yet been returned the entirety of their investment, SIPC’s subrogation rights are not yet viable and cannot be a basis for Picard’s current claims against HSBC and BLMIS’s other financial services providers.

## The Wagoner Rule Bars Claims

Finally, the court indicated that, if Picard was in fact seeking to bring the common law claims on behalf of the BLMIS estate itself, he would be barred from such an action by the doctrines of *in pari delicto* and the *Wagoner* rule. Under those doctrines, a trustee does not have standing to bring a common law claim that results from a wrong in which the debtor took part. Here, the court noted, Picard’s complaint was “replete with allegations of Madoff’s role as the ‘mastermind[]’ of the fraud” and, thus, the *Wagoner* rule barred Picard, as Madoff’s successor in interest, from bringing common law claims arising from that fraud. Therefore, to the extent that Picard’s common law claims were not brought on behalf of BLMIS customers, but rather on behalf of the estate, the claims must be dismissed for lack of standing.

## Conclusion

These cases draw a sharp line as to where the standing of a SIPA trustee ends. Under Judge Rakoff’s analysis, the trustee is not authorized under either SIPA or the Bankruptcy Code to pursue claims on behalf of the customers or creditors of a debtor. In addition, where the debtor was complicit in the wrong that gave rise to the actions brought by the Trustee, the action is also likely barred by the *in pari delicto* doctrine or the *Wagoner* rule if brought on behalf of the estate rather than on behalf of its creditors. ☺

## Court Approves Settlement of DOJ Antitrust Action Against Visa and MasterCard

*By David H. Evans and Benjamin D. Bleiberg*

A New York federal court recently approved a settlement and final judgment which terminates the antitrust claims brought by the Department of Justice (“DOJ”) and numerous state attorneys general against Visa and MasterCard for their implementation and enforcement of alleged anticompetitive merchant agreements in violation of Section 1 of the Sherman Act. *United States v. Am. Express Co.*, No. 10-4496 (E.D.N.Y. 2011). After reviewing the public comments concerning the proposed

settlement, Judge Nicholas Garaufis of the Eastern District of New York found that the final judgment was in the public interest and approved the parties' agreement. The settlement requires Visa and MasterCard to alter their current agreements and rules to allow merchants to provide customers with discounts, incentives or information that would encourage customers to use methods of payment that are less costly to the merchants, and ultimately, the customers themselves. The settlement, however, does not require Visa or MasterCard to pay any fines, confess to any wrongdoing, or admit to any of the complaint's allegations. American Express, the remaining defendant in the action, elected not to join the settlement and litigation in the matter is ongoing as against it.

The transaction fees are a set percentage of the transaction price and vary by defendant. For example, American Express generally charges higher transaction fees than its competitors. Pursuant to the defendants' agreements with the merchants or the merchants' banks, the transaction fees are withheld either by the merchants' banks or by the credit card company directly. To cover the costs of these fees, merchants allegedly charge higher retail prices to their customers.

The defendants' agreements with the merchants or the merchants' banks further require that the merchants abide by various restraints as a condition of acceptance of any General Purpose Cards (the "Merchant Restraints"). Visa's Merchant Restraints prohibit merchants from offering discounts to consumers who choose to use a competitor's General Purpose

**The settlement requires Visa and MasterCard to alter their current agreements and rules to allow merchants to provide customers with discounts, incentives or information that would encourage customers to use methods of payment that are less costly to the merchants, and ultimately, the customers themselves.**

## Background

American Express, Visa and MasterCard (the "defendants") are operators of the three largest credit and charge card transaction networks in the U.S. and, according to the DOJ, individually possess market power in the general purpose credit or charge cards ("General Purpose Cards") network services market. In 2009, the defendants allegedly had a combined market share of 94% of the over \$1.6 trillion in transaction volume of General Purpose Cards issued in the U.S. During that period, Visa and MasterCard General Purpose Cards were accepted by over 8.2 million U.S. merchants. While American Express General Purpose Cards were only accepted by 4.9 million U.S. merchants, many of the merchants who opted not to accept American Express were smaller merchants and did not account for a significant volume of transactions.

Merchants who accept any of the defendants' General Purpose Cards are required to pay a fee for each transaction.

Card. MasterCard's Merchant Restraints similarly prohibit merchants from offering discounts or other benefits to consumers who use competing General Purpose Cards, and also bar merchants from favoring its credit card competitors. American Express's more restrictive Merchant Restraints prohibit merchants from, among other things, (1) indicating or implying preference for another General Purpose Card, (2) attempting to dissuade American Express cardholders from using the card, (3) criticizing American Express's General Purpose Card or other services, (4) attempting to persuade cardholders from using any other method of payment, (5) imposing any restrictions on American Express acceptance not imposed on other General Purpose Cards, or (6) promoting other payment methods more actively than American Express. The defendants' allegedly actively monitored and enforce their Merchant Restraints.

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## DOJ Antitrust Action

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### The Antitrust Action

On October 4, 2010, the DOJ and seven state attorneys general filed a civil antitrust action against the defendants alleging that their Merchant Restraints restrained trade and limited competition in violation of Section 1 of the Sherman Act, and sought a permanent injunction to remedy and further prevent the defendants' practice of imposing and enforcing the Merchant Restraints. The plaintiffs later filed an amended complaint to add an additional 10 state attorneys general as plaintiffs.

The plaintiffs argued that Merchant Restraints are not reasonably necessary to accomplish any of the defendants' precompetitive goals, that any allegedly precompetitive benefits of the Merchant Restraints are outweighed by their anticompetitive harm, and that less anticompetitive and restrictive methods are available to the defendants to reasonably achieve their purported precompetitive goals. The plaintiffs further noted that in foreign jurisdictions where similar merchant restraints had been reduced or eliminated, merchants encouraged customers to use less expensive General Purpose Cards or other forms of payment.

**The court reasoned that because the requested relief would resolve the specific anticompetitive violations alleged in the complaint, the public interest would be best served by the agreement's approval.**

The plaintiffs asserted that the Merchant Restraints harm competition, in part, by (1) disrupting the competitive process and the free-market's price-setting mechanisms; (2) preventing merchants from directly forcing the defendants to compete with each other over fees; (3) preventing competition among the defendants by barring merchants from encouraging payment with a specific General Purpose Card at the point of sale; (4) restraining merchants from promoting payment methods other than the defendants' General Purpose Cards, such as cash; (5) restraining merchants from competing for customers with each other by offering discounts, promotions, or other benefits to customers who use of a lower cost General Purpose Card or other payment method; (6) causing increased retail prices for goods and services paid by customers regardless of payment method; (7) stifling innovation in network services and card offerings at the point of sale; and (8) denying cost and fee information about General Purpose Card to consumers that would allow them to choose lower cost payment methods.

### The Settlement and Final Judgment

On October 4, 2010, the plaintiffs also filed a proposed settlement and final judgment with Visa and MasterCard, and published it in several newspapers with a notice soliciting public comments for sixty days. The final judgment prohibits Visa and MasterCard from keeping or adopting any rules that further restrains merchants from offering (1) discounts or rebates; (2) free or discounted products or services, or (3) incentives, encouragement, or other benefits when a customer uses a particular method of payment. The final judgment further prohibits Visa and MasterCard from restraining merchants from promoting or expressing a preference for any particular method of payment, or informing customers about the costs incurred by the merchant when the customers use a General Purpose Cards or other method of payment.

The final judgment, however, does not prevent Visa or MasterCard from enforcing or entering into agreements with merchants to (1) accept only Visa or MasterCard General Purpose cards; (2) promote a merchant's co-branded or an

affinity partner's General Purpose Cards over other methods of payment; or (3) to prohibit merchants from encouraging customers from using a General Purpose Card issued by certain banks over others. It further does not require Visa or MasterCard to pay any fines or admit to any of the complaint's allegations.

The plaintiffs received comments from six groups during the comment solicitation period, including a plaintiff class, individual merchant plaintiffs, a public service consumer education website, and a trade association of retailers.

### The Court's Public Interest Assessment

After a review of the public comments, on July 20, 2011 the court approved the proposed final judgment, finding that it serves the public interest pursuant to the Tunney Act, 15 U.S.C. § 16(e). The court emphasized that most of the public comments were "overwhelmingly positive if not enthusiastic," and that none of the comments specifically contested the proposed final judgment. Although several commenters expressed "lukewarm" support due to their concerns about the future impact and effectiveness of the proposed relief, the court held that those concerns would be applicable to any proposed settlement. The court reasoned that because the requested relief would resolve the specific anticompetitive violations alleged in the complaint, the public interest would be best served by the agreement's approval.

The final judgment as approved requires that Visa and MasterCard to implement changes to their respective Merchant Agreements within five days of approval. However, because American Express's merchant agreements — and accordingly, its Merchant Restraints — are still in effect and binding on merchants and the merchants' banks, the final judgment against Visa and MasterCard may not result in any immediate reduction in retail prices or in merchant behavior. ☺

## Creative Arguments Partly Succeed in Circumventing Indenture's "No Action" Clause

By Nicolas Stebinger

In his recent decision in *RJ Capital, S.A. v. Lexington Capital Funding III, Ltd.*, 10 Civ. 25 (PGG), 2011 U.S. Dist. LEXIS 82912 (S.D.N.Y. July 28, 2011), Judge Paul G. Gardephe dealt with a noteholder's creative attempts to circumvent noncompliance with a "no action" clause in an indenture that required several conditions to be met before suit thereunder could be brought. Judge Gardephe's opinion partially granting a motion to dismiss highlighted that basic tenets of contractual interpretation govern even complex securities contracts, and courts will not brook attempts to recharacterize contractual claims to circumvent the intent of the contract. Nevertheless, the plaintiff's creativity paid off when the court held that, because requiring strict compliance with the no action clause could lead to an absurd result, some leniency was warranted.

### The Securities Arrangement

RJ Capital, S.A. ("RJ Capital") held notes issued by Lexington Capital Funding III, LLC ("Lexington Capital"). An indenture governed the notes, and designated the Bank of New York Trust Mellon Company ("BoNY") as the indenture trustee, which entailed, among other things, serving as an agent for payments of principal and interest on the notes. The indenture contained a no action clause, which set forth several conditions a noteholder was required to meet before bringing suit under the indenture. Specifically, a noteholder was first required to notify the trustee of default, ensure that holders of 25% of the outstanding notes request that the trustee institute proceedings to correct the default, offer to indemnify the trustee for its legal expenses and subsequently wait 30 days, at which point a noteholder could bring suit if the trustee had not initiated a proceeding and the majority of noteholders had not instructed the trustee to refrain from bringing suit. The indenture further provided that Harding Advisory, LLC ("Harding") would serve as collateral manager, and Lexington Capital entered into a Collateral Management Agreement with Harding to formalize the arrangement. / continued page 26

## “No Action” Clause

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Under the Collateral Management Agreement, Harding agreed to supervise and direct the maintenance of the collateral, and to assist BoNY in providing Lexington Capital with various reports and data.

### Confusion over Payment Calculations

The suit arose from a dispute over the method of calculating the amounts of principal payments on the notes. The indenture contained provisions setting forth an “account payment priority.” Initially, Lexington Capital calculated distributions of principal and interest payments without applying the account payment priority. BoNY, as the trustee, distributed those payments into RJ Capital’s accounts.

Lexington Capital later revised its principal payment distributions — but not its interest payment distributions — to incorporate the account payment priority. As a result, RJ Capital allegedly received approximately \$500,000 less in principal payment distributions than it otherwise would have, and sued Lexington Capital, BoNY and Harding to recover its losses. RJ Capital sought to vindicate its alleged rights by asserting claims sounding in contract, quasi-contract, breach of fiduciary duty, diversion, tortious interference with contract, specific performance and declaratory judgment.

### The Contract Claims and the “No Action” Clause

The indenture’s no action clause set forth several conditions a noteholder was required to meet before bringing suit on the contract. RJ Capital conceded that it had not satisfied those conditions, but argued that the clause did not apply to its breach of contract claims because RJ Capital based its claims upon allegations of mismanagement, and because the terms of the clause did not apply to actions against indenture trustees, such as BoNY. At the outset, the court noted that no action clauses are generally enforceable, but went on to address RJ Capital’s arguments that the clause at issue did not apply to its claims.

The court first rejected RJ Capital’s assertion that claims of mismanagement removed a suit from the scope of a no action clause. The court noted that RJ Capital cited to only one case to support its argument, *Metropolitan West Asset Management, LLC v. Magnus Funding, Ltd.*, No. 03 Civ. 5539 (NRB), 2004 U.S. Dist. LEXIS 11761 (S.D.N.Y. June 25, 2004), in which noncompliance with a similar no action clause was held not to bar

mismanagement-based claims of wrongful liquidation of collateral against the trustee and investment manager. In *Metropolitan West*, the no action clause applied only to claims seeking payment on the notes, thus the claims of wrongful liquidation of collateral which would not affect the priority of payments from that collateral were held to be outside the scope of the no action clause.

In contrast, RJ Capital alleged only that it had not received proper payment on the notes, an event plainly constituting a default under the indenture, and falling within the scope of the no action clause. The mere invocation of “mismanagement” did not serve to somehow remove the alleged breached obligation from the scope of the no action clause. The court further noted that, even were claims of mismanagement grounds for exemption from a no action clause, RJ Capital alleged no specific facts suggesting mismanagement or impairment of collateral. Because RJ Capital could muster no convincing argument for the non-application of the no action clause against Lexington Capital and Harding, the court held RJ Capital’s non-compliance with the clause to bar its breach of contract claims against Lexington Capital and Harding.

The court found more merit in RJ Capital’s argument that the no action clause did not bar claims against BoNY. The no action clause contained language that required a noteholder to give notice to trustee of any default, and request that the trustee bring suit to repair the default. RJ Capital had already given notice to the trustee, BoNY, of BoNY’s alleged breach. The court held that requiring RJ Capital to comply further with the no action clause and request that BoNY bring suit against itself would present an “absurdity.” The court thus held that further compliance with the no action clause was not required and the contractual claims against BoNY could go forward.

### Breach of Fiduciary Duty, Unjust Enrichment and Breach of Implied Covenant of Good Faith and Fair Dealing

In addition to its claims for breach of contract, RJ Capital asserted claims for breach of fiduciary duty, unjust enrichment and breach of the implied covenant of good faith and fair dealing. The court found that RJ Capital based its breach of fiduciary duty claim upon BoNY’s allegedly improper application of the account payment priority, the same factual assertion supporting its breach of contract claim. Because a plaintiff may not pursue a breach of fiduciary duty claim arising out of the same facts as a breach of contract claim, the court dismissed this claim against BoNY. Similarly, because a plaintiff may not

recover on theories of quasi-contract when no party disputes the existence of a contract governing the dispute, the court dismissed as duplicative RJ Capital's quasi-contract claims of unjust enrichment and breach of the implied covenant of good faith and fair dealing.

### **Diversion, Tortious Interference with Contract and Specific Performance**

RJ Capital also alleged a cause of action for diversion, under which corporate officers or directors may be liable for misappropriation of corporate assets, and a claim of tortious interference with contract against Harding based upon Harding's alleged provision of flawed information that induced Lexington Capital and BoNY's breaches of the indenture. The court dismissed both claims as entirely without merit. First, the complaint alleged no facts involving the diversion of corporate assets by an officer or director. Second, the allegation that Harding provided information to Lexington Capital was insufficient to make the required showing that Harding had intentionally induced Lexington Capital to breach its obligations under the indenture.

The court also dismissed RJ Capital's claim for specific performance, noting that specific performance is not a distinct cause of action, but instead is an equitable remedy for breach of contract. The court reserved judgment, however, on whether specific performance would ultimately be an acceptable remedy.

### **Declaratory Judgment**

Finally, the court allowed a claim for declaratory judgment to survive. Under the Declaratory Judgment Act, a court may declare the rights of an interested party if declaratory relief would "serve a useful purpose in clarifying and settling the legal relations in issue." Although resolution of the breach of contract claims would settle the controversy with respect to past distributions, it would not clarify the proper method of calculation of future distributions under the agreement, which the court had found to be ambiguous. Therefore, in order to preclude the need for future suits over the proper calculation of distributions, the court allowed the claim to go forward.

### **The Take-Away**

RJ Capital was unable to evade the no action clause in the indenture by attempting to recharacterize its breach of contract claims. Nevertheless, its creative arguments that unyielding adherence to the contractual language would lead to

absurd results did preserve some of its claims against the trustee. Finally, despite non-compliance with the no action clause, RJ Capital's suit provided the means to define its rights vis-à-vis each of the defendants by way of declaratory judgment, thus the clause did not provide the defendants with the comprehensive shield they may have desired. ☺

## **Rajat Gupta's Equal Protection Claim Against the SEC Can Proceed in Federal Court — and then is Settled**

*By Pamela J. Marple and Maureen Schad*

Recently, in *Gupta v. SEC*, No. 11 Civ. 1900 (S.D.N.Y.), Judge Jed S. Rakoff of the United States District Court of the Southern District of New York allowed the equal protection claim of Rajat K. Gupta to proceed against the SEC in federal court. In denying the SEC's motion to dismiss, Judge Rakoff held that district courts can have jurisdiction over constitutional claims against the Commission and that there is no requirement that a plaintiff exhaust administrative remedies before bringing such a claim. Shortly following that ruling, however, the equal protection claim was settled with the SEC agreeing to bring its claims against Gupta, if any, in the federal court.

### **Background**

In March 2011, the SEC issued an Order Instituting Public Administrative and Cease-and-Desist Proceedings ("OIP") against Rajat K. Gupta, a former board member of both the Goldman Sachs Group, Inc. and the Procter & Gamble Company. The OIP accused Gupta of knowingly disclosing material nonpublic information about these companies to Raj Rajaratnam, the head of Galleon Management, LP ("Galleon"), who allegedly traded on the basis of this inside information. Rajaratnam was convicted of insider trading crimes in May 2011.

Over the course of the year and a half prior to instituting proceedings against Gupta, the SEC brought in federal court a series of related actions charging 21 / continued page 28

## Equal Protection Claim

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individuals and 7 companies with Galleon-related insider trading. These actions, like the action against Gupta, sought civil penalties, disgorgement and various forms of injunctive relief.

In response to the SEC's institution of administrative proceedings against him while bringing its claims against other defendants in federal court, Gupta filed a lawsuit in the Southern District of New York. Gupta alleged that the OIP singled him out for uniquely unfavorable treatment, denying him — alone out of the 28 individuals and entities similarly accused — the opportunity to contest the allegations against him in federal court. The SEC's action, Gupta claimed, thus violated his constitutional rights under the equal protection clause. Gupta accused the SEC of trying to gain an unfair advantage by depriving him of the protections he would have had if a

rather than in federal court, as it has invariably done with similarly situated defendants. To the contrary, the only plausible inference is that the Commission is proceeding how and where it is against Mr. Gupta for the bad faith purpose of shoring up a meritless case by disarming its adversary.

Gupta also complained that the SEC was improperly trying to apply retroactively the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203 124 Stat. 1376 (the "Dodd-Frank Act"), to conduct that allegedly occurred in 2008-09. The Dodd-Frank Act, which was passed in July 2010, made available in administrative actions certain penalties that previously were only available in federal court.

The SEC moved to dismiss Gupta's complaint on several grounds, arguing that (1) the federal court lacks a statutory basis for jurisdiction; (2) Gupta's claims against the SEC are

**In denying the SEC's motion to dismiss, Judge Rakoff held that district courts can have jurisdiction over constitutional claims against the Commission and that there is no requirement that a plaintiff exhaust administrative remedies before bringing such a claim.**

case were brought against him in federal court, including full discovery, application of the federal rules of evidence, the ability to assert counterclaims against the SEC or third party claims for indemnification and contribution, and the right to a jury trial. These protections, Gupta emphasized, were made available to every other Galleon-related defendant as the SEC brought its actions against them in federal court. As the complaint alleged:

Against the history of [the other] Galleon-related actions for civil penalties already brought in this Court, there is no benign and non-discriminatory explanation for the Commission's applying Dodd-Frank retroactively against Mr. Gupta, or more generally for filing the action against him administratively,

barred by the doctrine of sovereign immunity; (3) the doctrines of exhaustion and ripeness bar Gupta's claims; and (4) Section 25(a)(1) of the Exchange Act, 15 U.S.C. § 78y(a)(1), when read together with Section 703 of the Administrative Procedure Act ("APA"), grants to the courts of appeal exclusive jurisdiction to review orders entered in SEC administrative proceedings.

### The Motion to Dismiss Decision

In July 2011, Judge Rakoff denied the SEC's motion to dismiss and ruled that Gupta could proceed with his equal protection claim against the SEC in federal court. First, the court rejected the SEC's argument that the court lacked a statutory basis to assert jurisdiction. Since Gupta alleged constitutional violations, the court explained, jurisdiction exists under 28 U.S.C. §

1331. The complaint also alleged the prerequisites for jurisdiction under the Declaratory Judgment Act, 28 U.S.C. § 2201. Second, the court disagreed that Gupta's claims were barred by the doctrine of sovereign immunity. The court held that the SEC is subject to Section 702 of the APA, which by its plain language waives sovereign immunity for actions against any agency – indeed, for any action in a federal court – seeking relief other than money damages. As Gupta's complaint sought injunctive relief, the waiver of immunity applied.

Further, the court held that no statute expressly or impliedly forbids the relief sought. Addressing Section 25(a)(1) of the Exchange Act – the only statute that the SEC plausibly suggested forbids the relief sought – the court turned to *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138 (2010), in which the U.S. Supreme Court held that Section 25(a)(1) does not deprive district courts of original jurisdiction over suits against the SEC when certain criteria are met. The critical question, the court explained, is whether Gupta's action meets the three-prong test set forth in *Free Enterprise* for when an action may be brought against the SEC in a district court.

The same analysis applied to the SEC's arguments that Gupta must exhaust administrative remedies before seeking redress in federal court and that the instant action was not ripe for judicial review. As the court wrote, "[a]ll of the SEC's asserted grounds for dismissal hinge on its fourth and final argument: that the special statutory scheme established by Section 25(a)(1) of the Exchange Act, 15 U.S.C. § 78y(a)(1), when read together with Section 703 of the APA, prevents the court from exercising jurisdiction over Gupta's claims." The court rejected the SEC's contention that these two provisions, read together, establish that review of any SEC action is available only in a federal court of appeals and only after the administrative proceeding is completed. Rather, the court held, on their face the two statutes provide that a lawsuit challenging SEC action is appropriate "if the statutorily-provided review of final SEC orders by the courts of appeal is in some relevant respect inadequate." The court explained that *Free Enterprise* settled any doubt on this score. There, the Supreme Court set forth a three-prong test for when a case could proceed against the SEC in district court, holding that Congress does not intend to limit jurisdiction if: (1) a finding of preclusion could foreclose all meaningful judicial review; (2) the suit is wholly collateral to a statute's review provisions; and (3) the claims are outside the agency's expertise.

### The Three-Prong *Free Enterprise* Test

Applying the *Free Enterprise* factors to Gupta's case, the court held that the action could proceed in district court; however, it narrowed the theory of the complaint to one of equal protection. At the outset, the court wrote that the third prong of the *Free Enterprise* test is easily satisfied, as Gupta's constitutional claims are not peculiarly within the SEC's competence or expertise; equal protection claims are in fact far more commonly reviewed by district courts than by the SEC. As to the second prong, the court held that only the equal protection claim is wholly collateral to the review provisions of Section 25(a)(1). That claim, the court noted, is entirely independent of the administrative proceeding – that is, even if the allegations made against Gupta in the OIP were true and he was fully guilty of the charges made against him in the administrative proceeding, his federal court complaint would still state a claim of unequal protection. Indeed, the court explained, even if the SEC were acting within its discretion when it imposed disparate treatment, arbitrary and irrational agency action would still state a viable constitutional claim.

In contrast, the court found that Gupta's retroactivity claim did not meet the second prong of the *Free Enterprise* test. The court distinguished Gupta's claim from others which have, for example, challenged the facial validity of a particular statute. Rather than challenging the validity of the Dodd-Frank Act, however, Gupta here was challenging only the retroactive application of one provision of that Act relating to only one of several penalties the OIP seeks against him – which the court deemed a potentially peripheral issue. The court also referenced general principles of conservation of judicial resources when it held that the retroactivity claim – which it noted could very well be mooted during the course of the administrative proceeding – should not proceed in federal court.

Lastly, the court held that Gupta's equal protection claim satisfied the first prong of the *Free Enterprise* test – that a finding of preclusion would foreclose all meaningful judicial review – for two reasons. First, there was no reasonable mechanism for raising a constitutional claim in the context of the SEC administrative proceeding; the SEC's Rules of Practice do not permit counterclaims against the SEC nor do they allow adequate discovery for such a claim. Second, the equal protection claim is entirely collateral to the issue of Gupta's guilt for insider trading, and no evidence or findings from the administrative proceeding will bear on the constitutional claim.

Thus, having determined that Gupta's / continued page 30

## Equal Protection Claim

*continued from page 29*

equal protection claim met the standards set forth in *Free Enterprise*, the court denied the SEC's motion to dismiss. The court also explained that since Gupta sought injunctive relief engaging the SEC's pursuit of its administrative proceeding against him, further proceedings were required on a moderately expedited basis.

In his decision, Judge Rakoff appeared to give some credence to Gupta's substantive arguments, characterizing the OIP as a "seeming exercise in forum-shopping," and emphasizing that its claims were not materially different from those in the complaints in the 28 other Galleon-related actions filed by the SEC in federal court. He distinguished the case from those that might be easily disposed of through dismissal for failure to plead a claim; rather, he wrote, "[h]ere . . . we have the unusual case where there is already a well-developed public record of Gupta being treated substantially disparately from 28 essentially identical defendants, with not even a hint from the SEC, even in their instant papers, as to why this should be so."

## The Settlement

On August 3, 2011, the parties signed a 2-page stipulation agreeing to dismiss both the administrative proceeding against Gupta and Gupta's lawsuit against the SEC. Under the terms of the agreement, the SEC agreed not to bring any future administrative or cease-and-desist proceedings against Gupta based on the same factual allegations. In return, Gupta pledged not to bring any new lawsuit against the SEC regarding its administrative proceedings. While the SEC retains the ability to file an action against Gupta for insider trading, the settlement agreement provides that any such action must be filed in federal court in the Southern District of New York, and will be designated as related to the other Galleon cases pending before Judge Rakoff.

## State Law Claims over Gift Cards not Preempted by Federal Law

*By C. Jonathan Wood*

A New York trial court recently ruled that federal banking laws did not preempt a plaintiff's state law claims against a National Bank that issued stored-value gift cards. The ruling allowed the plaintiff to move forward with her class action claims of breach of contract, implied covenant of good faith and fair dealing, violation of Section 349 of the New York General Business Law, indebtedness, and unjust enrichment. *Sheinkin v. Simon Property Grp., Inc.*, No. 022038/2010, 2011 Slip Op. 31908(U), at \*1 (Sup. Ct. Nassau Co. 2011). The decision noted that it was following a line of cases which have agreed that nothing in federal law preempts the assertion of state law claims for violations of deceptive practices statutes.

## Background

The lead plaintiff, Janet Sheinkin, allegedly received a \$50 stored-value gift card which had been purchased from a Simon Group mall. While the card was sold by the Simon Group, it was issued by and contained disclosures prepared by U.S. Bank. The disclosures included a sticker on the front of the card which described dormancy, replacement and renewal fees — drawing attention to the expiration date of the card. The back of the card allegedly contained the same disclosures, and referred the user of the card to a multi-page "sleeve" document which allegedly was attached to the card and contained all the relevant disclosures.

Sheinkin never used the card and, by the expiration date of January 1, 2009, the balance on the card had been automatically reduced to \$22.50 as a result of monthly dormancy fees. Following the card's expiration, monthly dormancy fees continued to accrue until April 1, 2009 when U.S. Bank charged an account closure fee that consumed the remaining \$12.50 on the card. Thereafter, the plaintiff brought a class action suit.

## The National Bank Act

The National Bank Act ("NBA") created a set of uniform standards for the regulation of so-called national banks. This provision finds its roots in the National Banking Acts of 1863 and 1864. This early framework has grown into the dual system of

nationally regulated and state regulated banks that we have today. The business activities of the national banks are governed by the NBA, along with the Office of the Comptroller of the Currency (“OCC”) which is responsible for overseeing the operations of the banks, and how the banks interact with their customers.

The NBA gives the OCC the ability to oversee the banks through audits and oversight functions, but the NBA also gives the national banks incidental powers to carry out business. These incidental powers include a variety of functions, such as the delegation of specific functions to subsidiaries and other functions necessary to carry out the day to day activities of national banks. The NBA also has the power to preempt state laws that are targeted at regulating the activities of a national bank under certain circumstances.

court found no indication that “all state laws which might affect a national bank’s operations are preempted [by federal law], as would be the case in field preemption.” The court continued by stating “[r]ather, only those state laws that specifically conflict with the National Bank Act’s regulation of national banks are preempted.”

Defendants attempted to rebut this argument by making a showing that stored-value cards are an incidental power of nationally chartered banks. This argument failed because, as the court noted, the U.S. Supreme Court has held that with respect to such incidental or enumerated powers, “states are permitted to regulate the activities of national banks where doing so does not prevent or significantly interfere with the national bank’s or the national bank regulator’s exercise of its powers.” In this respect the court also noted that the OCC which regu-

## The decision noted that it was following a line of cases which have agreed that nothing in federal law preempts the assertion of state law claims for violations of deceptive practices statutes.

### The Claims

In her complaint, the plaintiff asserted that U.S. Bank charged allegedly illegal fees on stored-value gift cards that it sold at Simon Malls through Simon Property Group. The plaintiff filed a complaint alleging breach of contract, implied covenant of good faith and fair dealing, GBL § 349, indebtedness, and unjust enrichment. The plaintiff made these class claims on behalf of all those that purchased the stored-value gift cards.

### The Motion to Dismiss

Defendants filed a motion to dismiss to the complaint on the grounds that the state law claims asserted were preempted by the NBA. The court denied the motion, finding that the NBA did not preempt state laws in this area.

The court based this holding on an examination of the powers within federal law generally and those within the NBA. The

lates national banks “has stated in its regulations that laws of general applicability . . . are not preempted.”

Distinguishing this case from cases relied on by the defendants; the court noted that those cases concerned laws that were aimed specifically at regulating the use of stored-value cards. For example, the court distinguished the holding in *SPGCC, LLC v. Ayotte*, 488 F.3d 525 (1st Cir. 2007), by pointing out that the state statute in that case sought to directly regulate the use of stored-value cards. Another case relied on by the defendants was distinguishable because it involved the application of a state statute that sought to specifically regulate stored-value cards to a subsidiary of the Simon Group who was not a national bank. *Goldman v. Simon Property Grp. Inc.*, 58 A.D.2d 208 (N.Y. App. Div. 2d Dep’t 2008).

The court concluded that, because the plaintiff’s causes of action are generally applicable to any / continued page 32

conduct, not just conduct by the banks, they are not specific to the issuance of stored-value cards. The court continued that “there is no reason to conclude that [the plaintiff’s causes of action] as applied to stored-value cards . . . would substantially interfere with or impair the OCC’s ability to regulate the operations of the national banks.”

The defendants “strenuously argue[d] that ‘resolving any of these theories in [the plaintiff’s] favor would significantly interfere with U.S. Bank’s authorized power to charge such fees in conjunction with its gift card program.’” Rejecting this argument the court discussed that national banks do not operate in a legal void in the absence of OCC regulation. Therefore state laws, such as usury laws, are still applicable to national banks. The court focused this distinction on the reasoning that “[s]imply put, there is a difference between challenging a national bank’s power to do something and challenging the manner in which it is done.”

## Conclusion

This *Sheinkin* case makes clear that banks, national or otherwise, have the duty to abide by laws of general application within states, regardless of whether the power it exercises emanates from the NBA. A bank cannot simply invoke the NBA to rebut any claims that it violated a state law which does not specifically seek to regulate the activity of the national bank. The only recourse for a national bank against a generally applicable law is to argue that the law significantly interferes with the operation of the national bank, or the operation of the OCC’s regulatory power over a national bank. These arguments, however, must be considered within the context of an acceptance within courts that state law concerning usury and other generally applicable matters will likely be enforced despite a national bank status. ©

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