

# Financial Services Litigation

December 2010

NEWSWIRE

## Multidistrict Court Dismisses Mortgage Foreclosure Class Actions

By Jonathan C. Cross and Stacey Trimmer

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The extraordinary surge in residential mortgage foreclosures during recent years has led to the filing of hundreds of putative wrongful foreclosure class actions across the United States challenging various aspects of the foreclosure process. Many of these challenges focus on the role in the foreclosure process of the Mortgage Electronic Registration System (MERS), an entity established in the 1990s to electronically register mortgage loans and mortgage loan assignments and serve as the mortgagee of record in local land records. Dozens of putative MERS foreclosure class actions filed in the federal courts were transferred, by the Judicial Panel on Multidistrict Litigation (the "JPML"), to the United States District Court for the District of Arizona (the "MDL court").

On September 30, 2010, the MDL court dismissed, for failure to state a claim, numerous challenges to MERS' role in the foreclosure process. The MDL court's decision reaffirmed MERS' role in non-judicial foreclosures, and held that plaintiffs asserting challenges to property foreclosures must plead the absence of payment default as an element of their claim. While the MDL court's dismissal was without prejudice, the decision suggests that wrongful foreclosure class actions may face an uphill struggle in the federal courts.

### The Function of MERS

MERS was established in 1998 by the mortgage banking industry to facilitate the computerization of mortgage loan records and facilitate the assignment and securitization of

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mortgage loans. It is owned by a number of financial institutions involved in the mortgage lending, origination and securitization businesses. MERS maintains a national home mortgage loan registration database, reflecting information concerning the origination, initial ownership and subsequent assignment of millions of individual mortgage loans.

Acting as a nominee on behalf of the owner of the mortgage note, MERS is recorded in local land records as the mortgagee of record. Subsequent transfers of the mortgage note—from the original lender to a mortgage securitization vehicle, such as a Real Estate Mortgage Investment Conduit (REMIC), or to another purchaser of the note—occur within the MERS database. These transfers do not typically result in the recordation of mortgage assignment documents in local land records. As the mortgagee of record, MERS frequently commences foreclosure proceedings on behalf of the mortgage loan servicer and noteholder. Because MERS is the recorded holder of the mortgage, but does not beneficially own the mortgage note, its role in the foreclosure process has led to significant legal controversy.

In particular, attorneys challenging foreclosures have argued that a mortgage note may not be “split” from a mortgage security interest, such that the mortgagee of record (or the recorded holder of the deed of trust) is not the beneficial owner of the mortgage note. *See, e.g., In re Vargas*, 396 B.R. 511, 517 (Bankr. C.D. Cal. 2008) (holding that MERS lacked standing to foreclose because it was not the beneficial owner of the note). In contrast, MERS takes the position that it is contractually designated as a nominee for the lender, and argues that, consequently, it is a lawful beneficiary of the mortgage, as well as the record owner. Therefore, MERS argues it has authority to bring foreclosure actions on behalf of a noteholder as an authorized agent. In addition, MERS defends its standing on the ground that the owner of a note authorizes and transfers the note to MERS before foreclosure proceedings actually commence.

### The Multidistrict Transfer Order

On December 7, 2009, the JPML ordered six MERS cases transferred to the MDL court for consolidated pretrial proceedings. Although the cases alleged a variety of theories, the transfer order specified that only claims related to the formation and operation of the MERS system would be transferred. The order remanded all other causes of action to the respective transferor

courts, most notably claims pertaining to the origination and collection of loans. Subsequently, the JPML issued an order specifying that cases would be transferred to the MDL court only when they involve claims arising in “non-judicial foreclosure” states, which permit the holder of a deed of trust to foreclose without the involvement of courts. Since the initial transfers in December 2009, additional cases have been transferred to the MDL Court, which is now responsible for 83 class actions in total.

### The MDL Court’s Dismissal

Defendants in six of the putative class actions transferred to the MDL court—four governed by Nevada law, one governed by California law and one governed by Arizona law—filed motions to dismiss for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6). On September 30, 2010, the MDL court granted each of these motions in their entirety. *In re Mortgage Electronic Registration System (MERS) Litigation (In re MERS)*, MDL Docket No. 09-2119-JAT, 2010 WL 4038788 (D. Ariz. Sept. 30, 2010). The court dealt with the motions by grouping similar claims together. In particular, the MDL court held that the four Nevada complaints failed to state viable claims for wrongful foreclosure and conspiracy to commit wrongful foreclosure, all six complaints failed to state a claim for conspiracy to commit fraud, and complaints that asserted slander of title and unjust enrichment failed as well.

### Wrongful Foreclosure

The MDL court held that the complaints had failed to state a claim for the tort of wrongful foreclosure under Nevada law, for two reasons. First, the court held that plaintiffs had failed to allege that they were current on their loan obligations. The court noted that, under Nevada law, a wrongful foreclosure plaintiff must establish that he or she was not in default when the power of sale was exercised. Because several of the putative class action complaints actually alleged that plaintiffs had *not* made the payments required by their respective mortgage notes, and because the remaining complaints failed to allege that plaintiffs were current on their payments, the court held that all of the plaintiffs’ claims were barred as a matter of law.

Second, the MDL court emphatically rejected plaintiffs’ “split the note” theory that “when the note is split from the deed of trust, then the note becomes unsecured and a person holding only the note lacks the power to foreclose and a person holding only a deed of trust suffers no default because only the

holder of the note is entitled to payment on it.” The court noted that under the language of the relevant mortgage deeds of trust, MERS is empowered to act as a nominee on behalf of the current holder of the mortgage note. Because the complaints had not alleged that MERS was anything other than a nominee for the noteholder, the court held that plaintiffs had not properly alleged that the mortgage note and the deed of trust were, in fact, bifurcated. The court relied on Nevada precedent holding that a nominee has the power to carry out a non-judicial foreclosure under Nevada law.

The MDL court distinguished certain bankruptcy cases that have denied MERS standing to seek relief from the automatic stay of proceedings in bankruptcy, holding that the requirements for a federal court to grant affirmative relief to MERS as the “real party in interest” are more stringent than the requirements under Nevada law for a party to commence a

under Federal Rule of Civil Procedure 9(b).

The court likewise dismissed the claim asserted by all six actions for “conspiracy to commit fraud related to the MERS System,” pursuant to Nevada, California and Arizona law. This claim revolved around allegations that the MERS system was itself fraudulent because (i) MERS lacks a beneficial interest in the mortgage notes at issue; (ii) the MERS system is a means of circumventing public mortgage recording requirements, and (iii) the MERS system “facilitated” fraud in the inducement of the underlying mortgage notes. The court held that plaintiffs’ claims relating to the alleged lack of a beneficial interest and noncompliance with mortgage recording requirements failed, insofar as plaintiffs had not properly alleged the necessary elements of falsity, reliance and injury. In this respect, the court relied on its own recent decision in a case governed by Arizona law, rejecting virtually identical

**While the MDL court’s decision directly pertains only to a limited subset of foreclosure actions governed by Nevada, California and Arizona law (and plaintiffs will have an opportunity to re-plead their claims), the decision is likely to have considerable impact on the MDL court’s handling of similar motions to dismiss wrongful foreclosure claims arising from other non-judicial foreclosure states.**

non-judicial foreclosure. Other bankruptcy courts have recognized MERS’ standing to seek an automatic stay, and the issue of MERS’ bankruptcy standing is far from settled. *See In re Tucker*, No. 10-61004, 2010 WL 3733916, at \*1, \*6 (Bankr. W.D. Mo. Sept. 20, 2010) (granting relief from automatic stay because noteholder had standing; MERS, acting as nominee, “became agent for each subsequent noteholder under the Deed of Trust when each such noteholder negotiated the Note to its successor and assign.”).

### Conspiracy Claims

The MDL court also dismissed the Nevada plaintiffs’ claims for conspiracy to commit wrongful foreclosure, holding that plaintiffs had (i) failed to allege a viable underlying claim for wrongful foreclosure, without which no conspiracy claim could lie, and (ii) failed to allege with particularity the specifics of the alleged conspiracy, including the “who, what, when, where and how of the misconduct charged,” as required

claims for similar reasons. *Cervantes v. Countrywide Home Loans*, No. CV 09-517-PHX-JAT, 2009 WL 3157160 (D. Ariz. Sept. 24, 2009).

The court held that, insofar as plaintiffs’ claim related to conspiracy to “facilitate” fraud in the inducement of mortgage loans, plaintiffs had failed to plead any such fraudulent inducement with specificity. Noting that three of the six complaints at issue included no allegations of fraudulent mortgage lending conduct, and that the other three complaints made only “vague and conclusory” allegations of fraudulent inducement, the court held that plaintiffs had failed to plead any such claims with particularity under Federal Rule of Civil Procedure 9(b). The court also held that the facts of the alleged conspiracy had not been alleged with specificity.

### Additional Claims

The court also dismissed plaintiffs’ claims for “slander of title”—a tort involving “false and

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malicious communications, disparaging one's title in land"—for failure to allege a false statement, insofar as the court held that MERS did, in fact, possess the power to foreclose, under Nevada's non-judicial foreclosure law, upon borrowers in default. Finally, the court dismissed plaintiffs' claims for unjust enrichment and declaratory and injunctive relief, holding that their failure to state any other viable claim for relief foreclosed both of these claims.

### Implications of the Decision

While the MDL court's decision directly pertains only to a limited subset of foreclosure actions governed by Nevada, California and Arizona law (and plaintiffs will have an opportunity to re-plead their claims), the decision is likely to have considerable impact on the MDL court's handling of similar motions to dismiss wrongful foreclosure claims arising from other non-judicial foreclosure states. In particular, the MDL court's focus on the apparent inability of plaintiffs to allege the absence of payment default, if applied broadly, may bar the vast majority of wrongful foreclosure class action claims against MERS that are before the MDL court. The court's ruling indicates that borrowers who are unable to allege that they were timely paying their obligations will not be able to pursue affirmative claims for wrongful non-judicial foreclosure based upon "splitting the note" theories or other challenges to MERS' status as mortgagee.

The MDL court's decision certainly is not the last word, however, regarding MERS' foreclosure standing. Foreclosure is governed by state law, and requires judicial involvement in many states, so that the question of MERS' foreclosure standing will ultimately be decided by state courts pursuant to state law. It is far too early to tell whether any of the myriad challenges to MERS' role in the foreclosure process will ultimately prove successful on a broad scale. ☺

## Mortgage Investors' Class Action Suit Dismissed for Not Complying with Pooling and Service Agreement

*By Thomas J. Hall and Marcelo Blackburn*

Mortgage originators and servicers won a victory recently in a battle with mortgage bond investors over who would bear the losses caused by mortgage modifications. In *Greenwich Fin. Servs. Distressed Mortgage Fund 3, LLC v. Countrywide Fin. Corp.*, No. 650474/08 (N.Y. Co. Oct. 13, 2010), a New York trial court dismissed a lawsuit brought by mortgage bond investors on the grounds that it failed to comply with the procedural requirements set forth in the Pooling and Service Agreement (PSA) that governed the trust in which the plaintiffs had invested.

The court's ruling emphasizes the need for investors who wish to assert claims against mortgage servicers to comply with the challenging procedural requirements typical of PSAs that govern mortgage trusts. In *Greenwich Fin. Servs.*, for example, the PSA required as a prerequisite to suit that at least 25% of the investors in the trust make a written demand on the trustee, provide an indemnity, and allow the trustee 60 days to bring suit. It remains to be seen to what extent these procedural requirements prove to be insurmountable obstacles to investor suits against mortgage originators and servicers.

### Background

The bursting of the housing bubble and the accompanying economic recession sparked a sharp increase in mortgage delinquencies and foreclosures. Since then, a number of efforts have been made to limit the effects of foreclosures on homeowners and their communities by facilitating the modification of delinquent mortgages, including, at the federal level, the passage of the Helping Families Save Their Homes Act of 2009.

The defendants in this case, Countrywide Financial Corporation and two of its affiliates, have been under particularly intense pressure to restructure troubled mortgages. In 2008, the Attorney Generals of several states, including California and Illinois, filed numerous lawsuits against Countrywide alleging that it had engaged in predatory lending. Countrywide ultimately reached an omnibus settlement with the states in October 2008 that required Countrywide to reduce mortgage payments on loans that it had originated by \$8.4 billion.

### The Mortgage Bond Investors' Lawsuit

Countrywide's settlement with the states was not universally welcomed. Countrywide owned only about 12% of the mortgages that it had originated. Thus, the bulk of the losses arising from the reduced mortgage payments were to be borne by the investors in the mortgage bonds sold and serviced by Countrywide. In December 2008, two hedge funds, Greenwich Financial Services LLP and QED LLC, filed a class action complaint on behalf of investors who had purchased mortgage bonds sold and serviced by Countrywide. The lawsuit sought a declaratory judgment that the PSAs obligated Countrywide to repurchase any mortgage loan on which payments were modified pursuant to Countrywide's settlement with the states.

### Countrywide's Motion to Dismiss

Countrywide moved to dismiss the complaint on two grounds. First, it argued that the defendants had failed to comply with the procedural requirements set forth in the PSA for bringing a suit. The PSA provided that no investor in the trust had any right to initiate a lawsuit or proceeding unless (1) the holders of more than 25% of the securities governed by the PSA had submitted a written request to the trustee to initiate an action, (2) those investors had offered a reasonable indemnity to the trustee for bringing such an action, and (3) the investors had allowed 60 days for the trustee to initiate the action. Second, Countrywide argued that the PSA only required the mortgage servicer repurchase mortgages that had been modified "in lieu of refinancing," which was not the case with mortgages modified pursuant to the settlement.

The plaintiffs acknowledged that they had not complied with the PSA's requirements for bringing suit, but offered several reasons why the PSA's procedural provisions did not apply

to their claims. First, they argued that because their complaint was a class action, it should not be governed by the provisions of a single PSA, even though that PSA governed the particular bonds held by the named plaintiffs. Second, they argued that the PSA's provisions applied only to actions that would treat some of the investors more favorably than others and that alleged a breach by the mortgage servicer, neither of which was true of the plaintiffs' lawsuit. Finally, the plaintiffs argued that demand on the trustee was excused because it would be futile. The plaintiffs also offered various arguments in support of their claim that the PSA required Countrywide to repurchase all of the modified mortgages and not only those modified in lieu of refinancing.

### The Court's Opinion

The court granted the defendants' motion to dismiss the complaint without reaching the substantive question of whether the PSA required Countrywide to repurchase mortgages modified pursuant to the settlement. Instead, it referred to the straightforward language of the PSA to reject the plaintiffs' arguments that they were not required to comply with the PSA's procedural requirements. Observing that the plaintiffs had not complied with any of these requirements, the court concluded that they were barred from commencing the lawsuit.

### Conclusion

The holding of *Greenwich Fin. Servs.* is perhaps not terribly surprising. The PSA's procedural requirements for bringing suit were unambiguous, and the plaintiffs' various arguments as to why the requirements did not apply did not have a strong enough legal basis to prevail.

It is too soon to say, however, whether the dismissal is more than a temporary setback for mortgage bond investors. The *Greenwich Fin. Servs.* complaint was filed less than two months after Countrywide reached its settlement with the states. The plaintiffs' failure to comply with the PSA's requirements in this case may be more indicative of their desire to file an action quickly than of the practical difficulty of satisfying the PSA's procedural requirements. Time will tell whether this or any other plaintiff group is able to file a complaint that satisfies the PSA's procedural requirements and finally forces a court to grapple with how mortgage losses should be allocated between mortgage investors and mortgage servicers. ☺

# Lender's Public Statements Support Borrower's Commercial Impracticability Defense

By Thomas J. Hall and C. Jonathan Wood

An action to recover payment on a defaulted loan recently brought renewed vitality to the affirmative defense of commercial impracticability. Most intriguing is the fact that the borrower supported its impracticability defense with public statements made by the lender concerning the unforeseeability of the economic collapse. The Illinois federal district court distinguished the instant case from other cases finding the economic downturn foreseeable on the ground that the lender “has acknowledged that the economic conditions, including those affecting the availability of credit, are unprecedented and not reasonably foreseeable.” The court did, however, dismiss claims based on the methodology for calculating interest, the lender using a 360-day year in its calculations. *Bank of America, N.A. v. Shelbourne Dev. Grp., Inc.*, 2010 WL 3269647, No. 09-C-4963 (N.D. Ill. Aug. 18, 2010).

## Background

Shelbourne Development Group planned to build the Spire Building in Chicago. In furtherance thereof, Shelbourne entered into a loan agreement with Bank of America (BOA) in December 2006 for a \$3 million revolving line of credit. The loan agreement provided that interest would be calculated at LIBOR plus one percent and that “all interest and fees, if any, will be computed on the basis of a 360-day year and the actual number of days elapsed.” The note attached to the loan agreement contained a similar interest computation clause and was signed by Garrett Kelleher as guarantor.

The loan agreement was amended twice—first in early 2007 in which BOA agreed to loan \$7 million to Shelbourne, and again in late 2008 when the parties executed an amendment obligating Shelbourne to obtain a construction loan commitment, which Shelbourne later failed to do. Asserting that this failure constituted a default, BOA accelerated all amounts due under the loan. BOA then brought suit to recover under the note and guarantee.

Defendants asserted counterclaims for (1) violation of the

Illinois Interest Act (IIA), (2) breach of good faith and fair dealing, (3) violation of Illinois Consumer Fraud and Deceptive Business Practices Act (ICFA), and (4) common law fraud. The defendants also asserted affirmative defenses for (1) breach of duty of good faith and fair dealing, (2) breach of the IIA, and (3) commercial impracticability. BOA moved to dismiss the counterclaims and to strike the affirmative defenses.

## The Commercial Impracticability Defense

Turning to the more intriguing part of the decision, the court denied the bank's motion to dismiss the defendants' affirmative defense of commercial impracticability. Defendants argued that their inability to secure a construction loan commitment was temporary and the result of “an unforeseeable and unprecedented economic downturn and recession, particularly in the real estate market.” Defendants demonstrated that BOA's “own executives and officers have repeatedly made public statements and other communications describing the current economic conditions, including those effecting the real estate market and the availability of credit as ‘unprecedented,’ ‘unparalleled’ and, not reasonably foreseeable.” BOA countered that both parties “foresaw and expressly provided for the possibility that Shelbourne would be unable to obtain financing.”

The court examined the viability of this defense, focusing on whether the economic downturn was foreseeable. While the court acknowledged that establishing an event as unforeseeable can frequently be difficult, it held that the issue of foreseeability could not be decided here on a motion to strike. The court distinguished this case from other cases finding that the economic downturn was foreseeable by pointing to the statements of BOA executives and officers, which created doubt as to whether the economic downturn was foreseeable at the time the parties entered into the agreement.

## The Excessive Interest Claims and Defenses

According to the applicable provision, interest was to be determined based on a 360-day year. Under this method, the lender divides the annual interest rate by 360 and then applies the daily interest rate to each of the actual 365 or 366 days in the year. This provision generates an extra five or six days of interest for each calendar year.

Defendants' first counterclaim and second affirmative defense alleged that, as a result of the 360-day interest computation clause, BOA violated the IIA by receiving more interest than was authorized under the IIA. The court dismissed

these claims and defenses on two grounds. First, the court concluded that the IIA was preempted by the National Bank Act (NBA). The defendants conceded that state usury law was preempted by the NBA, but argued that their claim was not for usury. The court disagreed, looking to the plain meaning of “usury” to conclude that the defendants’ claim that BOA charged excessive interest, as clearly being a claim for usury. The court concluded: “[A]s the saying goes, if it walks like a duck and quacks like a duck, it must be a duck.”

The court further explained that, even if the IIA was not preempted by the NBA, the claim would still fail because the IIA excludes coverage of corporate loans. The court based this conclusion on the plain language of the IIA, which clearly states that a corporation may contract for any amount of interest. Additionally, even if the IIA applied to corporate loans the applicable provision was merely a gap filler which could be altered by contract.

Next, the court dismissed the defendants’ claims and defenses for breach of good faith and fair dealing. Defendants alleged that BOA violated the duty of good faith by deliberately creating ambiguity in the loan documents and by exercising discretion in calculating interest in a manner which created “more interest than [the defendants] reasonably expected to be charged.” The dismissal rejected these arguments because the provision which calculated interest on a 360-day year was not discretionary and was completely unambiguous, the court concluded that “[b]ecause BOA did not exercise any discretion in calculating interest based on a 360-day year, it cannot be held to have breached the covenant of good faith and fair dealing.”

The court then dismissed the ICFA and common law fraud counterclaims. The ICFA claim was dismissed because the defendants “cannot state an ICFA claim based on terms that are revealed within the very loan documents that it signed.” A party simply cannot close its eyes to the terms of the agreement, and later claim “the other party committed fraud merely because it followed the contract.” The common law fraud claim was dismissed on the similar grounds—the defendants could not show a false statement, because the method for calculating interest was set forth squarely within the document itself.

## Conclusion

*Bank of America, N.A. v. Shelbourne Development* sounds a cautionary alarm concerning public remarks by financial institutions. While remarks about the unforeseeability of the

economic crisis may serve to assuage the concerns of shareholders about the competency of management, these remarks may haunt the institution in other venues. ©

# Fraud Claims Survive Against Morgan Stanley Over Inflated Credit Ratings

By Robert A. Schwinger and Emily Abrahams

In a recent decision, Judge Shira A. Scheindlin of the United States District Court for the Southern District of New York denied defendant Morgan Stanley’s motion to dismiss fraud claims brought by two institutional investors in connection with the collapse of a structured investment vehicle (SIV) called Rhinebridge. *King County, Washington, et al. v. IKB Deutsche Industriebank AG, et al.*, 2010 U.S. Dist. LEXIS 115351 (S.D.N.Y. Oct. 29, 2010). As alleged in the complaint, Morgan Stanley, in conjunction with defendants IKB Deutsche Industriebank AG (IKB) and ratings agencies Moody’s, S&P and Fitch (the “Rating Agencies”), designed, structured, marketed and maintained Rhinebridge. The crux of plaintiffs’ fraud claims is that Morgan Stanley, along with IKB and the Rating Agencies, caused Rhinebridge’s senior debt securities (the “Notes”) to receive false and misleading ratings such that investors believed the Notes were a safe, secure and reliable investment, despite the allegation that, as alleged, Rhinebridge was loaded with toxic assets.

Judge Scheindlin denied Morgan Stanley’s motion, holding that although plaintiffs had not alleged that Morgan Stanley had communicated directly with plaintiffs or that any of the alleged misrepresentations were directly attributable to Morgan Stanley, the allegations of Morgan Stanley’s extensive involvement in creating the documents containing the alleged misrepresentations were sufficient to meet the standard for pleading fraud under the group pleading doctrine.

## Allegations of Fraud

According to the complaint, in addition to working with IKB to structure, market and maintain Rhinebridge, Morgan Stanley (with IKB) also engaged the Rating Agencies to rate Rhinebridge and to structure the Notes, which plaintiffs alleged were assigned ratings that did / continued page 8

## Fraud Claims Against Morgan Stanley

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not reflect the true quality of the collateral. Morgan Stanley allegedly provided these purportedly false and misleading ratings through core deal documents. Plaintiffs alleged that Morgan Stanley, the Rating Agencies and IKB achieved these false and misleading ratings by knowingly designing a model that used outdated, incorrect and irrelevant historical information and did so because, without high ratings, the Notes would be unsaleable. Plaintiffs further alleged that Morgan Stanley sought these false and misleading ratings so that it would not lose its \$15 million fee for Rhinebridge's successful launch or its portion of Rhinebridge's net distributable profits.

In addition to allegations specifically concerning the ratings, the complaint alleged that Morgan Stanley (1) caused

why the statements (or omissions) are fraudulent.

Despite the extensive allegations of fraud, plaintiffs did not allege in the complaint that any of the alleged misrepresentations were directly attributable to Morgan Stanley or that Morgan Stanley had ever communicated directly with plaintiffs. For that reason, Morgan Stanley argued that plaintiffs failed to meet the requisite pleading standard, or, at best, had pled that Morgan Stanley was a secondary actor in the perpetuation of the Rating Agencies' or IKB's fraud. Morgan Stanley argued that, even under a secondary actor theory of liability, plaintiffs had failed to meet the requisite pleading standard because secondary actors can only be held liable for fraud for statements *attributed* to the secondary actor at the time of dissemination.

The court, however, found that the extensive allegations of Morgan Stanley's involvement in the fraud rendered it an

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Rhinebridge to acquire hundreds of millions of dollars of toxic assets that IKB was trying to unload, (2) coerced the Rating Agencies to allow risky Home Equity Loans (HELs) to constitute a disproportionately large percentage of Rhinebridge's liquid eligible assets, and (3) caused Rhinebridge to acquire Countrywide securities in an amount that was three times higher than the permissible limit set forth in the operating documents for exposure to a single obligor. Plaintiffs also alleged that Morgan Stanley knew that Rhinebridge had failed its capital loss test prior to Rhinebridge's issuance in June 2007.

### Applicable Legal Standards

To plead fraud adequately under Federal Rule of Civil Procedure 9(b), a complaint must (1) detail the statements (or omissions) that the plaintiff contends are fraudulent, (2) identify who made those statements, (3) state where and when the statements (or omissions) were made, and (4) explain

"insider" for purposes of the group pleading doctrine and that, therefore, plaintiffs had met their pleading burden. The court further held that, under the group pleading doctrine, it is not necessary that each individual defendant actually make the alleged misrepresentation where, as here, the documents containing the alleged misrepresentations—the private placement memoranda, the information memoranda and selling documents—constituted the collective work of individuals with everyday involvement with Rhinebridge. The court drew a distinction from the facts in this case from instances where the sole allegations of fraud are based on an affiliation with another defendant or a tenuous connection with a fraudulent scheme.

Applying that standard to the facts alleged, the court found that plaintiffs had met the requisite pleading standard as follows: First, the court held that, as a result of Morgan Stanley's intimate involvement in creating the false and misleading ratings and the core deal documents disseminated to

investors containing those ratings (private placement memoranda, information memoranda, and selling documents), those allegations were sufficient to allege a material misrepresentation by Morgan Stanley under the group pleading doctrine. Second, the court held that plaintiffs had adequately pled reasonable reliance because of allegations that (1) they relied on Rhinebridge's ratings in purchasing the Notes and (2) Morgan Stanley had access to nonpublic information showing that the credit ratings were false, including that Rhinebridge had violated its operating instructions and its capital loss test, and that the ratings process was flawed in that the models were deliberately manipulated to produce inflated ratings. Third, the court held that plaintiffs adequately pled scienter because (1) Morgan Stanley had the motive and opportunity to commit fraud in that it stood to earn certain fees and distributions of Rhinebridge's profits and (2) there was strong circumstantial evidence of Morgan Stanley's conscious misbehavior or recklessness because it knew that Rhinebridge was not the safe, secure, and reliable investment it was touted to be.

The court also found that plaintiffs had stated a claim for aiding and abetting common law fraud because they had pled (1) facts showing the existence of the underlying fraud on the part of both the Rating Agencies and IKB, (2) Morgan Stanley's knowledge of that underlying fraud, (3) that Morgan Stanley provided substantial assistance to advance the fraud's commission, and (4) damages. ©

## Auction Rate Securities Class Action Dismissed

By Robert Grossman

The United States District Court for the Southern District of New York recently issued a ruling dismissing securities fraud claims against Oppenheimer & Co., Inc. and Oppenheimer Holdings, Inc. (together, "Oppenheimer"), arising from Oppenheimer's sale of auction rate securities (ARS). *Vining v. Oppenheimer Holdings, Inc.*, No. 08 Civ. 4435, 2010 U.S. Dist. LEXIS 103689 (S.D.N.Y. Sept. 29, 2010). The *Vining* court held that the class action plaintiffs had failed to plead scienter because they had not adequately pled both motive and opportunity, or circumstantial evidence of misconduct. In particular, the court observed that, while the complaint's allegations of scienter

raised an inference of securities fraud, that inference was no stronger than the inference that Oppenheimer merely acted negligently in failing to identify and disclose facts concerning the imminent collapse of the ARS market.

### Issuance of Auction Rate Securities

For purposes of adjudicating defendants' motion to dismiss, the court assumed, as it was required, that the allegations in plaintiffs' complaint were true. Plaintiffs' complaint described ARS as long-term equity or debt instruments, issued by public or private entities, that are bought and sold at ARS auctions. At a successful auction, the number of bids to buy at a particular price would be equal to or greater than the number of ARS offered for sale at that rate. To prevent an unsuccessful auction in which the offers to purchase ARS were less than the offers to sell (*i.e.*, insufficient demand), auction dealers frequently intervened by placing "support bids" to purchase ARS for themselves. As a consequence of this practice, auction dealers accumulated large ARS inventories, which they sold through brokerage firms such as Oppenheimer. Oppenheimer, in turn, would sell those ARS directly to investors.

In August 2007, auction dealers ceased placing support bids in auctions for ARS that were backed with collateralized debt and other high-risk investments. They continued, however, supporting auctions for other ARS until February 2008, at which time all of the major auction dealers refused to place support bids in any auction. The auction dealers' withdrawal from the ARS auctions caused the entire ARS market to collapse, rendering the remaining ARS illiquid.

Plaintiffs' class action representatives allegedly purchased ARS from Oppenheimer in multiple tranches between March 2007 and February 2008, which they continued to hold at the time the ARS market collapsed. These representatives claimed that their Oppenheimer financial advisors had falsely told them that, *inter alia*, ARS were cash equivalents and/or highly liquid investments.

### The Alleged Misrepresentations and Omissions

Plaintiffs alleged that Oppenheimer directed its financial advisors to sell ARS as highly liquid investment vehicles despite the fact that they would become illiquid if auction dealers ceased intervening in auctions. Plaintiffs also asserted that Oppenheimer failed to disclose material facts about ARS and the ARS market, including that the ARS market had been under stress since at least the time of the August 2007 auction failures.

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## Auction Rate Class Action Dismissed

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### The Securities Fraud Claims

Plaintiffs alleged that Oppenheimer had committed securities fraud under Section 10(b) of the Securities and Exchange Act. The court held that, even assuming plaintiffs had pleaded the existence of material misstatements or omissions, they had failed to allege a strong inference of scienter—*i.e.*, “a mental state embracing intent to deceive, manipulate or defraud.” Scienter can be established by alleging facts that (i) show defendants had a motive and opportunity to commit the fraud, or (ii) constitute strong circumstantial evidence of conscious misconduct.

The court rejected the contention that Oppenheimer’s profit motive established scienter because the motive to increase its ARS business was a generalized motive that could be imputed to any similar market participant. The court also observed that allegations of Oppenheimer’s insider trading were insufficiently specific to demonstrate a motive to defraud, because they did not refer to specific ARS sold or to any non-public information underlying those sales.

In an attempt to raise a strong inference of scienter through “circumstantial allegations of conscious misbehavior or recklessness,” plaintiffs alleged that Oppenheimer should have known the ARS market was going to collapse because (i) Oppenheimer’s chairman was watching the ARS market closely after the August 2007 auction failure, (ii) Oppenheimer knew that some auction dealers were contemplating exiting the ARS market, and (iii) Oppenheimer was aware that the SEC had issued a staff interpretation stating that ARS were not cash equivalents. The court rejected each of these arguments because the complaint failed to plead specific facts to support the conclusory assertion that Oppenheimer could have anticipated the market’s February 2008 collapse on the basis of these allegations. For example, the complaint failed to “specify how many . . . auction dealers were allegedly contemplating exiting the market, whether these dealers managed auctions for the ARS held by plaintiffs, and what implications [Oppenheimer] foresaw for the ARS market as a whole.” The court also acknowledged that courts “generally do not afford great weight to SEC staff interpretations” and that because such documents “do not carry the force of law, Oppenheimer’s alleged failure to follow the letter’s dictates was not deliberately illegal behavior.”

Plaintiffs also attempted to impute scienter to Oppenheimer by alleging that one of its trainers neglected to

provide its financial advisors with adequate information regarding the ARS they were selling to investors. The court refused to credit this argument, however, because the complaint failed to allege facts showing the trainer had a motive or intent to defraud, or that he acted recklessly. The court also rejected plaintiffs’ allegations that Oppenheimer’s management directed its financial advisors to claim that the ARS were highly liquid, since the complaint did not identify any specific statement to this effect.

The court completed its analysis by observing that plaintiffs’ allegations must be evaluated in their entirety and considered in conjunction with plausible opposing inferences. In performing this analysis, the court concluded that, while it was plausible that Oppenheimer’s management directed its advisors to sell ARS as highly liquid investments (while knowing full well that they were not), “it is not at least as strong as the inference that Oppenheimer negligently or carelessly provided insufficient training to its financial advisors and was merely negligent in not detecting and disclosing the imminent market collapse.”

### Conclusion

*Vining* underscores the high degree of specificity necessary to allege the level of scienter required to support a Section 10(b)(5) claim. In the absence of sufficiently specific allegations, defendants may be able to achieve dismissal of claims against them arising from the 2008 financial crisis by arguing that they innocently failed to anticipate an impending market collapse. ☺

## Lender’s Letter of Interest to Borrower Held Not Binding

*By Jeffrey I. Wasserman and Andrea Voelker*

A New York trial court recently held that a so-called letter of interest did not obligate a lender to provide a loan to a prospective borrower. *HP Hotel Sponsor LLC v. Strategic Capital Solutions LLC*, 603707/08 (N.Y. Co. Aug. 26, 2010). Specifically, the court found that, notwithstanding various email communications between the parties in which the lender stated that it would close the loan on a specific date, the letter of

interest—which contained cautionary and noncommittal language—did not obligate the lender to provide the loan.

## Background

Plaintiff HP Hotel Sponsor, LLC (HP Hotel) planned to purchase and renovate a resort and spa in Colorado for \$70 million. HP Hotel intended to borrow \$44 million for this project.

In June 2008, Defendants Strategic Capital Solutions, LLC, SCS-Strategic Capital Solutions, LLC (SCS) and E&E Consulting, LLC (entities that plaintiff alleged used their names interchangeably), and their respective principals (collectively, the “SCS Defendants”), contacted HP Hotel and proposed to lend it \$24 million. On June 22, 2008, the SCS Defendants sent HP Hotel an email that stated that one of the SCS Defendants’ principals would be investing his own money in the project, and that the loan would close by July 1, 2008.

The next day, June 23, 2008, HP Hotel and SCS signed a Letter of Interest (the “Letter”). The Letter stated that SCS would provide \$24 million in mezzanine—*i.e.*, middle level—financing to HP Hotel subject to the terms and conditions set forth in the Letter. Those terms and conditions included the conditions that HP Hotel would arrange for a third party to provide senior financing, and that HP Hotel would pay SCS a \$35,000 expense deposit and a \$50,000 application and processing fee. HP Hotel paid the deposit and fee, and alleged that it spent substantial additional amounts in reliance upon the Letter and certain emails from the SCS Defendants that indicated the SCS Defendants’ “eagerness to close the deal.”

On July 28, 2008, however, the SCS Defendants informed HP Hotel that they would not finance the project because HP Hotel failed to obtain senior financing. The lawsuit ensued.

## The Claims and Defenses

HP Hotel filed a multi-count complaint against the SCS Defendants. As relevant here, HP Hotel asserted breach of contract and unjust enrichment claims, seeking \$85,000 in damages (*i.e.*, the amount of the fee and the deposit it paid), and sought an accounting regarding how the SCS Defendants used the \$35,000 expense deposit. HP Hotel also asserted a claim for breach of the implied covenant of good faith and fair dealing, alleging that the SCS Defendants accepted consideration from HP Hotel even though the SCS Defendants knew that they could not provide the promised financing. (HP Hotel also filed various tort claims, each of which was dismissed, but they are not relevant to this article.)

The SCS Defendants moved, pursuant to New York Civil Practice Law and Rules (CPLR) sections 3211(a)(1) and (a)(7), to dismiss the claims. The SCS Defendants denied entering into an enforceable agreement with HP Hotel, and claimed that the Letter was simply an unenforceable agreement to agree. The SCS Defendants also argued that the breach of contract, breach of implied covenant and unjust enrichment claims could be asserted only against SCS because none of the other defendants were named in the Letter or signed the Letter. HP Hotel ultimately withdrew the breach of contract, breach of implied covenant and unjust enrichment claims against all defendants except the signatory, SCS.

## The Letter of Interest

The Letter stated that its terms were “merely an outline and framework and are not an offer or commitment for financing,” and that it “is subject to the lender’s complete satisfaction, in all respects and in its sole and absolute discretion . . . .” It further stated that it was subject to the “negotiation, execution and delivery of all required definitive documentation with respect to the contemplated loan,” and that the closing of the loan was subject to the Preliminary Closing Conditions, which included the closing of a senior loan.

The Letter further stated:

If the lender discovers information which it, in its sole and absolute discretion, believes is negative information with respect to any aspect of the project or which does not conform to the terms of the contemplated loan in the Letter, the Lender may, in its sole discretion, suggest alternative financing . . . or decline to provide the contemplated Loan or any financing.

The Letter stated, moreover, that any obligation of SCS “will only arise upon the mutual execution and delivery of the definitive loan documents or a written commitment letter . . . ,” and that HP Hotel “acknowledge[s] understand[s] and agrees[s] that SCS . . . does not in any way guarantee, commit, covenant, represent or warrant that a commitment for the contemplated Loan . . . can or will be provided.” Finally, the Letter contained a merger clause that provided that the Letter constituted the entire agreement between the parties, superseded any previous communications between the parties and survived the termination of the Letter.

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## Letter of Interest Non Binding

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### The Court's Ruling

As the court recognized, a complaint is subject to dismissal under CPLR 3211(a)(1) “if documentary evidence conclusively established a defense to the claims as a matter of law,” and under CPLR 3211(a)(7) “if its allegations utterly fail to manifest any cause of action cognizable under the law.”

With respect to HP Hotel's breach of contract claims, the court addressed the threshold issue of the enforceability of the Letter, emphasizing its “cautionary and noncommittal language.” While New York law does not enforce mere agreements to agree, *Aksman v. Xiongwei Ju*, 21 A.D.3d 260, 261 (1st Dep't 2005), the court noted, citing *IDT Corp. v. Tyco Group, S.A.R.L.*, 54 A.D.3d 273, 247-75 (1st Dep't 2008), *aff'd*, 13 N.Y.3d 209 (2009), that New York law does recognize the existence

“major items,” but leaves other important terms for future negotiations. Type II agreements thus do not bind the parties “to their ultimate contractual objective.” See *IDT Corp.*, 54 A.D.3d at 275. Rather, the only binding obligation is that the parties negotiate the remaining open issues in good faith. If, after negotiating in good faith, the parties are unable to reach an agreement, the parties have no further obligations to each other.

Based on its review of the language of the Letter, the court determined that the Letter was not a Type I preliminary agreement—*i.e.*, one in which the parties already agreed to all of the material terms requiring negotiation—because the Letter set forth several conditions, including the completion of due diligence and SCS's satisfaction thereof. The court further determined that the Letter was not a Type II preliminary agreement because the Letter did not bind the parties to

## The court further determined that the Letter was not a Type II preliminary agreement because the Letter did not bind the parties to negotiate the unresolved issues in good faith.

of certain binding preliminary agreements, which courts (especially federal courts applying New York law) sometimes refer to as “Type I” and “Type II” preliminary agreements. In its decision in *IDT*, the Court of Appeals pointed out that it did not find the “rigid classifications into ‘Types’ useful,” but it nonetheless confirmed that it did not disagree with the reasoning in the federal cases that utilize those classifications. The *HP Hotel* court ultimately analyzed the Letter in light of these “Type” classifications.

As described by the *HP Hotel* court, a “Type I” preliminary agreement is a complete agreement that reflects a comprehensive meeting of the minds on all issues requiring negotiation, “leaving only a formal writing to be completed.” Because the agreement with respect to all material terms is complete, a Type I agreement is binding on both parties, even if the parties do not execute a formal writing memorializing the terms.

A “Type II” agreement, on the other hand, is one that reflects an agreement between the parties on several

negotiate the unresolved issues in good faith. Indeed, the court emphasized that the Letter “expressly provides that the parties will not be bound in the absence of a formal, executed writing.”

Given the absence of any binding obligations, the court concluded that the Letter merely “expresses the parties’ intentions to negotiate and discuss a transaction within the parameters outlined in the Letter and to limit any negative consequences that might arise out of the discussion or failure to close the transaction. Either party could decide not to go ahead with the transaction for any reason without incurring an obligation to the other party [with two specific exceptions regarding fees and expenses].” The Letter was, in other words, a “preliminary, nonbinding proposal to agree[.]” The court therefore concluded that “plaintiff may not claim that SCS breached the Letter by not” providing the loan.

On the strength of the court's conclusion that the Letter was but a “preliminary, nonbinding proposal to agree,” the

court also concluded that, “[t]o the extent that plaintiff asserts that SCS breached a duty to negotiate in good faith, that duty is inconsistent with the terms of the Letter,” which contained no such obligation.

With respect to the two binding sections of the Letter—namely, “those dealing with fees and expenses”—HP Hotel asserted a viable cause of action regarding the \$35,000 expense deposit because there was a dispute regarding how much of that amount had to be refunded to HP Hotel. That portion of HP Hotel’s complaint therefore was not dismissed.

The court, however, dismissed HP Hotel’s claim for unjust enrichment because, as argued by the SCS Defendants, an unjust enrichment claim can exist only where there is no agreement. Thus, because the unjust enrichment claim sought the same damages as the breach of contract claim with respect to the two binding sections of the Letter, *i.e.*, the \$85,000 for fees and expenses, recovery was precluded because the events “ar[ose] out of the same subject matter as the contract.”

In sum, the court granted the SCS Defendants’ motion to dismiss on all grounds, except to the extent that HP Hotel sought recovery of the unspent expense deposit that it paid pursuant to the terms of the Letter.

## Conclusion

Courts will not enforce obligations when an intent to be bound is not reflected within the four corners of the document. As a result, parties should be careful when analyzing whether a preliminary document containing cautionary and noncommittal language creates binding obligations, particularly when other informal communications between the parties suggest that such obligations do exist. The best practice for parties seeking formal commitments, therefore, is to enter into formal contracts that specifically identify the parties’ respective obligations. Such formal agreements bring clarity to the contracting parties’ relationships—thus helping to avert or minimize disputes—and would help the party in HP Hotel’s shoes avoid taking on the burdens and costs associated with binding obligations when, in fact, none exist. ☺

# Wells Fargo Pays \$71 Million in Settlement Arising from “Pick-a-Payment” Toxic Mortgages

*By Scott S. Balber and J. Carson Pulley*

Wells Fargo Home Mortgage (Wells Fargo) recently entered a settlement with New Jersey’s Attorney General and Division of Consumer Affairs stemming from allegations of fraudulent mortgage sales practices. Under the settlement, Wells Fargo agreed to pay approximately \$71 million in loan modifications to an estimated 900 New Jersey residents, restitution, and payments to state programs to fight mortgage fraud and prevent foreclosures. The settlement concludes a New Jersey investigation into Wells Fargo subsidiaries Wachovia Corp., Golden West, and World Savings (collectively, the “Subsidiaries”) for potential violations of the New Jersey Consumer Fraud Act arising from allegedly deceptive marketing of the Subsidiaries’ “Pick-a-Payment” mortgage products. The settlement is part of a wider settlement that Wells Fargo has reached with regulators in Arizona, Colorado, Florida, Illinois, Nevada, Texas and Washington relating to the Pick-a-Payment products. Pursuant to the settlement with the eight states, it is estimated that loan modifications will be offered to more than 8,700 borrowers at a total economic value of over \$770 million, with more than \$400 million in overall principal forgiveness.

## The Pick-a-Payment Mortgages and the Consumer Fraud Act

The mortgages at issue, referred to as the Pick-a-Payment products, allowed customers to select one of three payment options: (1) a fully amortizing 15- to 30-year interest and principal payment; (2) an interest-only payment; or (3) an even lower minimum payment. The Subsidiaries’ Pick-a-Payment mortgages were typically advertised by emphasizing the lowest minimum payment option feature. The Subsidiaries allegedly did not advise potential borrowers, however, that the minimum payment option was often insufficient to cover the interest on the loan. When borrowers’ payments did not cover the interest, it caused the outstanding principal balance of the loan to increase and to sometimes / continued page 14

## Wells Fargo Settlement

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balloon out of control as the required minimum monthly payments also increased proportionally. As recognized by Wells Fargo in the settlement agreements: "In light of the Pick-a-Payment mortgage loan features, the dramatic declines in home prices, and rising unemployment, some Pick-a-Payment mortgage loan borrowers are unable to meet their mortgage obligations." As a result, some borrowers lost their homes to foreclosure.

The Subsidiaries' alleged failure to notify potential borrowers of the effects the lower minimum payment feature could have on the outstanding principal balance was the basis of the New Jersey Consumer Fraud Act investigation. Section 56:8-2 of the Act states in relevant part:

The act, use or employment by any person of any unconscionable commercial practice, deception, fraud, false pretense, false promise, misrepresentation, or the knowing, concealment, suppression, or omission of any material fact with intent that others rely upon such concealment, suppression or omission, in connection with the sale or advertisement of any merchandise or real estate, or with the subsequent performance of such person as aforesaid, whether or not any person has in fact been misled, deceived or damaged thereby, is declared to be an unlawful practice. . . .

Following its acquisition of the Subsidiaries in 2008, Wells Fargo began efforts to modify certain borrowers' loans and, as of August 2010, the Subsidiaries' Pick-a-Payment customers across the United States had already been granted almost \$3.4 billion in principal forgiveness. Notably, Wells Fargo itself never offered Pick-a-Payment mortgages, and it has admitted no wrongdoing under the settlements with the eight states.

### The Settlement with New Jersey

On October 5, 2010, Wells Fargo, the New Jersey Attorney General and the Division of Consumer Affairs entered an "Assurance" in which the parties agreed:

New Jersey and Wells Fargo share concerns regarding the ability of troubled Pick-a-Payment mortgage loan borrowers to repay their loans. This Assurance sets forth a framework through which Wells Fargo will offer

distressed Pick-a-Payment mortgage loan borrowers affordable loan modifications that include significant principal forgiveness.

Under the settlement, Wells Fargo will pay \$67 million in the form of loan modifications to an estimated 900 New Jersey residents who borrowed from the Subsidiaries under the potentially fraudulent Pick-a-Payment mortgages. The modifications will vary based on the unique circumstances of the mortgagee. Such modifications may include principal forgiveness, loan extension, interest rate reduction and principal forbearance. To incentivize borrowers to remain current on their loan repayments going forward, additional principal forgiveness may be awarded to those borrowers who stay current over a three-year period. In addition, qualifying borrowers will have the option of converting their mortgages into fixed-rate loans, and Wells Fargo has agreed to waive modification fees and prepayment penalties.

An additional \$2 million is to be paid by Wells Fargo towards restitution for qualifying consumers forced to leave their homes due to foreclosure or short sales between January 2, 2005 and December 18, 2010. Finally, another \$1.98 million is to be contributed to programs designed to prevent deceptive sales practices by mortgage companies operating in New Jersey. In total, Wells Fargo is required to pay \$24 million to the eight states to combat consumer fraud relating to mortgages.

In addition to the settlement payments and expected loan modifications, Wells Fargo has promised to make various commitments to Pick-a-Payment borrowers to assist them with the modification process. These concessions include supplying telephone hotlines to assist consumers, deciding whether consumers are eligible for modifications within 30 days from completion of the application, and providing an official appeals process for consumers who are denied modifications, among others. The associated cost of these services will be borne by Wells Fargo.

### Implications for Mortgage Companies

In the wake of the "toxic" mortgage-backed securities collapse and related economic recession, regulators remain focused on potentially fraudulent sales practices and associated investment and mortgage loan products. Such practices and products pose liability risk not only to the companies that offered them to consumers, but also to successor companies, like Wells Fargo, that acquire the risk as part of a corporate

acquisition. The Wells Fargo settlements highlight the importance of pre-acquisition due diligence with respect to consumer investment and loan products, and the need to identify, understand, quantify and adjust for these risks prior to closing. ☺

## Subfeeder Fund Not Liable for Failing to Uncover Madoff Scheme

By Benjamin D. Bleiberg

Judge Leonard B. Sand of the United States District Court for the Southern District of New York recently granted a motion to dismiss a complaint filed by a putative class of investors against a subfeeder investment fund that invested in the now well-known Ponzi scheme orchestrated by Bernie Madoff. *Newman v. Family Management Corp.*, No. 08-11215, 2010 U.S. Dist. LEXIS 111589 (S.D.N.Y. Oct. 20, 2010). The court found that the subfeeder fund lacked the requisite scienter to be held liable for federal securities fraud because it lacked motive and opportunity, and was not reckless in failing to recognize the supposed “red flags” pointing to evidence of Madoff’s fraud. The court further dismissed the plaintiffs’ state law claims against the subfeeder and feeder funds as precluded by the Securities Litigation Uniform Standards Act, and denied their derivative claims for failure to satisfy demand requirements.

### Background

The plaintiff investors’ claims arose from their investments as limited partners in the FM Low Volatility Fund (the “FM Fund” or “Subfeeder Fund”), a subfeeder fund that allegedly invested in three Madoff feeder funds—the Maxim Absolute Return Fund, L.P.; the Andover Associates LLC fund; and the Beacon Associates LLC I fund (together, the “Feeder Funds”). Family Management Corporation (“FMC”) was the FM Fund’s general partner and investment advisor, and was allegedly responsible for making the decision to invest in the Feeder Funds and for monitoring those investments. The Feeder Funds in turn invested the Subfeeder Fund’s assets in Madoff’s investment company, Bernard L. Madoff Securities LLC (“BMS”).

FMC offered participation in the FM Fund only to sophisti-

cated, accredited investors through an offering memorandum and attached Form ADV. According to the offering memorandum, the FM Fund would invest assets through other investment vehicles, such as hedge funds and hedge “funds-of-funds,” rather than trading on its own. FMC warranted it would conduct ongoing due diligence on all third-party managers and their investment vehicles. The offering memorandum disclaimed, however, the accuracy of the information that the third-party managers provided to the FM Fund, disclosed that the FM Fund might sustain losses if “a Manager does not operate in accordance with its investments strategy . . . or if the information furnished by a Manager is not accurate,” and cautioned that it did not guarantee that the investments would be diversified. The Feeder Funds’ offering memoranda contained similar disclaimers and disclosures to those in FMC’s offering memorandum.

When Madoff’s fraud was exposed in late 2008, the FM Fund and the plaintiffs allegedly lost a large portion of their investments, which led FMC to dissolve the FM Fund. Consequently, the plaintiff investors filed a 13-count complaint against FMC and the FM Fund; the Feeder Funds and their respective investment advisors, officers, and managers; the Feeder Funds’ outside consultants; and various John Does. The complaint alleged claims against FMC and its officers (the “FMC Defendants”) for securities fraud in violation of Rule 10b-5 and Sections 10(b) and 20(a) of the Exchange Act; multiple state law claims including common law fraud, negligent misrepresentation, breach of fiduciary duty, gross negligence and mismanagement, unjust enrichment, malpractice and professional negligence, and aiding and abetting breach of fiduciary duty; and multiple derivative claims based upon similar securities fraud and state law grounds.

### The Securities Fraud Claims

The court first dismissed the plaintiffs’ securities fraud claims on the ground that they failed to plead scienter—a mental state that involves an intent to deceive, manipulate, or defraud. To state a securities fraud claim under Section 10(b), the complaint was required to plead that the FMC Defendants made a materially false statement or omitted a material fact, with scienter, in connection with the purchase or sale of securities. Scienter is sufficiently pled when the allegations of the complaint demonstrate either (1) that the defendant has a motive and opportunity to commit fraud, or (2) that the defendant acted with conscious recklessness. The Private Securities Litigation Reform Act / continued page 16

## Madoff Subfeeder Fund

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(PSLRA) establishes a heightened pleading standard and requires particular allegations giving rise to a strong inference of scienter. Allegations of an inference of scienter must be compelling, not merely plausible or reasonable, and a court will consider collectively all the facts alleged, as well as any opposing inferences of non-fraudulent intent.

The complaint alleged that the FMC Defendants possessed the requisite scienter because (1) due to their own self-interest in obtaining exorbitant fees and commissions from the plaintiffs, the FMC Defendants were motivated to ignore numerous red flags that would have led to the discovery of Madoff's fraud or a determination that BMS was a bad investment; and (2) the FMC Defendants exhibited extreme recklessness in failing to recognize numerous red flags regarding

single strategy hedge funds, BMS was audited by a small accounting firm; (4) that Madoff did not employ any third-party administrators and custodians; (5) that Madoff lacked transparency and limited access to his books and records; and (6) that Madoff admitted to illegally manipulating his accounting records.

The plaintiffs alleged that the FMC Defendants must have known about these red flags because other industry professionals detected them and were equally available to each defendant. Applying the Second Circuit's precedent in *South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98 (2d Cir. 2009), however, Judge Sand rejected the plaintiffs' red flag theory of scienter, reasoning that "[f]or twenty years, Madoff operated this fraud without being discovered and with only a handful of investors withdrawing their funds as a result of their suspicions. The actions of the minority cannot support an infer-

### Building on Second Circuit precedent, the *Newman* decision presents yet another hurdle to investors seeking to recover the money they lost through indirect investments in Madoff's Ponzi scheme from the managers of their investment vehicles.

their investments in BMS and taking no further action to investigate or disclose the risk. The court first dismissed the plaintiffs' theory of scienter based on motive and opportunity because the complaint failed to allege any facts that the fees the FMC Defendants had received, which consisted of 1.4% of the FM Funds' assets, were exorbitant or in excess of the industry standard fees. The court reasoned that a mere desire to receive high compensation for their investment services does not constitute motive for the purpose of determining scienter.

The court next dismissed the plaintiffs' "red flag" theory of scienter. The plaintiffs alleged that the FMC Defendants ignored publicly available facts and data that should have been red flags that warned them of Madoff's fraud. These alleged red flags included: (1) that Madoff offered consistent investment returns in both up and down markets; (2) discrepancies between Madoff's purported trading activity and the open interest of index option contracts; (3) that unlike 90% of

ence of intent to defraud as to the numerous other investors who were still in the dark." Specifically, the plaintiffs failed to assert factual allegations supporting that the FMC Defendants knew that Madoff's returns could not be replicated by others, that the investors who chose not to invest with Madoff informed the FMC Defendants about their decision, or that the FMC Defendants had access to additional information that was unavailable to other industry professionals. Finding no allegations of primary liability under Section 10(b), the court additionally dismissed the Section 20(a) claim as well.

#### The State Law Claims

The court further dismissed the plaintiffs' multiple state law claims alleged directly as a class because the claims were precluded by the Securities Litigation Uniform Standards Act (SLUSA). A claim is precluded by SLUSA when: (1) the suit is a "covered class action"; (2) the action is based on state or local

law; (3) the action concerns a “covered security”; and (4) the defendant misrepresented or omitted a material fact “in connection with” the purchase or sale of the covered security. The plaintiffs argued that SLUSA preclusion does not apply because the defendants’ misrepresentations were made in connection with limited partnership interests, which are not “covered securities,” and that their state law claims for unjust enrichment and aiding and abetting breach of fiduciary duty do not sound in fraud.

The court held that, although shares in the FM Fund were not covered securities as defined by the Securities Act, misrepresentations related to non-covered securities such as the FM Fund’s limited partnership interests were still considered “in connection with” covered securities. As indicated in its offering memorandum, the FM Fund was created for the purpose of investing in covered securities. Further, the plaintiffs alleged that the defendants’ misrepresentations had the purported effect of facilitating Madoff’s fraud, which the court had held in a prior decision was conducted in connection with the purchase and sale of securities. The court reasoned that the fact that the FM Fund did not directly invest in the covered securities, and instead invested in Feeder Funds that adopted the same investment objectives and strategies, was irrelevant to the court’s analysis and dismissal of the state law claims.

### The Derivative Claims

Finally, the court dismissed the plaintiffs’ remaining derivative claims on behalf of the FM Fund because the complaint failed to plead sufficiently that making a demand on FMC would have been futile. Applying Delaware law, the court held that as limited partners of the FM Fund, the plaintiffs were required to make a demand on the general partner before bringing a derivative claim, or to adequately explain why they did not do so. Acknowledging that they did not make a pre-suit demand, the plaintiffs argued that making a demand on FMC would have been futile because, having benefited from the Madoff-related transactions, FMC was neither independent nor disinterested in its investment decisions, and because FMC faces a substantial likelihood of liability for its actions.

The court first found that the plaintiffs failed to allege sufficient facts that FMC was not disinterested because it benefited at the expense of the limited partnership. Generally, facts that establish that a general partner received substantial commissions or fees that were lavish or excessive would

excuse the demand requirement. The court rejected the plaintiffs’ argument, however, finding that the complaint failed to plead any particularized facts demonstrating that the fees were excessive, inconsistent with the industry standard, or anything more than regular advisory fees. The court further held that the plaintiffs failed to allege that FMC faced a substantial likelihood of liability because the “mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors.” The court reasoned that FMC did not face a substantial likelihood of liability because (1) the FM Fund’s offering memorandum contained exculpatory provisions that limited FMC’s tort liability; (2) many of the claims were preempted by the Martin Act; and (3) the plaintiffs’ argument that FMC acted without valid business judgment was based on the failed “red flags” theory for failing to uncover Madoff’s fraud.

### Implications

Building on Second Circuit precedent, the *Newman* decision presents yet another hurdle to investors seeking to recover the money they lost through indirect investments in Madoff’s Ponzi scheme from the managers of their investment vehicles. ©

## Countrywide Executives Settle with SEC Over Allegations of Fraud and Insider Trading

By Paige Willan

On October 15, 2010, Angelo Mozilo, a founder and former chairman and CEO of Countrywide Financial Corporation, settled a lawsuit brought by the SEC for a record \$67.5 million in penalties and disgorged profits. The consent judgment against Mozilo forever bars Mozilo from operating as an officer or director of a publicly traded company. Two additional former Countrywide executives, David Sambol and Eric Sieracki, also settled with the SEC for \$5.5 million and \$130,000, respectively.

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## Countrywide Settles with SEC

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### The Complaint

The SEC filed suit against Mozilo in June 2009, alleging that Mozilo, along with Sambol, the former COO, and Sieracki, the former CFO, defrauded investors by certifying financial statements with false or misleading statements about Countrywide's lending practices. The SEC alleged that the defendants violated Section 17(a) of the Securities Act, Sections 10(a) and 13(a) and Rules 10b-5, 12b-20, 13a-1, and 13a-13 of the Exchange Act, and that Mozilo and Sieracki violated Rule 13a-14 of the Exchange Act. In addition, the SEC alleged that Mozilo had engaged in insider trading, earning approximately \$139 million while in possession of material, nonpublic information about the negative outlook for Countrywide's business.

The SEC's complaint included two broad categories of false statements allegedly made by the Countrywide executives in public statements and in Countrywide's financial disclosure documents. One category of statements related to "Pay-Option ARM loans," while the other related to Countrywide's general loan origination standards.

### Pay-Option ARM Loans

Pay-Option ARM loans allow a borrower to select from several payment levels, including a level that is insufficient to cover accruing interest. If the borrower selects this level, the accruing interest is added to the principal balance of the underlying loan, until the principal balance reaches 115% of the original balance. At that point, the borrower's payment is automatically reset to the amount necessary to repay both the principal and interest within the remaining term of the loan.

In its 2006 10-K filing, Countrywide claimed that it had "prudently underwritten" the Pay-Option ARMs that it originated. Further, Mozilo stated in a speech in late May 2006 that "Pay-Option loans represent the best whole loan type available for portfolio investment from an overall risk and return perspective."

Internally, however, Mozilo and other Countrywide executives allegedly were concerned about the performance of Pay-Option ARM loans. The SEC pointed to specific statements in internal emails to and from Mozilo regarding Pay-Option ARM loans that indicated that Mozilo was concerned about customers whose loans would adjust to an increased payment rate. In early June 2006, Mozilo allegedly determined that Countrywide should stop originating Pay-Option ARM loans

to borrowers with low credit scores and that such loans already on Countrywide's books should be sold. In addition, Mozilo advised that Countrywide should review its reserves relating to these loans and indicated that management should "assume the worst."

### Expanding Underwriting Guidelines

According to the SEC complaint, Countrywide greatly expanded its underwriting guidelines for new borrowers over the years 2003 to 2007, in part because it adopted a "supermarket strategy" by which it would offer to its customers any products that were offered by a competitor, including sub-prime lenders. Even with its relaxed underwriting guidelines, Countrywide's supermarket strategy caused it to originate a large number of loans as "exceptions" to its already broad underwriting standards. Those loans typically were made to extremely risky borrowers.

The SEC alleged in its complaint that Countrywide's 10-K filings for the years 2005, 2006 and 2007 contained a description of Countrywide's loans that did not alert investors to the degree of risk that Countrywide was undertaking in its mortgage origination, particularly when taking into consideration its vastly expanded mortgage origination guidelines.

In contrast, the SEC pointed to internal Countrywide emails and reports that allegedly demonstrated concern about increased credit risk from mortgage originations as early as late 2004. In particular, the complaint pointed to numerous warnings from Countrywide's Chief Risk Officer, John McMurray, in which he asserted—as early as June 2005—that, due to the supermarket strategy, Countrywide's mortgage origination guidelines "will be a composite of the outer boundaries across multiple lenders" and that, therefore, Countrywide's mortgage origination guidelines "are likely among the most aggressive in the industry." Despite the internal concern about widened underwriting guidelines, a suggestion from McMurray that information about these relaxed guidelines be included in Countrywide's public filings was dismissed by Sieracki and Sambol.

### Summary Judgment and Settlement

In September 2010, Judge John F. Walter of the Central District of California denied the defendants' motion for summary judgment on all but one of the SEC's claims. The court found that the SEC raised genuine issues of material fact as to whether Countrywide's periodic reports contained materially false or misleading statements and as to whether the defen-

dants made those statements with scienter. In making this determination, the court rejected an argument that Countrywide's "extensive disclosures about the risk characteristics of its loan originations in periodic SEC filings" rendered the omissions and misstatements immaterial. In so holding, the court noted that "Defendants fail to demonstrate that the disclosures actually conveyed the omitted information with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by Defendants' one-sided representations."

Regarding the SEC's insider trading allegations against Mozilo, the court found that "the SEC has raised genuine issues of material fact that Mozilo was aware of material, non-public information at the time he adopted or amended [his Rule 10b5-1] trading plans and that he acted with scienter." The sole count dismissed in the summary judgment order was that of violation of Rule 13a-14 of the Exchange Act. In dismissing that claim, the court found that violation of this rule did not constitute an independent claim for relief.

Approximately one month following the summary judgment order, Mozilo and the other defendants entered into settlement agreements with the SEC, only days before trial was set to begin. In approving the settlement, Judge Walter found the agreement "fair, adequate, reasonable, in the public interest, and consistent with the goals of the securities laws."

### Failure to Heed Warnings

The tenacity of the SEC's allegations in this case hinged not on the risky activities undertaken by Countrywide, but rather on its failure to disclose adequately the level of risk arising from those activities. Further, throughout the complaint and the court's order denying defendants' motion for summary judgment, the SEC and the court cited extensively to emails and reports compiled by Countrywide's Chief Risk Officer, John McMurray. McMurray not only issued internal warnings regarding the danger of Countrywide's policies, but also specifically requested that Countrywide disclose those risks in its periodic filings. Two of the defendants allegedly ignored those requests. This settlement should serve as a warning to executives of companies undertaking potentially risky financial strategies that they ensure adequate disclosure of those activities in the company's periodic reporting. Further, the Mozilo settlement should remind executives that warnings from risk control personnel, particularly warnings relating to the need to disclose certain risky policies in periodic filings, should be taken seriously and given full, documented consid-

eration before the decision is made not to act on those warnings. ©

## Court Rejects Attempt to Attach Electronic Funds Transfer

By Thomas E. Butler and Laura Rowntree

In *Allied Maritime, Inc. v. Descatrade SA*, 620 F.3d 70 (2d Cir. 2010), the Second Circuit Court of Appeals affirmed a decision by Judge Shira A. Scheindlin of the Southern District of New York that prohibited the process of maritime attachment and garnishment (PMAG) to secure a putative foreign arbitral award. *Allied Maritime* is the most recent in a series of decisions that have rejected not only attempts to attach electronic funds transfers (EFTs) through the use of Rule B of the Supplemental Rules for Admiralty or Maritime Claims and Asset Forfeiture Actions of the Federal Rules of Civil Procedure (Rule B). The Second Circuit not only rejected the attempt to attach the originating, foreign account, but also the effort to attach a suspense account created to comply with a PMAG and the related right of refund under the "money-back guarantee" provision of the Uniform Commercial Code. As a consequence, the court determined that *quasi in rem* jurisdiction was lacking, and it affirmed the dismissal of the attachment proceeding accordingly.

### Factual Underpinnings

The New York litigation between Allied Maritime, Inc. (Allied) and Descatrade, SA (Descatrade) arose out of damages sustained to a vessel that Descatrade chartered from Allied in July 2008 to transport cargo from China to West Africa, and a subsequent arbitration proceeding in London in which Allied sought approximately \$1.4 million in damages. On April 10, 2009, Allied filed a complaint in the federal district court for the Southern District of New York, seeking to attach Descatrade's assets under Rule B as a pre-judgment security for the anticipated London arbitration award.

On April 15, 2009, Judge Scheindlin authorized the issuance of a PMAG against "all tangible and intangible property belonging to, claimed by or being held for [Descatrade] by any garnishees" in the Southern District of / continued page 20

## Electronic Funds Transfer

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New York, including BNP Paribas and HSBC Bank USA, N.A. The issuance was in accordance with Second Circuit law at the time, which provided that under Rule B an EFT between two foreign banks that “cleared” momentarily through a so-called “intermediary bank” in New York was attachable property of the originator or the beneficiary of the transfer. See *Winter Storm Shipping, Ltd. v. TPI*, 310 F.3d 263 (2d Cir. 2002). The PMAG was issued *ex parte* because, under the then-current rule, a putative defendant need only receive notice after its property is attached.

On June 25, 2009, Descatrade, a Swiss company, issued a payment order to a Paris branch of BNP Paribas to transfer \$400,000 electronically to another Descatrade account with HSBC France, also in Paris. BNP Paribas arranged for the trans-

fer of the EFT, which was routed through HSBC Bank USA in New York. Pursuant to the PMAG served on BNP Paribas’s New York branch earlier that year, BNP Paribas suspended the EFT and placed it into a suspense account. Whether the suspense account was located in Paris or in New York was not clear from the record.

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The court summarized its holding by concluding where “a suspense account that purportedly triggers the right is created solely to hold funds that were improperly attached in the first place,” such as in the case of Descatrade, that account cannot form the basis of jurisdiction.

retained an attachable interest in the suspense account pursuant to the Uniform Commercial Code’s “money-back guarantee” provision, codified at N.Y. U.C.C. § 4-A-402, which allows an originator to recover its funds in the event a funds transfer cannot be completed.

### Separate Entities

Allied initially argued that *Jaldhi* did not apply because BNP Paribas was both the originating and the intermediary bank. The Second Circuit affirmed the district court’s rejection of this argument, however, without total reliance on *Jaldhi*, but because of New York’s separate entity rule. According to the separate entity rule, each branch of a bank is treated as a separate entity for the purpose of attachment such that a BNP Paribas branch in Paris is treated as an entirely separate entity from a BNP Paribas branch in New York. The district court read this rule in conjunction with the Uniform Commercial Code, which states: “A creditor of the originator can levy on the

account of the originator in the originator's bank before the funds transfer is initiated [but] [t]he creditor of the originator cannot reach any other funds because no property of the originator is being transferred." N.Y. U.C.C. § 4-A-502 cmt. 4. Treating the Paris and New York branches of BNP Paribas as separate entities under a Section 4-A-502 analysis, the district court determined that a PMAG in New York could attach only those funds originating in a New York branch, even though the originating bank had a branch in New York, because the transfer was initiated elsewhere.

Reviewing the decision *de novo*, the Second Circuit affirmed Judge Scheindlin's determination that the Descatrade's account with BNP Paribas in Paris was not subject to *quasi in rem* jurisdiction.

### The Suspense Account

The Second Circuit also rejected Allied's alternative argument that the suspense account was located in New York and, therefore, attachable in the jurisdiction. The court noted that the record on appeal did not indicate whether the suspense account had been created by BNP Paribas in Paris or in New York, such that its location was ultimately unclear. Nonetheless, the court stated that the suspense account would not be subject to attachment as property of Descatrade because the funds contained in an EFT cease being the property of the originator once the EFT is initiated, and do not become the property of the beneficiary until the EFT is completed by the beneficiary bank's acceptance of the payment order. In effect, the BNP Paribas branch in Paris had relinquished control of the funds and the HSBC branch in Paris had not gained control at the time when the suspense account was created. Even though Descatrade was transferring its funds from one of its accounts (BNP Paribas in Paris) to another one of its accounts (HSBC in Paris), at the point when the suspense account captured the funds in the EFT (from BNP Paribas in New York), the funds were not in Descatrade's possession because Descatrade did not have an account with a New York branch of BNP Paribas.

Moreover, given that the suspense account would never have been created, in New York or otherwise, but for the improper attachment, the court found it could not rely on the suspense account's location in New York to establish *quasi in rem* jurisdiction.

### The "Money-Back Guarantee" Provision

The Second Circuit also rejected Allied's final alternative argument, that BNP Paribas's decision to stop the EFT and create a suspense account using funds contained in it triggered Descatrade's attachable right of repayment under the "money-back guarantee" provision of N.Y. U.C.C. § 4-A-402(3)-(5), which was in turn subject to attachment. Under that provision, where an originator has already paid its bank the amount it seeks to transfer but the transfer is not completed, the originator is entitled to a refund. Where multiple banks are involved in a transfer, including multiple intermediary banks, the duty to provide the refund is reciprocal to each bank in the transfer chain. Accordingly, if a court order calls for an attachment while the EFT is in the possession of an intermediary, the originator retains the right to sue the intermediary.

The district court rejected Allied's reliance on this provision because of the Second Circuit decision in *Grain Traders, Inc. v. Citibank, N.A.*, 160 F.3d 97 (2d Cir. 1998), which generally requires privity between the party seeking the refund and the bank from which it seeks that refund. Under N.Y. U.C.C. §§ 4-A-402(3), (4) and *Grain Traders*, the court determined Descatrade was in privity only with BNP Paribas in Paris, and thus had no attachable property interest in the right of refund from BNP Paribas in New York.

The Second Circuit affirmed this determination, adding that an attachment could not be justified because of a right of refund that would not have existed but for the attachment as effected by a suspense account. The court stated: "The jurisdictional defect that renders the suspense account unattachable under Rule B also renders unattachable any recovery right arising out of the suspense account." The court summarized its holding by concluding where "a suspense account that purportedly triggers the right is created solely to hold funds that were improperly attached in the first place," such as in the case of Descatrade, that account cannot form the basis of jurisdiction. ©

# Court Rejects “Intended Payee Defense” to Claim for Recovery of Proceeds of Altered Checks

By Christopher Cusmano

In a recent decision, Judge Paul A. Crotty of the United States District Court for the Southern District of New York denied defendant banks’ motion for judgment on the pleadings in a case involving the alleged wrongful honor of altered checks. The plaintiff filed suit to recover the proceeds of two checks, totaling \$85,000, from defendants Wachovia Bank, N.A. (Wachovia) and T.D. Bank, N.A. (T.D. Bank) on the grounds that the checks had been altered prior to the banks accepting them for payment. The defendants moved for judgment in their favor, arguing that the plaintiff’s claims were barred by the intended payee defense. The court was unpersuaded, however, ruling that the intended payee defense was not applicable, choosing instead to let the case proceed past the pleading stage. *Roberts v. Wachovia Bank, N.A.*, No. 09 Civ. 1968 (S.D.N.Y. Sept. 16, 2010).

## The Plaintiff’s Claims

The plaintiff, Darren Roberts, was allegedly a victim of fraud. Roberts was approached by a man who identified himself as Michael Howard. Howard allegedly told Roberts that he had advanced funds to Chad Adler, Roberts’ friend and business associate, for the purchase of a defaulted mortgage note. After building a relationship, at Howard’s request, Roberts made two payments to Howard totaling \$85,000, based on Howard’s representation that the money would be used to satisfy Adler’s debt to Howard. Roberts wrote two checks payable to “Michael Howard” and “Mike Howard” in the amounts of \$80,000 and \$5,000, respectively.

Unbeknownst to Roberts at the time, Howard was actually Michael Howard Clott, a felon with multiple convictions for mortgage fraud, who had never loaned any money to Adler. After Clott received the checks from Roberts, he altered them by adding “Clott” to the payee’s name. Clott then endorsed the altered checks and presented them for deposit into his account at Wachovia. Wachovia accepted the altered checks, and then sent them to Roberts’ bank, Commerce Bank, N.A.

(Commerce), for payment. Commerce also accepted the checks, and paid Wachovia from Roberts’ account.

Roberts eventually discovered Clott’s true identity, and he and Adler filed suit against Clott in New York state court, which entered a judgment against Clott by confession in the amount of \$539,675. Roberts then brought suit against Wachovia and T.D. Bank, as successor in interest to Commerce, to recover the \$85,000 and costs and attorneys’ fees, alleging that the alterations on the checks were “materially apparent,” and that his losses would have been prevented had the banks not accepted the checks.

## The Intended Payee Defense

The defendant banks moved for judgment on the pleadings pursuant to Rule 12 of the Federal Rules of Civil Procedure. Under this rule, after accepting all the factual allegations in the complaint as true and drawing all reasonable inferences in favor of the plaintiff, the court will dismiss a complaint if it fails to state a plausible claim for relief. In support of their motion, defendants argued that Roberts’ claim was precluded by the intended payee defense.

According to the banks, the intended payee rule provides that whenever the proceeds of a check reach the intended beneficiary, notwithstanding the fact that the check may have been altered or not properly endorsed, the drawer of the check cannot recover these proceeds from the bank which mistakenly accepted the check. Thus, since Roberts admitted he intended to make a payment to Clott, albeit under false pretenses, and Clott did receive the proceeds of the checks, he may not recover his losses against the bank for accepting the altered checks. Essentially, the defendants maintained that Clott’s fraud, and not the banks’ error, caused Roberts’ losses.

Roberts did not dispute this understanding of the intended payee defense, in theory, but argued that the defense does not apply where the plaintiff has alleged and suffered a loss. Roberts noted that, generally, when courts apply the intended payee defense, the drawer of the checks has not alleged that he suffered a loss attributable to the bank. Roberts insisted that his complaint was more precise, as it specifically alleged that he suffered an \$85,000 loss, and that the loss would have been prevented had the banks not accepted the checks. Because the complaint alleged a loss attributable to the banks, Roberts contended the defense did not apply.

## The Court’s Ruling

In his opinion, Judge Crotty first clarified that, while New York

law did not specifically acknowledge the intended payee defense by name, it recognized it under the rubric of unjust enrichment. In *Tonelli v. Chase Manhattan Bank, N.A.*, 363 N.E.2d 564 (1977), the New York Court of Appeals—the state’s highest court—had affirmed an “equitable defense . . . based on the view that the drawer should not be permitted to recover from the drawee bank where he has suffered no loss from the improper payment of a check.”

Although receptive to the concept of the intended payee defense, the court found that the question of whether the rule applies depended largely on the circumstances of the case, and is more “nuanced” than the brightline rules suggested by the parties. As the court explained: “Defendants’ understanding of the defense is too broad; Plaintiff’s too narrow. The intended payee’s receipt of the proceeds of an altered check does not ipso facto immunize banks from liabil-

court noted a situation whereby the drawer had marked a check to reflect a desire to pay money into a designated account. Where the intended payee alters the checks to defeat the drawer’s intent, deposits the money into a general account and it is then misappropriated, banks do not automatically avoid liability based on the fact that the intended payee received the money, since they could have prevented the drawer’s loss.

Similarly, the court found that Roberts’ contention that the intended payee defense cannot apply if the drawer suffers and alleges a loss to be an overstatement. The court noted that, in cases of fraud, the drawer always suffers a loss; even if the drawer did intend to pay a fraudster, he has still lost the money. Thus, according to the court, the important issue is the extent to which the bank contributed to the loss. Judge Crotty cited a New York case that applied the intended payee

### *Roberts v. Wachovia Bank demonstrates that, at least under New York law, the intended payee defense may not be an automatic bar against potential claims based on the use of altered checks.*

ity for improper payment. Nor does a loss by the drawer necessarily preclude banks from avoiding liability when the intended payee has received the proceeds of an altered check. The inquiry is more nuanced.” According to the court, the most significant issue when analyzing the application of the intended payee defense is causation. The “focus of the intended payee rule is not on the acts of the intended payee or third-parties, instead . . . the focus is on the extent to which the improper payment of the check contributed to the loss suffered by the plaintiff—even if the originating cause of the loss is the intended payee or a third-party.”

The court briefly reviewed some of the caselaw cited by both parties to demonstrate the importance of causation. For example, while the defendants argued that banks can never be held liable when the intended payee receives the funds, the court referred to previous cases holding banks liable, even when the intended payee receives the money, if the alterations on the check defeated the drawer’s specific purpose. The

defense despite a clear loss by the drawer. In that case, unendorsed checks were improperly deposited into a business account, and the proceeds were misappropriated by an officer of the company. The business filed suit against the banks for accepting the unendorsed checks, but the case was dismissed. Although the plaintiff had suffered a loss and the banks should not have accepted the unendorsed checks, the loss was attributable to the fact that the business had failed to establish separate bank accounts or procedures to limit account access, leaving it exposed to misappropriation. The court also discussed a case involving a Ponzi scheme. After losing money, the victim filed suit against a bank, which had accepted his checks even though the Ponzi scheme operator had failed to endorse them. Although the victim had lost money, the court dismissed the case by noting that, even if the checks were not accepted, the Ponzi scheme operator would have simply been asked to sign the checks and re-deposit them. Thus, the loss was

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## Altered Checks

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attributable to the fraud and not the bank's mistake.

In the current case, by focusing on the element of causation, Judge Crotty determined that the intended payee defense did not apply, and denied the defendants' motion for judgment on the pleadings. The court explained that, if Roberts' allegations were accepted as true, the alterations were "clearly apparent," and the banks should have never accepted the checks. And without the banks' mistake, Clott would not have received the \$85,000, his scheme would have been foiled and Roberts' losses would have been avoided. "[T]he improper payment was a substantial factor in causing plaintiff's loss, and therefore Defendants cannot avoid liability—at least on the well-pleaded facts in the Complaint—based on the intended payee defense." While surviving dismissal, to prevail on his claims Roberts must now prove that the banks' mistakes were indeed a "substantial factor" in his loss to recover.

### Implications

*Roberts v. Wachovia Bank* demonstrates that, at least under New York law, the intended payee defense may not be an automatic bar against potential claims based on the use of altered checks. Many courts will not mechanically apply the test, but rather will undertake a detailed analysis to determine whether the particular circumstances of the case warrant its application. The court's opinion here suggests that the analysis may turn on the precision with which the plaintiff alleges causation. ☺

# Court Enjoins Sale of Equity Collateral Based on Interpretation of Intercreditor Agreement

*By Caroline Pignatelli*

A New York state trial court recently granted the motion of plaintiffs Bank of America, N.A. (Bank of America) and U.S. Bank National Association for a preliminary injunction enjoining defendant PSW NYC LLC (PSW) from acquiring or selling

certain equity collateral without first paying plaintiffs the outstanding amounts owed to them under a senior loan made in connection with the financing of the acquisition of the residential housing development known as Peter Cooper Village and Stuyvesant Town. In *Bank of America, N.A., et al. v. PSW NYC LLC*, No. 651293, 2010 WL 4243437 (N.Y. Co. Sept. 16, 2010), the court determined that the Intercreditor Agreement entered into in connection with the loans was unambiguous and that the plain language mandated that the senior lenders be paid in full prior to any acquisition or sale of the collateral.

### The Loans

In 2007, Tishman Speyer Development Corp. (Tishman) purchased Peter Cooper Village and Stuyvesant Town (the "Property") for \$5.4 billion. Tishman financed the transaction through a \$3 billion Senior Loan and 11 Junior Loans totaling \$1.4 billion. The Senior Loan was financed by Tishman through various related entities (the "Borrowers") that obtained the \$3 billion loan from Wachovia Bank, N.A. (Wachovia) and Merrill Lynch Mortgage Lending, Inc. ("Merrill," and together with Wachovia, the "Senior Lenders"). In connection with that financing, the Borrowers delivered six notes totaling \$3 billion (the "Notes"), which were held in a mortgage securitization trust of which the plaintiffs were the trustees. The Borrowers granted the Senior Lenders security interests in the Property.

The \$1.4 billion in Junior Loans consisted of 11 mezzanine loans issued by Junior Lenders in exchange for pledges by the Borrowers' parent companies (the "Junior Borrowers") of their interests in the Borrowers and their respective general partners. The priority of the Junior Loans was in sequential order with Junior 1 Loan the most senior and Junior 11 Loan the most junior. Junior Loans 1-3 were each in the original principal amount of \$100 million. Wachovia and Merrill were the original Junior Lenders on Junior Loans 1-3, among others. Pursuant to separate Pledge and Security Agreements, each Junior Lender was granted a first priority security interest in its corresponding Junior Borrower's ownership interest in its corresponding subsidiary Borrower or Junior Borrower and that entity's general partner (Equity Collateral).

In connection with these financings, Wachovia and Merrill, in their capacities as Senior and Junior Lenders, entered into an Intercreditor Agreement.

### The Default

On January 8, 2010, the Borrowers defaulted on the Notes. Plaintiff Bank of America, through its Special Servicer

CWCapital Asset Management LLC (CWCAM), sent Borrowers a notice of default in which it demanded that the Borrowers pay all outstanding amounts. CWCAM also notified the Junior Lenders of the default which, under the Intercreditor Agreement, the Junior Lenders had the opportunity to cure. None of the Junior Lenders allegedly exercised those cure rights. CWCAM then notified both the Borrowers and the Junior Lenders that, because the default had not been cured, all unpaid debt outstanding under the Notes was accelerated and immediately due. On February 16, 2010, CWCAM, on behalf of the Senior Lenders, filed a complaint in the Southern District of New York seeking foreclosure of the Property. On June 21, 2010, the Southern District of New York entered a Judgment of Foreclosure and Sale of the Property in the amount of \$3,666,734,464, which constituted the amount due under the Notes and related Senior Loan documents. *Bank of America, N.A., et al. v. PCV ST Owner LP, et al.*, No. 10-Civ-1178.

### Defendant's Intended Sale of the Equity Collateral

On August 6, 2010, Wells Fargo, as successor to Wachovia, notified the Senior Lenders that it had transferred its interest in Junior Loans 1-3 to PSW, a "Qualified Transferee" under the Intercreditor Agreement. At the same time, PSW executed a "Representation Certificate" agreeing to be bound by the Intercreditor Agreement with respect to Junior Loans 1-3. On August 7, 2010, PSW notified the Senior Lenders that it intended to sell the Equity Collateral at a UCC public sale, and published in *The New York Times* a "Notice of Public Sale of Collateral" for Junior Loans 1-3, setting a sale date of August 25, 2010. In response, the Senior Lenders requested confirmation from PSW that, pursuant to Section 6(d) of the Intercreditor Agreement, it would cure the Senior Loan default as a condition to any acquisition or transfer of the Equity Collateral. Specifically, Section 6(d) provided:

*To the extent that any Qualified Transferee acquires the Equity Collateral pledged to a Junior Lender pursuant to the Junior Loan Documents in accordance with the provisions and conditions of this Agreement (including, but not limited to Section 12 hereof), such Qualified Transferee shall acquire the same subject to (i) the Senior Loan and the terms, conditions and provisions of the Senior Loan Documents and (ii) the applicable Senior Junior Loans and the terms, conditions and provisions of the applicable Senior Junior Loan Documents, in each case for the bal-*

*ance of the term thereof, which shall not be accelerated by Senior Lender or the related Senior Junior Lender solely due to such acquisition and shall remain in full force and effect; provided, however, that (A) such Qualified Transferee shall cause, within ten (10) days after the transfer, (1) Borrower and (2) the applicable Senior Junior Borrowers, in each case to reaffirm in writing, subject to such exculpatory provisions as shall be set forth in the Senior Loan Documents and the related Senior Junior Loan Documents, as applicable, all of the terms, conditions and provisions of the Senior Loan Documents and the related Senior Junior Loan Documents, as applicable, on Borrower's or the applicable Senior Junior Borrower's, as applicable, part to be performed and (B) all defaults under (1) the Senior Loan and (2) the applicable Senior Junior Loans, in each case which remain uncured or unwaived as of the date of such acquisition have been cured by such Qualified Transferee or in the case of defaults that can only be cured by the Junior Lender following its acquisition of the Equity Collateral, the same shall be cured by the Junior Lender prior to the expiration of the applicable Extended Non-Monetary Cure Period.*

PSW responded in a letter by calling the Senior Lenders' statements about Section 6(d) of the Intercreditor Agreement "ludicrous" and stating that Section 6(d) "does not require the payment of the Senior Loan as a condition to a transferee acquiring the Equity Collateral."

### Discussion

Bank of America and U.S. Bank National Association filed a complaint seeking: (i) a declaration of their rights under the Intercreditor Agreement and (ii) injunctive relief preventing PSW from acquiring or selling the Equity Collateral without first paying the outstanding amounts owed to plaintiffs under the Senior Loan and from causing commencement of bankruptcy while the Senior Loan is outstanding. In addition, plaintiffs moved, by order to show cause, for a preliminary injunction enjoining the sale of the Equity Collateral and commencement of bankruptcy.

### Likelihood of Success on the Merits

In granting plaintiffs' motion for a preliminary injunction, the court focused its analysis on the relevant provisions of the Intercreditor Agreement, including Section 6(d). The court explained: "[W]here the language [of a / continued page 26

## Intercreditor Agreement

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contract] is clear, unequivocal and unambiguous, the contract is to be interpreted by its own language’, and the ‘writing should as a rule be enforced according to its terms.’” The court concluded that the Intercreditor Agreement was unambiguous and that “[i]ts plain language obligates PSW to cure all Senior Loan defaults if PSW acquires the Equity Collateral, which includes the \$3.6 billion Indebtedness resulting from the Default.” Therefore, as PSW made clear its intention to acquire the Equity Collateral at the UCC sale and not to comply with its obligations under Section 6(d) to cure the Senior Loan default, “plaintiffs have ‘show[n] a likelihood of success on the merits by showing that [their] claims have prima facie merit.’”

The court rejected PSW’s argument that there was no justiciable controversy alleged in the complaint. In its August 2010 letter, PSW made clear that it did not intend to cure the Senior Loan default prior to acquiring the Equity Collateral when it characterized its obligations under Section 6(d) as “ludicrous.” Moreover, it was clear that PSW intended to acquire the Equity Collateral by virtue of its Notice of Public Sale of Collateral published in *The New York Times* and its formation of six shell entities to act as buyers. Accordingly, the court determined “there is clearly a justiciable controversy here, where plaintiffs are seeking ‘to adjudicate the parties’ rights before a wrong actually occurs in the hope that later litigation will be unnecessary.’”

The court denied, however, plaintiffs’ request for a preliminary injunction with respect to Section 11(d)(ii) of the Intercreditor Agreement, which prohibited PSW from orchestrating a Borrower’s bankruptcy unless the Senior Loan was paid in full. Although PSW retained bankruptcy counsel to represent the Borrowers once the UCC sale was completed, the court explained that “[t]he Intercreditor Agreement does not prevent PSW, as a Junior Lender, from seeking legal advice or planning for future contingencies.” Moreover, given that the court granted the preliminary injunction with respect to Section 6(d), “plaintiffs’ request to enjoin PSW concerning Section 11(d)(ii) of the Intercreditor Agreement is moot, and the purported hazard posed by plaintiffs is ‘speculative and abstract,’ and, therefore, nonjusticiable.”

### Irreparable Harm

With respect to irreparable harm, the court noted: “Irreparable harm is the single most important prerequisite for the issu-

ance of a preliminary injunction. To prevail, the movant must establish not a mere possibility that it will be irreparably harmed, but that it is *likely* to suffer irreparable harm if equitable relief is denied.” Additionally, “the loss of a bargained-for contractual right of control can constitute irreparable harm.” Here, the court explained that the Senior Lenders “expressly bargained” for a contractual provision that prevents junior lenders like PSW from acquiring ownership and control of the Equity Collateral without first paying off the outstanding indebtedness of the Senior Loan. Accordingly, “[a]ny loss of control is in violation of the Intercreditor Agreement and would constitute irreparable harm to plaintiffs.”

Additionally, the court noted that Section 34 of the Intercreditor Agreement “reinforces” this conclusion, as it provides that “injunction, declaratory judgment, and specific performance” are available remedies for breaches of the Intercreditor Agreement and “monetary damages are not an adequate remedy to redress a breach by the other hereunder and that a breach by any party hereunder would cause irreparable harm to any other party to this Agreement.” Notably, PSW agreed to be bound by the terms of the Intercreditor Agreement—including Section 34—by executing the Representation Certificate. Accordingly, as the parties “set down their agreement in a clear, complete document . . . their writing should . . . be enforced according to its terms.”

### Balancing of the Equities

Finally, the court explained that “[i]n balancing the equities, the court must weigh the harm suffered by the plaintiff if the injunction were denied against the harm suffered by the defendant if the injunction were granted.” The court also noted that in balancing the equities, the court must also consider the public interest involved. Here, the court determined that “the balance clearly tips in favor of the plaintiffs, who merely seek to hold PSW, as a Junior Lender, to its contractual obligations under the Intercreditor Agreement.” Additionally, the court determined that “the public interest is served by maintaining stability in what PSW concedes ‘is the largest residential property in Manhattan and home to a significant portion of the city’s moderate income housing.’”

### Outcome

The court granted plaintiffs’ motion for a preliminary injunction enjoining PSW from acquiring or selling the Equity Collateral without prior payment of the total outstanding indebtedness (in excess of \$3,666,000,000) of the Senior

loan. The court conditioned the order upon the posting by plaintiffs of a bond pursuant to CPLR § 6312 in the amount of \$4,500,000 (the undisputed price at which PSW purchased Junior Loans 1-3). Although PSW initially filed a notice of appeal of the court's preliminary injunction order, on October 26, 2010, the parties entered into a stipulation withdrawing PSW's appeal. On November 12, 2010, the court approved the parties' stipulation of voluntary discontinuance.

## Conclusion

This case demonstrates that when the language of the Intercreditor Agreement is clear and unambiguous, courts will hold the parties to the terms—even at the expense of junior lenders. As this court commented, in the context of its analysis of the equities, enjoining the acquisition or sale “is entirely consistent with the recognition that subordinated loans are inherently more risky than their senior counterparts—a reality of which [the Junior Lender], as a sophisticated party, was no doubt aware when it acquired the mezzanine loan here.”

# Fair and Accurate Credit Transactions Act Class Action Allowed to Proceed

By Francesca J. Perkins

The Ninth Circuit Court of Appeals has recently held that, where plaintiffs bring a putative class action alleging violations of the Fair and Accurate Credit Transactions Act (FACTA), class action certification should not be denied simply because a disproportional relationship exists between the defendant's potential statutory liability and the actual harm suffered by plaintiffs. In addition, the court found that the district court erred in denying class certification on the basis of defendant's post-complaint FACTA compliance. *Bateman v. American Multi-Cinema, Inc.*, 2010 WL 373355 (9th Cir. Sept. 27, 2010).

## The Facts

In an effort to protect against identity theft, the FACTA, 15 U.S.C. § 1681c(g), prohibits businesses that accept credit or debit cards from printing more than the last five digits of

account numbers on receipts. The statute incorporates the Fair Credit Reporting Act's statutory damages provision, which allows a consumer to recover damages “ranging from \$100 to \$1,000 for each willful violation of FACTA,” without having to prove actual damages.

Michael Bateman, the named plaintiff in this action, filed a putative class action suit on behalf of himself and those individuals similarly situated against defendant American Multi-Cinema, Inc. (AMC). The suit alleged that from December 2006 to January 2007, the company issued noncompliant receipts from its automated box offices. An internal AMC investigation, conducted after the lawsuit was filed, allegedly revealed that “more than 290,000 receipts had been printed in violation of the FACTA during the relevant time period.” With over 290,000 potential violations, the defendant's statutory damage exposure of \$100 to \$1,000 per violation could total between \$29 million and \$290 million.

Bateman sought class certification pursuant to Federal Rules of Civil Procedure 23(b)(3), which provides, in part, that where “the questions of law or fact common to class members predominate over any questions affecting only individual members . . . a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.” The district court denied class certification, finding that plaintiff “had failed to demonstrate that a class action would be superior to other available methods” for adjudication. The district court reasoned that because AMC's statutory liability “could result in enormous liability” that was “completely out of proportion to any harm suffered by the plaintiff,” class certification was not “superior to other available methods.”

## The Ninth Circuit's Ruling

On appeal, the Ninth Circuit began its analysis by noting that Rule 23 is noticeably silent on what constitutes “superiority” in determining whether to certify a class. The court pointed out that, while “[t]he rule provides a non-exhaustive list of factors relevant to the superiority inquiry . . . [n]one of these enumerated factors appear to authorize a court to consider whether certifying a class would result in disproportionate damages.”

The court wrote that a number of district courts have struggled with this superiority issue, in part because the statute (1) does not place a cap on these damages in the case of class actions, (2) does not indicate a threshold at which courts are free to award less than minimum statutory damages, and (3) does not limit the number of individ- / continued page 28

## Fair and Accurate Credit Transaction Act

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uals that can be certified in a class or the number of individual actions that can be brought against a single merchant. Notwithstanding this lack of guidance, the court noted that Congress amended the FACTA in 2008 and seemingly made the decision at that time not to limit the availability of class relief or the amount of aggregate damages reasonable. As such, the Ninth Circuit concluded that the district court's denial of class certification based on the disproportional relationship between the large potential award and any actual damages was in error.

The court made use of the same logic in determining that the district court had erred in relying on the sheer size of the potential award as grounds for denying class certification. The court wrote: "In the absence of such affirmative steps to limit liability, we must assume that Congress intended FACTA's remedial scheme to operate as it was written." To that end, "[t]o limit class certification availability merely on the basis of 'enormous' potential liability that Congress explicitly provided for would" in effect subvert Congressional intent.

With respect to issues of proportionality, the court noted that AMC's reliance on *Kline v. Coldwell* as an example of the Ninth Circuit denying class certification for disproportionality was misplaced. The court explained that *Kline* was distinguishable because it involved 2,000 defendant class members facing not only joint and several liability, but treble damages under both the Clayton and Sherman Acts, for a potential total of \$750 million in damages. In that case, the court held that class adjudication could subject the individual defendants to "vicarious liability by the coincidence of a class action for the staggering damages of the multitude," a result that Congress could never have intended.

Finally, the court held that the district court should not have found that, because AMC "demonstrated good faith by complying with FACTA within a few weeks of the filing of Plaintiff's Complaint," the deterrent effect of the class action was limited. The court wrote that where Congress chose not to include any safe harbor provisions or limitations on damages for good faith compliance, to deny class certification on good faith grounds "would communicate to other potential violators that, as long as they comply with FACTA after a complaint is filed, they may avoid liability for widespread violations."

## Conclusion

The Ninth Circuit's holding in *Bateman v. American Multi-Cinema, Inc.* stands for the proposition that a disproportionate relationship between potential liability and actual harm suffered or the enormity of potential damages should not be a material factor when determining whether, under FRCP Rule 23(b)(3), a class action is superior to individual cases under the FACTA. Moreover, this decision supports the notion that post-complaint good faith compliance is not an appropriate basis to deny class certification under the FACTA, as that would undermine the deterrent effect of the FACTA. ©

## Parent Company Potentially Liable for Subsidiary's Alleged Improper Mortgage Payoff Fees

*By Kimberly Zafran*

The federal district court for the Eastern District of New York recently allowed a class action against Washington Mutual Inc. (WMI) to go forward, in which plaintiff mortgage-holders alleged that WMI's subsidiary, Washington Mutual Bank, FA (WMB), charged improper payoff fees to the plaintiff class. The court ruled that plaintiffs' allegations that WMI supervised and controlled WMB's activities and operations were adequate to support the claim that WMI acted as its subsidiary's alter ego. *Cassese v. Washington Mutual, Inc.*, No. 05-cv-2724, 2010 WL 405126 (E.D.N.Y. Oct. 18, 2010).

## Background

In 2005, the named plaintiffs, who had home loans with defendant WMB, initiated this action alleging that WMB and related entities charged them and thousands of other banking customers improper fees for making early payments on their mortgages. WMB's parent company, WMI, was also named as a defendant as WMB's alleged alter ego. The class was loosely defined as all U.S. consumers or borrowers who had a mortgage or other residential loan serviced by WMB who paid or would be demanded to pay prohibited fees, charges, or penal-

ties in connection with requests for payoff statements, payoff amounts, prepayments, repayment discharge, settlement or satisfaction of loans secured by a residence.

After a long and complicated procedural history, WMI moved pursuant to Federal Rule of Civil Procedure 12(c) for a judgment on the pleadings dismissing all claims against it, arguing that the complaint failed to allege that it engaged in any improper actions, and that no basis otherwise existed to hold it liable for WMB's alleged wrongful acts.

### The Decision and Analysis

The court denied WMI's motions for dismissal, finding that the acts of WMB may be imputed to its parent, WMI, as its alter ego. The court stated that, pursuant to the standard from *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), "a complaint should be dismissed only if it does not contain enough allegations of fact to state a claim for relief that is 'plausible on its face.'" The court applied Washington law in this analysis, as WMB was incorporated in Washington State. The court observed that, under Washington law, "courts may disregard the distinction between a parent corporation and its subsidiary when necessary to do justice" (citing *In re Wade Cook Financial Corp.*, 375 B.R. 580, 598 (9th Cir. 2007)). The plaintiffs provided enough information, including WMI publications, to indicate that WMI actively supervised and controlled the activities and operations of its subsidiaries. The court found that, at the pleading stage, these allegations were sufficient to establish that it is plausible that WMB is the alter-ego of WMI.

WMI cited three cases to support its dismissal arguments, but the court distinguished each of them. In *Gunther v. Capital One, N.A.*, 703 F. Supp. 2d 264, 278 (E.D.N.Y. 2010), the plaintiff asserted that the parent company of Capital One Bank was liable for improper fees charged by Capital One Bank. The court dismissed the claims based on a failure to plead specific facts. The court here noted, however, that Virginia law was applied in that case and that such permits an alter ego theory of liability only when the corporate form is a "device or sham used to disguise wrongs," among other things. The court ruled that Washington law does not require "that the corporate form be actively used to conceal wrongs to pierce a corporation's veil." Thus, unlike under Virginia law, the plaintiffs here did not have to plead that it was WMI's intent to use the corporate form to disguise its wrongs. The court also distinguished the case of *McAnaney v. Astoria Financial Corp.*, 665 F. Supp. 2d 132, 145 (E.D.N.Y. 2009), which granted defendant's

summary judgment motion finding that the evidence presented concerning overlapping corporate officers was insufficient to pierce the corporate veil. Here, however, the plaintiffs used WMI's own corporate statements, including a declaration in a press release stating that WMI's Home Loans Division president would "[o]versee all aspects of the company's home loans business" to infer an alter ego relationship; similar statements were not alleged in *McAnaney*.

Finally, the court found that, at the pleading stage, plaintiffs did not need to prove their allegations to avoid dismissal; they must only demonstrate the plausibility of their claims. WMI cited *Youkelsone v. Washington Mutual, Inc.*, 418 B.R. 107, 115 (Del. Bankr. 2009), in which the bankruptcy court dismissed claims against WMI based solely on the acts of WMB. The court distinguished that case as, unlike the plaintiff in *Youkelsone*, the plaintiffs here alleged facts showing "that WMI made statements implying its shared identity with WMB." ☺

## Claims Continue Against AIG for Inadequate Disclosure of Credit Default Swap Risk

By Nicolas Stebinger

The federal district court for the Southern District of New York recently ruled that securities claims brought by a putative class of investors who were allegedly harmed by misleading public statements by American International Group, Inc. (AIG), regarding the level of risk in AIG's portfolio, were adequate to survive a motion to dismiss. *In re Am. Int'l Group, Inc.*, No. 08 Civ. 4772, 2010 U.S. Dist. LEXIS 101263 (S.D.N.Y. Sept. 27, 2010). In allowing the case to go forward, the court found that the class's securities claims could proceed against multiple defendants based on their varied degrees of involvement with several different public statements and filings.

### The Facts

During the second half of 2007, AIG made several public statements and filings regarding the risk the company had accumulated in its credit default swap (CDS) portfolio. In particular, AIG made statements from 2005 / continued page 30

## AIG Claims Continue

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to 2008 suggesting that it could easily hedge against any risk in its CDS portfolio and that its CDS investments were actually quite conservative. Internal communications, however, allegedly suggested that AIG recognized that its economic models were incapable of evaluating the risk in its CDS portfolio and that it was economically incapable of hedging against the magnitude of risk on its books. In 2008, however, AIG could no longer hide the mounting losses attributable to its CDS portfolio. News of the losses, and of AIG's alleged failure to follow generally accepted accounting principles (GAAP), caused a precipitous fall in AIG's stock price, tremendous losses to its investors and eventually a government bailout.

Investors who purchased AIG's stock in reliance upon the company's rosy forecasts and statements sued. The investors alleged that AIG's statements were false or misleading, and that AIG knew that the statements were false or misleading. The investors brought claims under several sections of the Securities Exchange Act of 1934 (Exchange Act) and the Securities Act of 1933 (Securities Act). In addition to bringing claims against AIG, the investors brought claims against AIG's directors and executives responsible for the statements, the underwriters of the various AIG securities, and AIG's auditor, PricewaterhouseCoopers LLP (PwC). The defendants filed a motion to dismiss the complaint, causing the court to embark on an analysis of the plaintiffs' claims.

### Section 10(b) False Statements

The plaintiff investors brought claims for violations of Section 10(b) of the Exchange Act against AIG and several AIG executives involved in the process of making public statements. Section 10(b) prohibits the making of a materially false statement or omitting a material fact, with scienter, in connection with the purchase or sale of securities. Applying the group pleading doctrine, the court cited *In re BISSYS Sec. Litig.*, 397 F. Supp. 2d 430, 438 (S.D.N.Y. 2005) for the proposition that the allegedly fraudulent statements need not be linked directly to the party accused of fraudulent intent, and plaintiffs can instead rely on the presumption that statements in group-published documents are the collective work of the individuals with direct involvement with the everyday business of the company.

The court first noted that, although an omitted fact is "material" when there is a substantial likelihood that a reasonable investor would view the fact as significantly altering the total mix of information made available, a company gen-

erally has no obligation to disclose every piece of information a reasonable investor would like to know. Once the company does speak, however, the communication creates a duty to disclose "all facts necessary to ensure the completeness and accuracy" of the statements. Because the plaintiffs specifically alleged that AIG and its executives were aware of material facts contradicting their public statements about the level of risk on AIG's books, the plaintiffs were able to plead successfully both the material false statement and scienter elements of a Section 10(b) claim without showing that any one defendant made a false statement with actual knowledge of its falsity and intent to mislead.

Finally, the court found that the loss causation requirement of a Section 10(b) claim was met, because the plaintiffs pleaded a corrective disclosure of AIG's previously undisclosed risk, which caused a decline in AIG's stock price and thus a loss of value for the plaintiffs. AIG argued that the entire stock market was in free-fall at the time of its corrective disclosures, and that the plaintiffs' losses could not be traced to its corrective statements. The court found, however, that the existence of events that break the chain of causation was a matter for proof at trial and could not be decided on a Fed. R. Civ. P. 12(b) motion to dismiss.

AIG also argued that, because its statements were forward-looking, and were accompanied by cautionary statements, it should be protected by the "bespeaks caution" defense. The court, however, cited *In re Int'l Bus. Machs. Corp. Sec. Litig.*, 163 F.3d 102, 107 (2d Cir. 1998) for the proposition that generic risk disclosures do not provide a shield from liability for failing to disclose known specific risks. Because AIG allegedly was aware of "hard facts" contradicting its public statements, the court held that the bespeaks caution defense provided no shelter.

### Control Person Liability

The plaintiff investors also sought to extend liability to AIG management by pleading a violation of Section 20(a) of the Exchange Act, which creates "control person liability," or liability for anyone with control of a primary violator of Section 10(b) who was "in some meaningful sense a culpable participant" in the primary violation. The court noted that the pleading requirements of the primary violation and culpability for AIG's executive defendants had already been satisfied by the plaintiffs' Section 10(b) allegations. Therefore, the plaintiffs needed to allege only that the executives each had "some indirect means of discipline or influence" to plead control. Because the executive defendants allegedly controlled the

flow of information within the company, managed operations and made key decisions, the court found that the plaintiffs had pleaded control sufficient to state claims of control person liability against the individual executives.

### Extending Liability to Accountants

In addition to Section 10(b) claims for false or misleading statements, the plaintiff investors brought claims under Section 11 of the Securities Act, which provides a private right of action for any investor who purchases securities pursuant to a registration statement that contains an untrue statement of material fact or omits a material fact required to be stated therein. Liability under Section 11 is broad, extending to issuing companies, executives, directors, underwriters and accountants named as preparing or certifying the registration statement or its supporting reports. Section 15 of the

(GAAS). Though PwC argued that the investor plaintiffs did not allege specific GAAP or GAAS violations, the court held that, where a plaintiff has made well-pleaded allegations that an accountant has signed off on statements that violate GAAP principles and are “fundamentally misleading to investors,” it is inappropriate to dispose of the claims at the motion-to-dismiss stage. Because the plaintiff investors had sufficiently alleged that AIG’s statements violated GAAP principles and were fundamentally misleading, the court refused to dismiss the Section 11 claims against PwC.

### Tying It Together

The defendants further argued that, because the plaintiffs purchased their shares in over 100 separate stock offerings when varying information was available, they lacked standing with regard to statements made in connection with stock

*In re Am. Int’l Group, Inc.* thus starkly illustrates how a pattern of prospective misrepresentations by a handful of managers can support a broad swath of claims against numerous classes of defendants within and without a company, based upon collective harms to multiple investors having acquired their stock at different times and under diverse circumstances.

Securities Act also creates control person liability for Section 11 violations similar to that of Section 20(a) of the Exchange Act. Though requirements for proving liability under the Securities Act are similar to those for proving liability under the Exchange Act, the plaintiffs made clear that their Section 11 claims rested not upon allegations of fraud, but upon allegations of negligence, and therefore the heightened pleading requirements of Fed. R. Civ. P. 9—requiring particularity in pleading allegations of fraud—did not apply.

The plaintiff investors also used Section 11 of the Securities Act to reach beyond AIG to AIG’s accountants, PwC, for the allegedly false statements in the financial statements PwC had audited. Section 11 creates potential liability against accountants that fail to prepare the applicable financial statements in accordance with GAAP, or that fail to conduct audits in accordance with generally accepted accounting standards

offerings other than those in which they took part. The court, however, found that the plaintiff investors had relied upon information furnished in the common elements of the 10K, 10Q and 8K filings available throughout the various offerings. The plaintiffs could therefore trace their various injuries to the same underlying misinformation spread by the defendants, satisfying standing requirements regardless of precisely when they purchased their stock.

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### FOR MORE INFORMATION, CONTACT:

#### New York

Oliver J. Armas  
Scott S. Balber  
Thomas E. Butler  
Thomas J. Hall  
Thomas J. McCormack  
M. Scott Peeler  
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Edited by Thomas Hall at +1 (212) 408-5487 ([thall@chadbourne.com](mailto:thall@chadbourne.com)) and Thomas McCormack at +1 (212) 408-5182 ([tmccormack@chadbourne.com](mailto:tmccormack@chadbourne.com)). Visit us at [www.chadbourne.com](http://www.chadbourne.com).

#### Chadbourne & Parke LLP

**New York**  
30 Rockefeller Plaza  
New York, NY 10112  
+1 (212) 408-5100

**Washington**  
1200 New Hampshire Ave., NW  
Washington, DC 20036  
+1 (202) 974-5600

**Los Angeles**  
350 South Grand Ave., 32nd Floor  
Los Angeles, CA 90071  
+1 (213) 892-1000

**Mexico City**  
Chadbourne & Parke SC  
Paseo de Tamarindos, No. 400-B Piso 22  
Col. Bosques de las Lomas  
05120 México, D.F., México  
+52 (55) 3000-0600

**London**  
Chadbourne & Parke (London) LLP  
an affiliated partnership  
Regis House, 45 King William Street  
London EC4R 9AN, UK  
+44 (0)20 7337-8000

**Moscow**  
Riverside Towers  
52/5 Kosmodamianskaya Nab.  
Moscow 115054 Russian Federation  
+7 (495) 974-2424  
Direct line from outside C.I.S.:  
(212) 408-1190

**São Paulo**  
Av. Pres. Juscelino Kubitschek, 1726, 16th floor  
São Paulo, SP 04543-000, Brazil  
+55 (11) 3372 0000

**St. Petersburg**  
Stroganovskiy Business Centre  
19A Nevskiy Prospect  
St. Petersburg 191186 Russian Federation  
+7 (812) 332-9300

**Warsaw**  
Chadbourne & Parke  
Radzikowski, Szubielska i Wspólnicy sp.k.  
ul. Emilii Plater 53  
00-113 Warsaw, Poland  
+48 (22) 520-5000

**Kyiv**  
25B Sahaydachnoho Street  
Kyiv 04070, Ukraine  
+380 (44) 461-7575

**Almaty**  
Dostyk Business Center  
43 Dostyk Avenue, 4th floor  
Almaty 050010, Republic of Kazakhstan  
+7 (727) 258-5088

**Dubai**  
Chadbourne & Parke LLC  
City Tower I, Sheikh Zayed Road  
P.O. Box 23927, Dubai, United Arab Emirates  
+971 (4) 331-6123

**Beijing**  
Beijing Representative Office  
Room 902, Tower A, Beijing Fortune Centre  
7 Dongsanhuan Zhonglu, Chaoyang District  
Beijing 100020, China  
+86 (10) 6530-8846

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