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Financial Services Litigation

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December 2011

District Court Significantly Limits Madoff Trustee's Claims Against Investors

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By Thomas J. Hall and Paige M. Willan

The U.S. District Court for the Southern District of New York recently issued a decision that will significantly limit the chances of success for many claims that the trustee of the Bernard L. Madoff Investment Securities ("BLMIS") estate, Irving Picard, has brought against former investors in BLMIS to recover funds for the estate. In *Picard v. Katz*, 11 Civ. 3605 (S.D.N.Y.), District Judge Jed S. Rakoff issued a decision that dismissed most of the causes of action brought against a group of investors under the U.S. Bankruptcy Code and all of the causes of action brought under New York's Debtor and Creditor Law based on a "safe harbor" contained in the Bankruptcy Code for transfers related to securities transactions.

The *Katz* Defendants

The defendants in the *Katz* case are members of the Katz and Wilpon families and their partners or closely held investment companies, primarily Sterling Equities. The Sterling companies, according to the Trustee's complaint, are a "multi-billion dollar real estate, professional baseball, private equity, and hedge fund empire." In particular, the Sterling companies own, in addition to numerous real estate holdings, the New York Mets baseball franchise, the Brooklyn Cyclones baseball franchise (the minor league affiliate of the New York Mets), and a majority interest in SportsNet New York, a broadcasting network that covers most New York area sports teams.

The Trustee's complaint alleges that the Katz and Wilpon family defendants had very close personal relationships with the Madoff family, with all three families often attending one another's family functions, such as weddings and bar mitzvahs, and frequently attending dinner parties at one another's homes. The Katz and Wilpon families also maintained season tickets to the Mets / continued page 2

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that were in close proximity to Madoff's own tickets and even traveled together to Japan to watch a Mets exhibition game. Further, the three families allegedly were all involved—through donations and board memberships—in a number of the same charities.

According to the Trustee's complaint, the Katz and Wilpon families, and the Sterling companies, also had massive, long-standing investments in BLMIS, with the controlling defendants beginning to invest in the mid to late 1980s and, over time, maintaining as many as 483 separate BLMIS accounts. The Trustee contends that the defendants therefore had unique access to information about BLMIS thorough their extensive investments, and that such information indicates that the defendants knew, or should have known, about the Madoff fraud. In fact, the Trustee alleges that one of the partners at Sterling Equities, who—because of the defendants' extensive investments with Madoff—had access to an extensive amount of data on BLMIS, tried several times to replicate Madoff's investment results, based on Madoff's own explanation of his strategy. But the analysis "always lagged behind Madoff by a significant percentage return," a result that was communicated to the other defendants.

Moreover, the Trustee alleged that the defendants set up their own fund to hedge their investments in Madoff, and at one point attempted to procure fraud insurance for their BLMIS investments. The complaint alleges that Merrill Lynch, which had a policy of not investing with BLMIS, became a 50% partner in the defendants' hedge fund in 2007. The Trustee alleges that the relationship with Merrill Lynch exposed the defendants to the type of due diligence that proved that Madoff was a fraud.

Claims Against The *Katz* Defendants

According to the Trustee, the defendants redeemed a large number of investments in BLMIS before Madoff's fraud was exposed. As such, the Trustee brought a number of claims against the defendants under the Bankruptcy Code to avoid such transfers.

Under the Bankruptcy Code, a trustee has the power to:

> "Avoid any transfer . . . that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—(A) made such transfer . . . with actual intent to hinder, delay, or defraud . . . ; or (B) received less than a reasonably equivalent value in exchange . . . ; and was insolvent on the date that such transfer was made . . . or became insolvent as a result of such transfer or obligation. . .; [or] was engaged in a business or a transaction or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; [or] intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured . . . ."

11 U.S.C. § 548(a)(1). Transfers that a trustee seeks to avoid under Section 548(a)(1)(A) are referred to as "actual" fraudulent transfers, because they require a showing of actual fraudulent intent. By contrast, transfers that a trustee seeks to avoid under Section 548(a)(1)(B) are referred to as "constructively" fraudulent transfers, because they do not require proof of actual fraudulent intent, but rather a showing that the debtor did not receive reasonably equivalent value for the transfers and was insolvent, had unreasonably small capital, or was unable to pay its debts at the time of the transfer.

In addition to fraudulent transfers, a bankruptcy trustee can also recover "preferences," or transfers made within ninety days of the filing of a bankruptcy petition. To recover a transfer as a preference, the bankruptcy trustee need only show that the transfer was (1) to or for the benefit of a creditor; (2) for, or on account of an antecedent debt; (3) made while the debtor was insolvent; (4) made within 90 days before the filing of a bankruptcy petition; and (5) that the transfer would enable a creditor to receive more than the creditor would have received under a Chapter 7 liquidation. 11 U.S.C. § 547(b).

The New York Debtor and Creditor Law also contains causes of action for both actual and fraudulent transfers. Under 11 U.S.C. § 544, a bankruptcy trustee may avoid transfers, and claw back the transferred funds, under applicable state law regarding fraudulent transfers, such as the relevant provisions of the New York Debtor and Creditor Laws.

The Safe Harbor Eliminates Many Claims

The court in the *Katz* case determined that the safe harbor for securities transactions contained in 11 U.S.C. § 546(e) applied to prevent all of the Trustee's claims under Section 547, as well as those for constructively fraudulent transfers under Section 548 and any claims under the New York Debtor Creditor law brought pursuant to Section 544.

The safe harbor provision eliminates certain claims under the Bankruptcy Code and local insolvency law for securities transactions:

> "Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract . . . commodity contract . . . or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

11 U.S.C. § 546(e). The court found that BLMIS was a registered stockbroker, which entitled its customers to the application of the safe harbor if the transfers at issue were made as settlement payments or in connection with a securities contract.

The court then found that the contracts that BLMIS had with its customers fell within the definition of securities contract contained in 11 U.S.C. § 741(7), because all of those contracts were "a contract for the purchase, sale, or loan of a security." In addition, the court found that "all payments" made by BLMIS to its customers could be considered settlement payments, which is a term with an "extremely broad" definition that includes a variety of specific types of payment as well as "any other similar payment commonly used in the securities trade." Because all payments at issue in the Trustee's complaints were made to or from a stockbroker, and all were either settlement payments or made pursuant to a securities contract, the court found that the safe harbor of Section 546(e) applied to all of the transfers alleged by the Trustee in the *Katz* complaint. Through the application of the safe harbor's limitation on the Trustee's power to avoid transfers, the court therefore dismissed all claims in the *Katz* action for preference, constructively fraudulent transfers, and claims under the New York Debtor Creditor Law brought pursuant to Section 544.

Demonstrating the power of the Section 546(e) safe harbor in the Bankruptcy Code, after the decision in *Katz,* the BLMIS Trustee has far fewer options for recovering transfers from BLMIS to investors. The safe harbor will likely eliminate billions of dollars of the Trustee's claims against Madoff investors.

In holding that the safe harbor applies, the court dismissed the Trustee's arguments that the safe harbor protects only stockbrokers—rather than their customers—and that the application of the safe harbor in this circumstance was at odds with the statute's purpose. In rejecting these arguments, the court found that the plain language of the statute nowhere limits the safe harbor's application to stockbrokers rather than customers. In addition, the court found that the purpose of the statute—to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries"—was implicated in precisely the circumstances of the BLMIS bankruptcy, which involved a major brokerage firm, $68 billion, and nearly 5,000 customers.

Actual Fraudulent Transfer Claims Are Limited

With respect to claims for "actual" fraudulent transfers brought by the Trustee under Section 548(a)(1), the court limited the Trustee's potential recovery, determining that "as to payments received by the defendants / *continued page 4*

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from Madoff Securities equal to a return of their principal, defendants can defeat the Trustee's claim of actual fraud simply by proving their good faith." The court based this holding on 11 U.S.C. § 548(c), which provides that a transferee may retain funds transferred if the transferee took the funds "for value and in good faith." The court stated that:

> "It is clear that the principal invested by any of Madoff's customers 'gave value to the debtor' and therefore may not be recovered by the Trustee absent bad faith. As for transfers made by Madoff Securities to its customers in excess of the customers' principal—that is, the customers' profits—these were in excess of the 'extent' to which the customers gave value, and hence, if adequately proven, may be recovered regardless of the customers' good faith."

This holding left only two theories upon which the Trustee could recover funds: (1) that the funds transferred were in excess of the defendants' principal investment in BLMIS and (2) that the transferees lacked good faith in receiving the transfers.

The court determined that the Trustee could establish lack of good faith only by either showing (1) actual knowledge of the Madoff scheme or (2) willful blindness to the scheme. The court held that willful blindness means that the investor "intentionally [chose] to blind himself to the 'red flags' that suggest a high probability of fraud." The court noted that simply alleging that investors should have investigated BLMIS more was not sufficient to adequately plead willful blindness; instead, the evidence must have been in front of the defendants and they must have turned a blind eye to that available evidence.

In applying that standard to the instant matter, the court indicated that the complaint in *Katz*, despite all its allegations of close relationships between the Katz, Wilpon and Madoff families, and the defendants' extensive investments in BLMIS, was "less than overwhelming" in alleging willful blindness. The court wondered "why would defendants willfully blind themselves to the fact that they had invested in a fraudulent enterprise?" Nevertheless, the court found adequate the Trustee's allegation that the defendants "felt they could realize substantial short-term profits while protecting themselves against the long-term risk," which was supported by the Trustee's allegations that defendants considered purchasing fraud insurance on their BLMIS investments and that they established a hedge fund to limit their exposure to BLMIS. In the end, therefore, the court held that the *Katz* complaint "pleads sufficient allegations to survive a motion to dismiss so far as this claim of willful blindness."

Conclusion

Demonstrating the power of the Section 546(e) safe harbor in the Bankruptcy Code, after the decision in *Katz*, the BLMIS Trustee has far fewer options for recovering transfers from BLMIS to investors. The safe harbor will likely eliminate billions of dollars of the Trustee's claims against Madoff investors. ◎

Release of Lender in Post-Default Forbearance Agreement Is Valid as Not Procured by Economic Duress

By Robert A. Schwinger and Marcelo Blackburn

The U.S. Court of Appeals for the Second Circuit recently upheld the dismissal of a lawsuit brought by Interpharm, Inc. against its lender, Wells Fargo Bank, on the grounds that the releases of claims executed by Interpharm in favor of Wells Fargo in a series of forbearance agreements were valid. *Interpharm, Inc. v. Wells Fargo Bank, National Association*, 655 F.3d 136 (2d Cir. 2011). In so doing, the Second Circuit rejected Interpharm's argument that Interpharm had been compelled to agree to the releases under economic duress by Wells Fargo's wrongful threats to restrict credit that would have otherwise been available to Interpharm under a credit agreement. The Second Circuit concluded that Wells Fargo's restriction of credit was not wrongful because Wells Fargo had no obligation to extend credit after Interpharm had defaulted on its obligations under the credit agreement, and that Wells Fargo's subsequent decisions to limit the collateral it would accept, and consequently the credit made available to Interpharm, were reasonable exercises of discretion under the terms of its credit agreement.

The Credit and Forbearance Agreements

Interpharm was a manufacturer and seller of generic pharmaceutical drugs. On February 9, 2006, it entered into a Credit and Security Agreement (the "Credit Agreement") with Wells Fargo that provided it with a line of credit of up to $22.5 million. The actual amount available to Interpharm under the Credit Agreement varied depending on the value of the collateral that secured the credit line, which consisted of Interpharm's accounts receivable, inventory and equipment. The Credit Agreement provided that the credit available would be calculated based on 85% of Interpharm's eligible accounts receivable and 50% of Interpharm's inventory cost, but it also provided that Wells Fargo could reduce those percentages and exclude certain receivables or inventory as ineligible in the credit calculation in its "reasonable discretion."

In 2007, Interpharm's revenue fell, putting it in default under the Credit Agreement. Interpharm's default entitled Wells Fargo to declare the outstanding amount immediately due and payable, take possession of the collateral and dispose of it in order to satisfy the debt. Rather than exercise its default remedies, Wells Fargo began to negotiate a forbearance agreement with Interpharm. During these negotiations, Wells Fargo pressed to exclude the receivables of one of Interpharm's large wholesale customers from the collateral base used to determine the amount of credit available to Interpharm, which Interpharm later characterized as an attempt to strong arm it into agreeing to onerous terms.

Ultimately, Interpharm and Wells Fargo executed a forbearance agreement in which Interpharm acknowledged that it had defaulted under the Credit Agreement, agreed to certain additional terms and financial targets, and released all claims against Wells Fargo (the "October 2007 Agreement"). Interpharm claimed that it had informed Wells Fargo that the financial targets in the October 2007 Agreement were "unattainable and unreasonable" and that Wells Fargo "vaguely propos[ed]" to renegotiate a new covenant in 2008. The October 2007 Agreement, however, lacked any commitment by Wells Fargo to renegotiate its terms. On the contrary, the agreement contained a merger clause which expressly limited the scope of the October 2007 Agreement to the written terms of the contract.

In early January 2008, Interpharm advised Wells Fargo that it would not be able to meet the financial targets in the October 2007 Agreement. Wells Fargo treated that development as a default and began to charge a higher interest rate and assess other default penalties. Later that month, Wells Fargo also began to exclude three other large wholesale customers from Interpharm's collateral base. Wells Fargo based this exclusion on the fact that the amounts due on those receivables were imprecise because the wholesale customers were entitled to "charge back" to Interpharm any difference between the prices they paid for Interpharm products and the prices negotiated by downstream customers such as pharmacy chains.

Interpharm's financial state continued to deteriorate, and by the end of January 2008, it had advised Wells Fargo that it would need additional working capital in order to avoid liquidation. On February 1 and February 5, Interpharm and Wells Fargo entered into new forbearance agreements (the "February Agreements"). The February Agreements acknowledged that Interpharm was in default of both the Credit Agreement and the October 2007 Agreement, released all claims that Interpharm may have had */ continued page 6*

The Second Circuit concluded that Wells Fargo's restriction of credit was not wrongful because Wells Fargo had no obligation to extend credit after Interpharm had defaulted on its obligations under the credit agreement, and that Wells Fargo's subsequent decisions to limit the collateral it would accept, and consequently the credit made available to Interpharm, were reasonable exercises of discretion under the terms of its credit agreement.

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against Wells Fargo, amended the Credit Agreement to exclude all receivables from wholesalers (including the four wholesalers previously excluded) from the collateral credit base, and provided for the appointment of a restructuring officer acceptable to Wells Fargo who would prepare and administer Interpharm's operating budget and oversee all credit requests and payments to Wells Fargo.

On March 6, 2008, Wells Fargo lowered the percentage of Interpharm's inventory that it would include in the collateral base from 50% to 39.6%. Interpharm protested that this reduction reduced the available credit below the amount that it needed to meet its obligations. As a result, Wells Fargo and Interpharm entered into yet another forbearance agreement in which Wells Fargo raised the percentage back to 49% (the "March Agreement"). Interpharm again acknowledged that it was in default, agreed to higher fees and released all claims.

Interpharm eventually agreed to sell its assets to certain third parties in transactions that were scheduled to close in late June 2008. In early May, Interpharm informed Wells Fargo that it would not be able to survive through closing unless Wells Fargo agreed to calculate Interpharm's available credit in certain ways. Wells Fargo agreed on the condition that Interpharm enter into a new forbearance agreement that, among others, released all claims against it (the "May Agreement"), to which Interpharm assented.

The District Court Proceedings

Sometime after the asset sale, Interpharm repudiated all of the forbearance agreements and brought suit against Wells Fargo, asserting claims for breach of contract, breach of the duty of good faith and fair dealing, tortious interference with business expectations, unjust enrichment and breach of fiduciary duty. Wells Fargo moved for dismissal based on the release provisions in the May Agreement.

Interpharm opposed the motion for dismissal by arguing that the release of claims in the May Agreement was not valid because it was induced by economic duress. Interpharm claimed that it would not have agreed to the releases had not Wells Fargo "wrongfully restrict[ed] credit that would have been available to Interpharm had Wells Fargo complied in good faith with its contractual obligations."

The district court granted Wells Fargo's motion to dismiss on the grounds that Interpharm had failed to plausibly allege an essential element of its economic duress theory—the existence of a "wrongful" threat by Wells Fargo that compelled Interpharm to agree to the releases. After the district court granted the motion, Interpharm agreed to dismissal of the remaining claims so that judgment could be entered and it could appeal the final judgment to the Second Circuit Court of Appeals.

The Second Circuit's Decision

On appeal, the Second Circuit reviewed the district court's dismissal of the complaint *de novo* and came to essentially the same conclusion as that of the district court.

As a threshold matter, the Second Circuit noted that, to void a release of claims on grounds of economic duress, a party must show that there had been a "wrongful" threat, which it defined as one "outside a party's legal rights." The court noted that it was not sufficient to allege that the lender benefitted from unequal bargaining power or that borrower did not believe it had other feasible options. While a lender's threat to withhold performance of an act that it was legally obligated to perform would be a wrongful threat, the lender's decision not to do something which the lender had no legal obligation to do was not wrongful.

The Second Circuit then evaluated the three actions taken by Wells Fargo that Interpharm alleged had been wrongful: (1) the January 2008 increase in interest rates after Interpharm's default under the terms of the October 2007 Agreement, (2) the late January 2008 exclusion of wholesale customers from the credit calculation, and (3) the March 2008 reduction in the inventory cost that would be included in the credit calculation.

Interpharm argued that the first of these actions, Wells Fargo's January 2008 increase in interest rates upon Interpharm's failure to meet its financial targets under the October 2007 Agreement, was wrongful because Wells Fargo knew from the outset that the financial targets were unattainable and had orally indicated a willingness to renegotiate them in 2008. This argument proved unavailing. As the Second Circuit noted, Wells Fargo had been entitled to exercise remedies upon Interpharm's initial default and had been under no obligation to grant any forbearance. Consequently, Wells Fargo's inclusion of new financial targets in the October 2007 Agreement was permissible, even if characterized as hard bargaining and even if those targets were "unattainable." Likewise, Wells Fargo was contractually entitled to enforce the default remedies in the October 2007 Agreement when those financial targets were not met.

The Second Circuit also concluded that Wells Fargo's late January 2008 exclusion of wholesale customers from the credit calculation was not wrongful. The Credit Agreement expressly provided Wells Fargo with "reasonable discretion" to exclude receivables. Although "reasonable discretion" was not defined, the court found that the exclusion of receivables from wholesale customers fell well within its scope because (1) these receivables were logically less desirable because they were subject to chargebacks, even if such chargebacks were common practice in the pharmaceutical industry, and (2) in the context of default, a lender might reasonably wish to exclude less desirable assets from the loan base.

For similar reasons, the Second Circuit also rejected Interpharm's argument that Wells Fargo's March 2008 decision to lower the percentage of credit it awarded based on inventory costs was wrongful. As with the receivables, the Credit Agreement provided Wells Fargo with reasonable discretion to exclude or limit inventory from the credit calculation, and the court reasoned that there was no allegation that the percentage change (50% to 39%) fell outside the broad range of discretion provided by the Credit Agreement. Finally, the Second Circuit rejected Interpharm's argument that the 50% multiplier for inventory was an essential element of the February Agreements because the written agreements lacked any such indication and, on the contrary, contained merger clauses that specifically restricted the agreements to the express terms of the written contracts.

Conclusion

The Second Circuit's decision is notable for the guidance it provides lenders and borrowers who find themselves in the not unusual circumstance of negotiating a forbearance agreement after a borrower has defaulted on its obligations. Two aspects of the ruling are worth highlighting.

First, not surprisingly, where a borrower's material default entitles a lender to exercise remedies, lenders have wide latitude in negotiating the terms of a forbearance agreement, in spite of what may be unequal bargaining power and constraints on the borrower's options. This does not mean, however, that lenders do not face the risk of lawsuits from borrowers claiming that the lender somehow reneged on the terms of the forbearance agreement. As *Interpharm* shows, the presence of a merger clause in the forbearance agreement can be very useful in establishing that the lender is under no obligations other than those set forth in the written agreement.

Second, *Interpharm* serves as a reminder that, while lenders frequently are granted some discretion under the terms of their loan agreements, such discretion is not boundless. An abuse of that discretion may later be construed to be a "wrongful threat" that voids a subsequent release of claims. Faced with a borrower whose continued viability is uncertain and who may be motivated to bring suit, the lender should proceed cautiously to ensure that it is acting in full compliance with the terms of its credit and forbearance agreements. ◎

FINRA Lacks Authority to Bring Judicial Proceedings to Enforce Collection of Disciplinary Fines

By Alan I. Raylesberg and Andrea Voelker

The Second Circuit Court of Appeals recently held that the Financial Industry Regulatory Authority, Inc. ("FINRA") lacks the statutory authority to bring judicial proceedings to enforce collection of fines it imposes on member firms. *Fiero v. Financial Industry Regulatory Authority, Inc.,* Nos. 09-1556-cv(L), 09-1863-cv(XAP) (2d Cir. Oct. 5, 2011). Specifically, the court found that FINRA did not have the authority to recover fines that it had imposed on a penny-stock firm at a disciplinary proceeding for violations of securities laws, where that firm had exited the business and no longer was a FINRA member. While FINRA could have used its expulsion power to force a member firm to pay a disciplinary fine, such power was futile when dealing with a former member.

Background

FINRA, a national securities association registered with the Securities and Exchange Commission ("SEC"), is a self-regulatory organization ("SRO") established pursuant to the Maloney Act of 1938. FINRA became the successor to the National Association of Securities Dealers ("NASD") in 2007 when the NASD consolidated with the regulatory arm of the New York Stock Exchange. All securities firms that deal with the public must be members of FINRA, and FINRA is responsible for investigating members firms and commencing disciplinary proceedings against them should they violate / continued page 8

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any federal securities laws or regulations.

FINRA is authorized by 15 U.S.C. § 78s(h)(3) to issue complaints against any member firm after authorization is provided by the FINRA regulation board. When FINRA issues a complaint against a member firm, a panel conducts a hearing on the issues and then delivers a decision, which can be appealed to the FINRA National Adjudicatory Counsel ("NAC"). Pursuant to 15 U.S.C. § 78y, NAC decisions, which can "affirm, modify, or reverse" the hearing panel's decision, can then be appealed to the SEC, and SEC decisions can then be appealed to the United States Court of Appeals.

The plaintiffs in this action are Fiero Brothers, a New York corporation and member firm of FINRA, and John J. Fiero (collectively, the "Fieros"), the corporation's sole registered representative. The NASD initiated disciplinary proceedings against the Fieros in 1998, and in 2000, a NASD hearing panel held that the Fieros had violated Section 10(b) of the Exchange Act, Rule 10b-5, and certain FINRA rules. As a result, the NASD "expelled the Fiero Brothers, barred Fiero from associating with any FINRA-member firm in any capacity, and fined the Fieros $1,000,000 plus costs, jointly and severally." The Fieros then appealed to NAC, which affirmed the hearing panel's decision. The Fieros did not appeal to the SEC.

State and Federal Court Proceedings

On December 22, 2003, FINRA commenced a proceeding in New York trial court after the Fieros refused to pay the fine imposed by the NASD, likely because the Fieros no longer wished to remain a FINRA member firm. The court held that the NASD's claim was "firmly based on ordinary principles of contract law," and awarded the NASD a judgment of $1,329,724.54. The decision was affirmed by the New York Appellate Division, but was reversed by New York's highest court for lack of subject matter jurisdiction as the claim "constituted an action to enforce a liability or duty created by the Exchange Act, and therefore, fell within the exclusive jurisdiction of the federal courts . . . ."

The Fieros then filed this federal action seeking a declaratory judgment that FINRA did not have the authority to collect the fines through judicial proceedings. FINRA asserted a counterclaim "seeking to enforce the fine under a breach of contract theory." Both parties moved to dismiss, and the court granted FINRA's motion to dismiss the complaint, but denied Fieros' motion to dismiss the counterclaim. The court then entered judgment in favor of FINRA on its counterclaim. The Fieros appealed.

> Because the court found that FINRA did not have the authority pursuant to either the Exchange Act or the 1990 Rule to bring judicial proceedings to enforce the collection of fine imposed upon member firms, the court reversed the judgment entered in favor of FINRA, and the judgment dismissing the Fieros' complaint for declaratory judgment.

Authority Under the Exchange Act

The Second Circuit reviewed *de novo* the district court's dismissal of the firm's declaratory judgment action, including the district court's legal conclusions and interpretation of federal law. The Second Circuit first looked to Section 15A(b) of the Exchange Act to determine whether FINRA had the authority to bring a court proceeding to enforce fines imposed on member firms. Section 15A(b) states that SRO's "have a statutory authority and obligation to appropriately discipline their members for violation of any provision of the Exchange Act, the rules or regulations promulgated thereunder, or their own rules, 'by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred

from being associated with a member, or any other fitting sanction.'" The court noted, however, that the Exchange Act does not provide express statutory authority for an SRO to bring court proceedings to enforce the collection of fines. The court believed the omission was a reflection of congressional intent, as the Exchange Act "carefully particularizes an array of available remedies, including permissible actions in the federal courts." Accordingly, the court found that "when Congress passed the Exchange Act . . . it was well aware of how to grant an agency access to the courts to seek judicial enforcement of specific sanctions, including monetary penalties."

The court noted that other statutory provisions favored this result, including the fact that parties were able to appeal FINRA decisions to the SEC and then to the United States Courts of Appeals. Further, the court stated that because all firms dealing in securities with the public must be FINRA members, and FINRA member firms that do not pay fines can have their membership revoked, this would serve to provide FINRA with adequate power to enforce sanctions.

Authority Under the 1990 Rule

FINRA alternatively argued that it had authority to collect fines through court proceedings pursuant to a rule it filed with the SEC in 1990 (the "1990 Rule"). The 1990 Rule proposal to the SEC stated that "should its own internal efforts for the collection of fines . . . fail, it may refer a matter to external collection agencies and in appropriate situations . . . seek to reduce such fines to a judgment." In April 1990, after the SEC filing, the NASD issued two notices to member firms informing them of the 1990 Rule and how it would be implemented. With regards to the 1990 Rule providing FINRA with the authority to use court proceedings to enforce fines, the court held that because the rule was not promulgated under proper Exchange Act procedures, it could similarly not provide FINRA with the authority to collect fines through judicial proceedings.

Specifically, the court noted that Section 19(b) of the Exchange Act, which establishes how an SRO such as FINRA can change their governing rules, states that "all new substantive rules and modification of existing rules [] must go through a notice and comment period and obtain SEC approval before becoming effective." While there is an exception for "House Keeping" rules and rules that "do not substantially affect the public interest or the protection of investors," the court, citing *Columbia Broad. Sys., Inc. v. United States*, 316 U.S. 407, 416 (1942), held that it was not bound by the NASD's characterization of the rule as a "House Keeping" rule. The court reasoned that, because the NASD did not previously have the power to commence judicial proceedings to collect fines, "it was a new substantive rule that affected the rights of barred and suspended members to stay out of the industry and not pay the fines imposed on them in prior disciplinary proceedings."

Because the court found that FINRA did not have the authority pursuant to either the Exchange Act or the 1990 Rule to bring judicial proceedings to enforce the collection of fines imposed upon member firms, the court reversed the judgment entered in favor of FINRA, and the judgment dismissing the Fieros' complaint for declaratory judgment.

Conclusion

While this decision at first blush may appear to have wide-ranging impact, its practical effect may not be all that dramatic. For one, because securities firms that deal with the public must be members of FINRA, this decision will likely affect only those entities that no longer wish to be FINRA member firms, as firms who wish to remain members may not have unpaid fines without facing expulsion. Moreover, while the Second Circuit's opinion prevents FINRA from currently using judicial proceedings to enforce the collection of fines from member firms, the language espoused by the court suggested that FINRA would be able to promulgate such authority by obtaining SEC approval. ◎

Post-Judgment Enforcement Subpoenas Served on New York Bank Branch Reaches Documents Outside the State

By Thomas J. Hall and Benjamin D. Bleiberg

Judge Alvin K. Hellerstein of the United States District Court for the Southern District of New York recently granted a judgment creditor's motion to compel an out-of-state bank to provide documents and materials located outside of New York in response to post-judgment subpoenas that the judgment creditor had served upon the bank's New York branch. *Eitzen Bulk A/S v. Bank of India*, No. 09-10118 (AKH) */ continued page 10*

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(S.D.N.Y. 2011). In reaching his conclusion, Judge Hellerstein reasoned that a subpoena *duces tecum* properly issued to a bank in New York reaches all material under a bank's control regardless of the material's location. The court further held that New York's "separate entity rule," which requires that each branch of a bank be treated as a separate entity for the purposes of prejudgment attachment, did not extend to a bank's obligation to respond to subpoenas issued in post-judgment enforcement proceedings.

Background

In July 2009, Judge Hellerstein had granted the petition of judgment creditor Eitzen Bulk A/S ("Eitzen") to recognize and confirm an English arbitral award against judgment debtor Ashapura Minechem, Ltd. ("Ashapura"). The court subsequently entered judgment in favor of Eitzen for over $36 million, plus costs and interest (the "Judgment"). In December 2009, Eitzen initiated an action in the New York trial court to enforce the Judgment in the underlying action by filing a petition for a turnover order and by serving restraining notices and subpoenas upon four banks as garnishees, including the Bank of India, to assist Eitzen in collecting the Judgment. The action was removed to federal court and assigned to Judge Hellerstein.

Bank of India is a foreign bank headquartered in Mumbai and licensed to conduct banking business in New York. Between December 2009 and December 2010, Eitzen served four subpoenas upon Bank of India at its New York City branch (the "New York Branch"). The New York Branch is not a separate corporation but, rather, a local office of Bank of India. The subpoena sought information and documents related to Ashapura, regardless of where in the world the information or documents were located. While Bank of India admitted that it maintained a commercial relationship with Ashapura, and that materials responsive to the subpoenas were located in Mumbai, it limited its subpoena responses to information and documents available at the New York Branch.

Bank of India claimed that the New York Branch did not maintain any accounts related to Ashapura, that the New York Branch could not easily obtain the requested information from any other Bank of India branch, and that complying with Eitzen's requests would be onerous and unduly burdensome. The New York Branch maintained its customer accounts separately from those held at other bank branches and had no authority or control over, or direct access to, any accounts held at any other branches. Bank of India then rejected any further requests by Eitzen to comply with the subpoenas, asserting that the subpoenas required Bank of India only to produce materials from the New York Branch. Bank of India further claimed that it had no legal obligation to respond to the subpoenas because it had immunity under the Foreign Sovereign Immunity Act ("FSIA"), and that any information that it had already provided to Eitzen had been disclosed voluntarily.

Motion to Compel

In March 2011, Eitzen filed a motion to compel Bank of India to answer the subpoenas and provide all requested documents and information. Eitzen argued that the 2006 amendments to the New York Civil Practice Law and Rules clarify that a subpoena served upon a corporation doing business or licensed to do business in New York reaches all responsive materials within the corporation's control, even if those materials are located outside of New York. Because Bank of India was served in New York by service upon the New York Branch, and the documents requested are within Bank of India's possession, custody and control, the broad scope of discovery in post-judgment enforcement actions mandates production of the requested materials.

Bank of India argued that it was not required to comply with Eitzen's subpoenas for three reasons. First, it claimed that pursuant to New York's separate entity rule, Bank of India's bank branches should be treated as separate entities for the purposes of post-judgment enforcement proceedings, and therefore should not be required to provide responses for requests made for documents located outside of the New York Branch. Second, it argued that the court lacked subject matter jurisdiction under FSIA. Because the government of India holds approximately 65% of Bank of India's total outstanding shares, Bank of India claimed that it is an agency or instrumentality of a foreign state, and accordingly, immune from suit in United States courts. Third, it asserted that the court had lacked personal jurisdiction over Ashapura in the underlying action and, accordingly, did not have authority to mandate compliance with the subpoenas issued in the post-judgment proceeding seeking to assist Eitzen in collecting the Judgment against Ashapura.

The Court's Analysis

The court granted Eitzen's motion to compel, finding each of Bank of India's arguments meritless. Relying on the holding of New York's highest court in *Koehler v. Bank of Bermuda Ltd.*, 12

N.Y.3d 533 (2009), Judge Hellerstein held that Bank of India's subpoena responses must account for documents and information located at branches outside of New York. The court explained that New York law expressly allows a party to seek materials located out-of-state by in-state service upon the party in control of the materials, and the separate entity rule is inapplicable to subpoenas in post-judgment enforcement proceedings.

The court first noted that, because post-judgment enforcement involves a proceeding against a person to demand that it convert any property to money to satisfy an outstanding judgment, post-judgment proceedings only require jurisdiction over persons, not jurisdiction over specific property. If the court maintains personal jurisdiction over a garnishee, the court may then require the garnishee to bring the judgment debtor's property into New York to satisfy the judgment. Because Bank of India continuously operated a branch in New York, it was subject to general personal jurisdiction in New York and, thus, required to provide materials related to the judgment debtor regardless of their location.

Judge Hellerstein further rejected Bank of India's reliance on the separate entity rule, finding that the rule only required separate treatment of bank branches for the purpose of prejudgment attachment, and did not apply in the context of post-judgment enforcement proceedings. The court reasoned that unlike post-judgment enforcement, which involves a proceeding against a person and requires only jurisdiction over persons, a proceeding for prejudgment attachment is based on the court's jurisdiction over the specific property to be used as security for a potential judgment. Because a prejudgment attachment is only binding on property within the court's territorial jurisdiction, an order of attachment served on the New York office of an out-of-state bank is insufficient to make property located at out-of-state branches subject to the attachment. Although Bank of India argued that two cases decided after *Koehler—Levin v. Bank of New York*, No. 09 Civ. 5900 (RPP) (S.D.N.Y. Mar. 4, 2011) and *Samsun Logix Corp. v. Bank of China*, 31 Misc. 3d 1226A (N.Y. Sup. Ct. 2011)—had applied the separate entity rule to post-judgment enforcement proceedings, Judge Hellerstein rejected their holdings as factually distinguishable or erroneous, and concluded that neither case was binding authority upon the court.

The court further found [that subject matter jurisdiction was appropriate] pursuant to FSIA because Bank of India failed to timely raise sovereign immunity as a defense and, therefore, implicitly waived its immunity. Although Bank of India had not filed a responsive pleading to assert a sovereign immunity defense, the court reasoned that the Bank of India still waived the defense because a party cannot indefinitely avoid filing a responsive pleading under the requirements of FSIA, and Bank of India had never challenged service of process in the two years since the action commenced. The court also found that Bank of India's conduct constituted a waiver when it responded to Eitzen's first subpoena without objecting on the basis of sovereign immunity, and did not object until more than a year after the proceeding was initiated and after Bank of India had already provided two subpoena responses.

Finally, the court rejected Bank of India's claim the court lacked the authority to mandate compliance with the subpoenas because it lacked personal jurisdiction over Ashapura in the underlying action. The court held that a party to a proceeding lacks standing to assert a third party's constitutional rights, and Bank of India made no showing that it had third-party standing to raise Ashapura's rights. The court, therefore, declined to address whether it had jurisdiction over Ashapura in the underlying action.

Conclusion

The *Eitzen Bulk A/S* case reaffirms the broad reach of recent New York precedent that foreign banks conducting business in New York must turn over all materials regardless of their location in response to a subpoena issued in a proceeding to enforce a judgment. The holding is consistent with the goals of post-judgment enforcement proceedings, and prevents judgment debtors from using foreign banks to their advantage to keep materials out of reach from their judgment creditors. ◎

Court Dismisses Complaint Arising from Downgrade of Mortgage-Backed Credit Default Obligation

By Jeffrey I. Wasserman and Caroline Pignatelli

A New York federal district court recently dismissed a fraud action brought by plaintiff Landesbank Baden-Württemberg ("Landesbank") against Goldman Sachs & Co. ("Goldman") and TCW Asset Management Company ("TCW") related to the devaluation and downgrade of a / continued page 12

Court Dismisses Complaint

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mortgage-backed Credit Default Obligation ("CDO") known as Davis Square Funding VI ("Davis Square"). *Landesbank Baden-Wurttemberg v. Goldman, Sachs & Co.,* No. 10 Civ. 7549, 2011 WL 4495034 (S.D.N.Y. Sept. 28, 2011). The court found that the complaint did not adequately allege that the defendants were aware of the toxicity of the mortgages at issue.

Facts

Landesbank allegedly purchased, on March 30, 2006, two Davis Square notes for a total of $37 million. Goldman underwrote and issued Davis Square and TCW managed the CDO's collateral, which consisted of residential mortgage-backed securities. The complaint further alleged that Goldman and TCW marketed Davis Square as a "High Grade Structured Product CDO" and highlighted as a "Strength[] of the Transaction" Davis Square's collateral profile and its triple-A-rating. The complaint also alleged that, prior to the offering, Goldman provided investors with a circular that disclosed the risks of its portfolio, including that Davis Square would invest in "subordinate classes" of mortgage-backed securities, which "are more sensitive to risk of loss and writedowns" and that investments would include risky loans such as "jumbo" and "balloon payment" loans that may have higher default rates.

While Moody's and Standard & Poors gave Davis Square ratings of AAA and Aaa, respectively, the circular warned investors to "consider and assess for themselves the likely level of defaults of the collateral assets, as well as the likely level and timing of recoveries on the collateral assets." The circular additionally required each purchaser, including plaintiff Landesbank, to represent that it (1) was a sophisticated investor; (2) understood that investing contained a risk of loss of the entire investment; (3) had access to the financial information of the mortgage-backed securities; (4) had evaluated the purchase price fully understanding the risks; and (5) had consulted its own experts and made its own investment decisions. The circular also required Landesbank to acknowledge that Goldman and TCW were not "acting as a fiduciary or financial or investment advisor for [Landesbank] [and Landesbank was] not relying upon any advice, counsel or representations of [defendants] other than in the Circular." As required by SEC regulation, Goldman filed with the SEC disclosures regarding the mortgage-backed securities backing Davis Square.

The complaint alleged that, prior to Davis Square's offering, Goldman learned that the mortgages were riskier than disclosed by the circular or than the ratings indicated. Specifically, the complaint alleged that Goldman analyzed the underlying mortgages and was provided detailed due diligence from Clayton Holding, Inc. ("Clayton"), the largest provider of mortgage loan due diligence for investment banks. The complaint further alleged that Goldman concealed the true quality of the mortgages from the rating agencies, and used the fraudulently obtained ratings to market Davis Square.

Landesbank specifically alleged that, it would not have invested in Davis Square's offering if it possessed the same knowledge as Goldman or if it knew that TCW had not conducted proper due diligence. After the housing market collapsed, many of Davis Square's underlying mortgage-backed securities were downgraded to "junk." Landesbank therefore brought claims against both defendants for common law fraud, negligent misrepresentation and unjust enrichment. Defendants moved to dismiss the complaint, in its entirety, for failure to state a claim upon which relief may be granted.

Common Law Fraud

With respect to Landesbank's common law fraud claim, the court explained that, "[u]nder New York law, fraud requires a showing of (1) a material misrepresentation of fact, (2) knowledge of its falsity, (3) an intent to induce reliance, (4) justifiable reliance by the plaintiff, and (5) damages." The court also recognized that under Federal Rule of Civil Procedure 9(b) "claims of fraud must be plead with particularity and '(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.'" Under the circumstances of this case, the court concluded that plaintiff failed to plead fraud with particularity and that, accordingly, the common law fraud claims must be dismissed.

The court found that plaintiff's allegations that Goldman knew of the poor quality of the mortgages prior to the Davis Square offering, and that Goldman knew that statements in the offering material were false, were insufficient under Rule 9(b)'s pleading requirements because, "it is well settled that '[w]here plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information.'" The court concluded that plaintiff's allegations with respect to the Clayton Report "do not satisfy the particularity requirements of Rule 9(b)" because (i) plaintiff only referenced the Report without alleging who drafted it, who prepared it, or who, if anyone, at Goldman

reviewed it; (ii) the "All Clayton Trending Reports" attached to plaintiff's opposition papers, which the court presumed to be the "Clayton Report," is dated from 2007 and therefore cannot support a fraud claim for securities sold in March 2006; and (iii) plaintiff failed to allege any connection between the mortgages reviewed in the Clayton Report and the mortgages that collateralized Davis Square.

The court explained that, plaintiff's other allegations tending to support an "inference" that Goldman had knowledge regarding the toxicity of the mortgages underlying Davis Square, did not satisfy Rule 9(b) because they "do not give defendants notice of the particulars: the 'who, what, when, where and how' required to support a fraud claim." Similarly, the court determined that plaintiff's "perfunctor[y]" allegations that Goldman and TCW received contradictory information because they were middlemen in the mortgage securitization business, had access to information unavailable to other investors, and conducted due diligence were also deficient because a "'[b]road reference to raw data' is not sufficient to plead that defendants knowingly made false statements."

With respect to TCW, the court concluded that the allegations were "similarly sparse and lack particulars." Specifically, while the complaint alleged that TCW knowingly misrepresented that it had performed due diligence on the Davis Square collateral, it was "bereft of any specifics about TCW's due diligence or how any of its statements were false." In addition, the court explained that the allegations that TCW should have uncovered the nonconforming loans, given the subsequent revelations of the toxicity of the mortgages, are impermissible "fraud by hindsight" allegations that cannot survive a motion to dismiss.

Negligent Misrepresentation

The court explained that, "[t]o state a claim for negligent misrepresentation in connection with a commercial transaction, a plaintiff must plead justifiable reliance." The court further explained that "[i]n assessing justifiable reliance, [New York's highest court] has described a three step inquiry: 'whether the person making the representation held or appeared to hold unique or special expertise; whether a special relationship of trust or confidence existed between the parties; and whether the speaker was aware of the use to which the information would be put and supplied it for that purpose.'" The court observed that "New York courts generally do not permit negligent misrepresentation claims based on arm's-length transactions between sophisticated counterparties" because a plaintiff cannot claim it relied on the special expertise of a defendant where it is clear the plaintiff itself had the necessary expertise. Similarly, the court stated that a sophisticated plaintiff cannot maintain a claim for negligent misrepresentation based upon an arm's length transaction if the plaintiff failed to utilize the means of verification -- such as reviewing the files of other parties to the transaction -- available to it.

The court therefore dismissed the negligent representation claim because plaintiff failed to allege a special relationship of trust or confidence with Goldman or TCW (in fact, the circular expressly disclaimed any such relationship); information about the mortgage-backed securities contained in portfolio were available to plaintiff in SEC filings; and / continued page 14

In granting Goldman and TCW's motion to dismiss in its entirety, this decision represents yet another example highlighting the difficulties that sophisticated purchasers of toxic mortgage-backed securities face in pursuing claims arising from typically well-documented transactions.

Downgrade Complaint Dismissed

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plaintiff represented that it was a sophisticated investor that adequately researched and accepted the risks associated with its investment.

Unjust Enrichment

The court explained that "[i]t is well settled under New York law that the 'existence of a valid and enforceable written contract governing a particular subject matter ordinarily precludes recovery in quasi contract for events arising out of the same subject matter.'" As the complaint alleges that the securities were sold pursuant to a purchase agreement, the court concluded that "recovery under a theory of unjust enrichment is precluded," as the purchase agreement is the governing contract.

The court determined, however, that even if there were no contract governing the subject matter, the claim would still fail. The court explained that "[t]o establish unjust enrichment, a plaintiff must allege '(1) that the defendant benefitted; (2) at the plaintiff's expense; and (3) that equity and good conscience require restitution.'" As the complaint failed to state a claim for fraud or "other unlawful behavior," the court concluded that there was no allegation that the defendants profited at plaintiff's expense or that "equity and good conscience require restitution."

Conclusion

In granting Goldman and TCW's motion to dismiss in its entirety, this decision represents yet another example highlighting the difficulties that sophisticated purchasers of toxic mortgage-backed securities face in pursuing claims arising from typically well-documented transactions. ◎

TARP's Golden Parachute Prohibition Not Sufficient to Vacate Arbitrator's Severance Award to Former Executive

By Stacey Trimmer

A Pennsylvania federal district court has dismissed a petition by Royal Bank America ("Royal Bank") to vacate an arbitration award that allegedly awarded its former executive a "golden parachute" payment in violation of in the Troubled Assets Relief Program ("TARP"). The court found that Royal Bank failed to establish that, in making the award, the arbitrator manifestly disregarded federal law. *Royal Bank America v. Kirkpatrick*, 2011 WL 4528349 (E.D. Pa. 2011).

Background

In October 2008, James E. Kirkpatrick ("Kirkpatrick") entered into an employment agreement with Royal Bank to become its executive vice president and chief lending officer. The agreement provided that Royal Bank could terminate Kirkpatrick without cause "upon giving written notice of such termination . . . at least ninety (90) days prior to the date upon which such termination shall take effect." In the event of termination, Royal Bank was to pay Kirkpatrick "any earned or unpaid salary accrued through the effective date of termination" and "any benefits which may be due . . . on the date of termination." In addition, the parties agreed to arbitrate any dispute arising out of the agreement.

Several months later, in February 2009, Royal Bank began participating in TARP. As part of participation, Royal Bank agreed to "prohibit any golden parachute payment" to a senior executive officer. In furtherance thereof, Royal Bank had Kirkpatrick sign a waiver of his right to bring a claim against Royal Bank "for any changes to [his] compensation or benefits that required to comply with" TARP.

In February 2010, Royal Bank terminated Kirkpatrick without giving him the contractually required 90 days notice, prompting Kirkpatrick to file a demand for arbitration seeking compensation for the 90-day period. During the arbitration, Royal Bank argued that the TARP prohibition of golden parachute

payments barred Kirkpatrick's claim for compensation because, under TARP, "golden parachute" is defined as "any payment for the departure from a TARP recipient for any reason." The arbitrator rejected Royal Bank's argument, finding that payment of wages for the 90-day period fell into an exception under TARP which provides that "payments for services performed or benefits accrued" do not qualify as a golden parachute payment. The arbitrator awarded Kirkpatrick $48,329 representing the amount he would have received during the 90-day period.

Kirkpatrick petitioned the Pennsylvania state court to confirm the arbitration award, which Royal Bank removed to the federal court. Shortly thereafter, Royal Bank filed a separate action in federal court to vacate the award. The cases were consolidated for disposition.

The Removal Action

Both parties moved for summary judgment. Royal Bank argued that the award must be vacated due to the arbitrator's manifest disregard of the federal law under TARP. Kirkpatrick contended that the federal court lacked subject matter jurisdiction of the controversy. Royal Bank countered that subject matter jurisdiction existed because the award raised a substantial issue of federal law, the alleged manifest disregard of TARP.

In ruling on the summary judgment motions, the court began by explaining that, because neither party asserted diversity jurisdiction, subject matter jurisdiction would only exist if a federal question was present. Federal question jurisdiction exists only where the plaintiff's stated cause of action arises from or is grounded upon federal law, and cannot be based simply on a defense that implicates federal law. Thus, the court found that the removal of Kirkpatrick's action was improper based on lack of subject matter jurisdiction as the petition to confirm the arbitration award only raised state law claims. Royal Bank's assertion of the TARP regulation as a defense was not enough to maintain federal question jurisdiction over Kirkpatrick's action. Nevertheless, the court proceeded to examine the merits of the parties' claims.

The "Manifest Disregard" Standard

In turning to analyze Royal Bank's action to vacate the arbitration award, the court first observed that Section 10 of the Federal Arbitration Act ("FAA") lists only four grounds for vacating an arbitrator's decision. Although not listed in the FAA as a ground for vacating an award, Royal Bank maintained that the award should be vacated because the arbitrator manifestly disregarded the TARP regulation in awarding compensation to the former executive.

The court discussed United States Supreme Court precedent that has called into doubt whether manifest disregard is a valid ground for vacating an arbitration award in addition to the four grounds listed in the FAA. Although the district court concluded that manifest disregard is not an independent basis for vacating an arbitration award, it went on to address whether, if applicable, Royal Bank had satisfied the manifest disregard standard and whether the application of that federal law standard provided the court with subject matter jurisdiction.

The court outlined the standard that certain caselaw has espoused to establish manifest disregard. To prove manifest disregard, a petitioner must demonstrate that the arbitrator was fully aware of the existence of a clearly defined legal principle, but refused to apply it. In other words, the arbitrator had to be aware of the law and then intentionally disregard it. The court observed that the doctrine is used in exceedingly rare circumstances where an arbitrator commits an egregious impropriety. Notably, the court explained that some courts have found federal subject matter jurisdiction where even the petitioner asserted "in good faith" that the arbitrator manifestly disregarded federal law. Those courts, however, still required the petitioner to show that the disregard of law be conscious to justify vacatur once the court turned to the merits. The court disagreed with those courts that found jurisdiction where the petitioner simply asserted manifest disregard of federal law and decided to follow the approach that a petitioner must claim that the arbitrator intentionally disregarded a clearly settled principle of federal law to establish jurisdiction. The court found that under either standard, Royal Bank failed to justify vacatur of the award.

Further, the court noted that federal courts should only hear FAA cases involving a substantial federal issue because otherwise state courts are competent to adjudicate federal law, FAA claims. The court found that "the substantiality requirement is meaningless if petitioners can invoke federal jurisdiction merely by baldly asserting that an arbitration award disregards federal law." Therefore, "[f]ederal courts should exercise jurisdiction only where the arbitrator grants an award based on an egregiously and clearly incorrect interpretation of federal law."

TARP Allegation Insufficient to Prove "Manifest Disregard"

The court held that Royal Bank failed to establish that the arbitrator manifestly disregarded federal / continued page 16

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law. The main flaw in Royal Bank's argument was that it could point to no clearly defined legal standard governing TARP's definition of a "golden parachute." Even if there was such a standard under TARP, Royal Bank also failed to provide any evidence that the arbitrator consciously disregarded that standard. While Royal Bank cited to the regulation that TARP forbids it from making "any payment for the departure from a TARP recipient for any reason," there is an exception for "payments for services performed or benefits accrued." The court found that the arbitrator made "the reasonable judgment that because the contract granted Kirkpatrick a 90-day notice of termination, his payment during that period was for 'services performed or benefits accrued' not a 'golden parachute' under TARP." Thus, the court dismissed Royal Bank's petition because, at most, Royal Bank asserted mere disagreement with the arbitrator's decision and could not demonstrate that its own interpretation of the TARP provisions represented a clear principle of federal law. Finally, the court denied Kirkpatrick's request for attorneys' fees pursuant to the removal statute because Royal Bank asserted a good faith reason for removal under TARP.

Conclusion

This decision suggests that banks governed by the TARP prohibition against golden parachute payments, as well as bank executives, may at times have a viable argument that severance payments to executives are permitted under the exception for "payments for services performed or benefits accrued." Significantly, the issue before the court here was whether the arbitrator manifestly disregarded TARP, not whether the arbitrator's interpretation of TARP was correct. As this decision suggests, however, the arbitrator's ruling does appear to present one reasonable interpretation of the TARP regulations. ◎

Title Insurer Liable for Indemnification Where Mortgage Unenforceable Due to Fraud

By Kimberly Zafran

A New York federal district court recently awarded an insured summary judgment finding that the defendant title insurance company was liable for indemnification where the relevant mortgage was found to be unenforceable due to fraud. In *Levi v. Commonwealth Land Title Ins. Co.*, No. 09 Civ. 8012 (SHS), 2011 WL 4542904 (S.D.N.Y. 2011), plaintiff Larry Levi established that a mortgage he had obtained through a series of complicated events was invalid due to the initial fraudulent nature of the transaction and that the insurance policy he purchased to insure the mortgage covered such an occurrence. District Court Judge Sidney H. Stein discredited defendant's arguments that it was the defects in the debt secured by the mortgage, and not the mortgage itself, that made the mortgage unenforceable, and that the plaintiff may have been complicit in the alleged fraud.

Background Facts

Henry Vargas allegedly fraudulently held himself out to be an officer and sixty percent owner of 2141 MD Jr., LLC ("2141 MD"), a company which owned a commercial property at 21-41 Lenox Avenue in Manhattan. In that capacity, Vargas sold Pete Skyllas an option to purchase his interest in 2141 MD in May of 2008. Vargas gave Skyllas a $1 million mortgage note on 2141 MD, secured by a mortgage on the commercial property in Manhattan owned by 2141 MD. The mortgage, mortgage note and related Option Agreement were executed on May 14, 2008, naming MD 2141 as the mortgagor, Skyllas as the mortgagee, and 21-41 Lenox Avenue as the mortgaged property. The mortgage and the note stated that 2141 MD was to pay $1 million to Skyllas in one lump sum on September 10, 2009. On July 14, 2008, Skyllas notified Vargas that he would not be exercising the option to purchase Vargas's interest in 2141 MD as provided in the Option Agreement. At the agreement of the parties, the mortgage and note were re-dated to be effective as of July 14, 2008 to reflect the early termination of the Option Agreement.

On July 21, 2008, Skyllas assigned his rights under the mortgage note and the mortgage to the plaintiff, Larry Levi, in exchange for $728,000. In connection with that assignment, Larry Levi purchased a mortgage title insurance policy from Vanguard Title Agency, Inc., an agent of the defendant, Commonwealth Land Title Insurance Company ("Commonwealth"). The policy was a $1 million "Loan Policy of Title Insurance" that insured 2141 MD's mortgage to Skyllas that was then assigned to Levi. The "Covered Risks" portion of the insurance policy provided for indemnification for a loss rendering the mortgage lien invalid due to "forgery, fraud, undue influence, duress, incompetency, incapacity, or impersonation."

In January 2009, after Levi learned of the fraudulent nature of the transaction from Skyllas and the Manhattan District Attorney's Office, he filed a claim seeking indemnification from Commonwealth. After months of allegedly ignoring Levi's claim and the documentary evidence Levi submitted to Commonwealth, in September of 2009 Commonwealth informed Levi's counsel that it was willing to bring litigation in Levi's name and on his behalf against Henry Vargas and Vanguard Title Agency. Frustrated by Commonwealth's response to his claim, Levi initiated this lawsuit.

The Lawsuit

The main claim advanced by Levi was that Commonwealth breached its contractual obligation to Levi by failing to indemnify him pursuant to the terms of the policy. After advancing this claim, and arguing that no issue of material fact was in dispute, Levi moved for summary judgment in his favor.

Levi argued that "Vargas fraudulently executed the lien on behalf of an entity he had no authority to bind" and that pursuant to the insurance policy "[a] plainly covered risk plainly occurred." Commonwealth, on the other hand, made two main arguments supporting its defense that it was not liable for coverage: (1) Levi's loss was caused by a defect in the mortgage debt, not Vargas's fraud; and (2) Levi does not qualify for coverage pursuant to the policy exclusion for "[d]efects, liens, encumbrances, adverse claims, or other matters . . . created, suffered, assumed, or agreed to by the insured Claimant." Commonwealth also argued that Levi violated the policy by refusing to cooperate with Commonwealth's efforts to bring a lawsuit against Vargas and Vanguard Title Agency. The court, however, dismissed this notion of non-cooperation quickly because, pursuant to *State Farm Indem. Co. v. Moore*, 58 A.D.3d 429, 430 (1st Dep't 2009), to disclaim coverage based on lack of cooperation, the insurer must show "diligent efforts" that were "reasonably calculated" to ensure the insured's cooperation and that the insured showed an attitude of obstruction. Commonwealth's assertions did not meet this heavy burden. In addition, Commonwealth did not establish that Levi's alleged non-cooperation resulted in prejudice to Commonwealth, which it is required to do in order to disclaim coverage under this theory.

Levi argued that Commonwealth had waived its arguments or, in the alternative, was estopped from making them. The court did not agree, finding that the doctrine of waiver was inapplicable and that the requirements of estoppel, that there be an act inconsistent with a lack of coverage by the insurer and detrimental reliance of the insured, were not present. The court then turned to Commonwealth's main arguments disclaiming liability.

> District Court Judge Sidney H. Stein discredited defendant's arguments that it was the defects in the debt secured by the mortgage, and not the mortgage itself, that made the mortgage unenforceable, and that the plaintiff may have been complicit in the alleged fraud.

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Title Insurer Liable

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The Court's Analysis

The court agreed with Commonwealth that the risk that a mortgage lien is not enforceable because there is no valid debt to collect is usually not covered by title insurance. Commonwealth argued further that, even if Vargas had been authorized to grant the mortgage, the mortgage debt would still be invalid because: (1) Skyllas did not pay the alleged loan proceeds to Vargas, as he was required to do; and (2) 2141 MD did not receive any loan proceeds. The court found that the first alleged issue was entirely contradicted by the evidence before the court. This evidence included Skyllas's deposition testimony, a notarized document, and the Option Agreement showing that Skyllas paid the alleged loan proceeds to Vargas. Commonwealth attempted to call Skyllas's credibility into question; however, the court stated that "contentions without evidence cannot defeat summary judgment."

The court further found that:

> "[the fact that] 2141 MD did not receive the loan proceeds in this arrangement would not preclude enforcement of the mortgage—a mortgage granted by a mortgagor to secure someone else's debt is valid in New York. . . . If Vargas had authority to grant the mortgage, 2141 MD's nonreceipt of the loan proceeds simply would not impair the enforceability of the mortgage."

Because it was clear that there was no independent defect in the debt which was not caused by Vargas's fraud, the court found that Commonwealth could not disclaim coverage on this basis.

The court also found Commonwealth's argument that the policy excluded Levi's loss unconvincing. This argument was based on the notion that Levi, either directly or through Skyllas, was responsible for the defects in the mortgage debt. The previous argument dealt with this point, as there was no defect in the debt apart from Vargas's fraud. Commonwealth further argued that Levi knew or was complicit in Vargas's fraud; however, Levi testified in his deposition that he never had any dealings with Vargas and Commonwealth was unable to contradict this with any evidence.

Liability and Damages

Based on the arguments of the parties and the evidence presented, the court found that Commonwealth was liable for Levi's loss. The court then turned to the issue of damages, finding that the actual loss of the holder of a junior lien, such as Levi, is the lesser of "1) the unpaid principal on the mortgage debt and 2) the mortgagor's equity in the property." Levi presented uncontroverted evidence that the principal on the debt is $1 million and the equity in the Lenox Avenue property was over $1 million. The court therefore found that Levi's damages were $1 million. Commonwealth argued that the following policy provision precluded it from having to pay prejudgment interest:

> "In the event of any litigation, including litigation by the Company or with the Company's consent, the Company shall have no liability for loss or damage until there has been a final determination by a court of competent jurisdiction, and disposition of all appeals, adverse to the Title or to the Lien of the Insured Mortgage, as insured."

The court, however, disagreed with this interpretation of this provision in the policy finding that it did not mention prejudgment interest and that it defines the timing, not extent, of liability. The court found that Commonwealth was liable to Levi for prejudgment interest starting from September 11, 2009, the date of Levi's actual loss. Because the mortgage debt was not due until September 10, 2009, and the loss could not occur before the mortgage debt went into default, the court found that the loss occurred on September 11, 2009. The prejudgment interest rate awarded to plaintiff was the statutory rate in New York, nine percent. Attorney's fees were not awarded to plaintiff as the court found that Commonwealth had not been acting in bad faith.

Conclusion

The court ruled that the insurance company was liable for indemnification where a mortgage was shown to be unenforceable due to fraud, absent a viable showing that the mortgage lien was unenforceable regardless of the fraud. Additionally, for the insurer to attempt to circumvent indemnification based on a lack of cooperation on the part of the insured in bringing a lawsuit against other relevant parties, the insurer needs to be able to meet the high burden of showing that it acted diligently to obtain the cooperation of the insured, that its efforts were reasonably calculated to lead to such cooperation, and that the insured showed an attitude of

obstruction. Finally, if an insurance company wishes to attempt to protect itself from having to pay prejudgment interest to its insured, it should state so clearly within its policies. It is clear that vague provisions concerning the timing of liability, like the one in the relevant policy at issue here, will not necessarily prevent a court from including prejudgment interest as a part of any judgment. ◎

Supreme Court to Interpret Real Estate Settlement Procedures Act

By Jonathan Cross and Jill Kahn

The U.S. Supreme Court has granted certiorari in a case turning on the interpretation of Section 8(b) of the Real Estate Settlement Procedures Act ("RESPA"), 12 U.S.C. § 2607(b). Circuit courts are currently split as to whether Section 8(b) prohibits banks or companies from charging fees for services they did not perform, or instead prohibits only kickback or fee-splitting arrangements, in which the bank or company shares fees with another party. The case is on appeal from the Fifth Circuit Court of Appeals, which held that RESPA § 8(b) applies only to those fees which are split with another party. *Freeman v. Quicken Loans, Inc.*, No. 10-1042, 2011 WL 578903 (2011).

The Real Estate Settlement Procedures Act

Congress passed the Real Estate Settlement Procedures Act in 1974 in an attempt to reform the real estate settlement process and protect consumers. Its stated goals were to create more effective advance disclosure to home buyers and sellers of settlement costs, to reduce the amounts home buyers are required to place in escrow accounts, and to eliminate referral fees, or "kickbacks," in connection with settlement services.

Section 8(b) of RESPA provides that "[n]o person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed." 12 U.S.C. § 2607(b). In 2001, the U.S. Department of Housing and Urban Development ("HUD"), the agency responsible for enforcing RESPA, issued a statement of policy identifying four types of overcharge schemes that this provision could potentially cover: (1) *fee splitting*, where two or more persons split a fee, any portion of which is unearned; (2) *mark-ups*, where a service provider charges the borrower for services performed by a third party in excess of the cost of the services to the service provider but keeps the excess itself; (3) *undivided unearned fees*, where a service provider charges the borrower a fee for which no correlative service is performed; and (4) *overcharges*, where a service provider charges a borrower for services actually performed but in excess of the service's reasonable value. HUD asserted that Section 8(b) related to each of these types of transactions.

The Lawsuit

The plaintiffs in *Freeman* are three couples who each obtained a mortgage from defendant Quicken Loans, Inc. ("Quicken"). At the closing of their mortgage transactions, Quicken allegedly charged two of the couples a loan discount fee and the third a loan origination fee and loan processing fee. Based on the theory that a loan discount fee can only be charged when there is a corresponding interest rate reduction, and that the loan origination fee was duplicative of the loan processing fee, the couples contend in their lawsuit that these were unearned fees, made unlawful by Section 8(b) of RESPA. Quicken argued the claims were not actionable under Section 8(b), as they were not split with another party, and this provision applies only to kickback fees.

The Fifth Circuit Court of Appeals agreed with Quicken, finding the statute's language unambiguous in that it does not cover undivided unearned fees. It read the phrase "no person shall give and no person shall accept" as unambiguous in its meaning that the statute applies only to divided fees. The Fifth Circuit also held that Section 8(b)'s language concerning "any portion, split or percentage" requires "that two parties share something." The court held that, when read in its entirety, RESPA is an anti-kickback statute, not an anti-price gouging statute, and noted that Section 2601's purpose statement does not discuss, mention, or even hint about a general prohibition on overcharges or unearned fees, or other forms of price abuse.

While HUD has offered a conflicting interpretation, the court explained that deference to government agencies is unnecessary where the intent of Congress is clear. Moreover, the court noted that HUD's statement of policy was not a regulation, lacked the force of law, and was therefore entitled to a lesser degree of deference. Noting the division among other circuit courts as to the interpretation of */ continued page 20*

Real Estate Settlement Procedures Act

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the statute, the Fifth Circuit joined the Fourth, Seventh, and Eighth Circuits in their reading of Section 8(b) as applying only to divided fees.

The Circuit Split

Freeman is one of many cases that have hinged on the courts' interpretation of Section 8(b), and the circuit courts are divided in their interpretations thereof. All circuits have agreed that the statute plainly prohibits fee splitting, and every circuit addressing the issue has rejected the contention that simple overcharges are actionable under the statute. The disagreement is on the statute's application to mark-ups and undivided unearned fees.

The Fourth, Seventh, Eighth, and now Fifth, Circuits have each held that RESPA § 8(b) is exclusively an anti-kickback provision. The Fourth Circuit has interpreted Section 8(b) as only prohibiting overcharges when a person or percentage of the overcharge is kicked back or split with a third party. *Boulware v. Crossland Mortg. Corp.*, 291 F.3d 261, 265 (4th Cir. 2002). The Seventh Circuit has consistently held the same, noting it was compelled to dismiss a RESPA claim unless plaintiff alleged a third party accepted unearned fees from defendant. *Echevarria v. Chicago Title & Trust Co.,* 256 F.3d 623, 627 (7th Cir. 2001). The Eighth Circuit's ruling echoes the court in *Freeman*, holding, "Section 8(b) is an anti-kickback provision that unambiguously requires at least two parties to share a settlement fee in order to violate the statute." *Haug v. Bank of Am., N.A.,* 317 F.3d 832, 836 (8th Cir. 2003). According to these courts, an action under Section 8(b) requires two culpable parties, a giver and a receiver of the unlawful fee.

In contrast, the Second, Third, and Eleventh Circuits have rejected any two-party requirement under Section 8(b), and held that mark-ups or unearned fees of any kind are prohibited. The Eleventh Circuit held that the "and" in "no person shall give and no person shall accept" serves to create two separate prohibitions, not a requirement that the unearned fee must be split to be actionable. *Sosa v. Chase Manhattan Mortg. Corp.,* 348 F.3d 979, 982 (11th Cir. 2003). The Third Circuit agreed, noting that as a practical matter, the economic harm to the consumer is the same whether the defendant retains an unearned charge for itself or passes it on as a kickback to a third party. *Santiago v. GMAC Mortg. Grp. Inc.,* 417 F.3d 384, 388-89 (3d Cir. 2005). The Second Circuit, the only court to assess an undivided unearned charge like the fee at issue in *Freeman*, held that it was prohibited by Section 8(b). The court found that the statute was ambiguous, and resolved the ambiguity by relying on the HUD interpretation, which says these fees need not be shared to be unlawful. *Kruse v. Wells Fargo Home Mortg., Inc.,* 383 F.3d 49, 58-62 (2d Cir. 2004).

In their petition for certiorari, the *Freeman* petitioners contended that "the present division and uncertainty—regarding a law governing one of the most important financial transactions most Americans ever undertake—is intolerable for consumers, lenders, and settlement service providers alike." They urged the court to intervene so that this law may be applied uniformly throughout the country in the future.

The Supreme Court's decision in *Freeman* will settle the debate over whether Section 8(b) of RESPA is purely an anti-kickback statute. While HUD has insisted it applies to fee splitting, mark-ups, overcharges, and undivided unearned fees, regardless of whether these fees are split, four U.S. circuit courts have disagreed.

Implications

The Supreme Court's decision in *Freeman* will settle the debate over whether Section 8(b) of RESPA is purely an anti-kickback

statute. While HUD has insisted it applies to fee splitting, mark-ups, overcharges, and undivided unearned fees, regardless of whether these fees are split, four U.S. circuit courts have disagreed. If the Supreme Court upholds the Fifth Circuit's decision, affirming the notion that the statute unambiguously applies only to kickbacks, it will eliminate a risk to mortgage originators that they will be charged with violations of Section 8(b) when no fee sharing is involved. However, if the court agrees with the minority position and with HUD, mortgage originators will need to be wary of a broader range of transactions (such as mark-ups of settlement services) which could lead to a Section 8(b) violation. ◎

The Edge Act Keeps AIG's Suit Against Bank of America in Federal Court

By Thomas J. McCormack and Jill Kahn

A recent decision by a New York federal district court upheld federal court jurisdiction under the Edge Act, 12 U.S.C. § 632 (the "Edge Act"), in a lawsuit brought by American International Group, Inc. ("AIG") and several other insurers against Bank of America, Merrill Lynch and Countrywide Affiliates. The case involves AIG's claim that defendants defrauded it into purchasing over $10 billion dollars of residential mortgage-backed securities ("RMBS"). Judge Barbara S. Jones of the Southern District of New York held that, despite the fact only a few of the hundreds of transactions in question involved international or territorial transactions, this was enough to create federal jurisdiction under the Edge Act. *Am. Int'l Grp., Inc., v. Bank of Am. Corp.,* No. 11 Civ. 6212(BSJ), 2011 WL 5022716 (S.D.N.Y. Oct. 20, 2011).

The Edge Act

Section 632 was incorporated into the Edge Act of 1913 by the Banking Act of 1933. It provides federal courts with original jurisdiction in any case in which a national bank is a party, and that arises out of transactions involving international banking or other international or foreign financial operations. It expressly provides for removal, at any time prior to trial, of cases commenced in state court that meet its jurisdictional requirements. The statute states that a case arises under the laws of the United States if: (1) the case is civil in nature, (2) one of the parties is a corporation organized under the laws of the United States, and (3) the suit arises out of transactions involving international banking, or banking in a dependency or insular possession of the United States, or out of other international or foreign financial operations.

In the past fifteen years, decisions of the Southern District of New York have outlined a broad scope for federal jurisdiction under Section 632 in suits where the underlying transaction arises out of international or foreign banking or financial operations. *See* Thomas J. McCormack, Robert Sidorsky & Dorollo Nixon, Jr., *Edge Act Enables National Banks to Invoke Federal Jurisdiction Over Suits Involving International Banking or Financial Operations*, Banking L.J., November/December 2007, at 907. The courts have held that jurisdiction exists if any part of the suit arises out of transactions involving international or foreign banking, and can be based on non-banking international financial operations. Jurisdiction may also be upheld in cases based on state law causes of action and containing only an incidental connection to banking law, and even though the international or foreign banking activity was not central to the case.

The Facts

The suit arose out of AIG's alleged purchase of 349 residential mortgage-backed securities for which the defendants acted as underwriters, sponsors, depositors and loan originators. In August of 2011, AIG filed a complaint in New York state court, alleging defendants perpetrated a "massive fraud" when they knowingly misrepresented and concealed the true quality of hundreds of thousands of defective mortgages underlying the RMBS sold to AIG. AIG contended that the offering materials used to sell the residential mortgage-backed securities fraudulently misrepresented and concealed the actual credit quality of the mortgages by providing false quantitative data about the loans. The complaint alleged defendants encouraged borrowers to falsify loan applications, pressured property appraisers to inflate home values, and ignored obvious red flags in the underwriting process.

AIG claimed that, had it known the truth, it would not have invested over $28 billion in defendants' residential mortgage-backed securities. The complaint alleges over $10 billion in losses in connection with these purchases, and seeks damages in that amount for fraudulent inducement, aiding and abetting fraudulent inducement, negligent misrepresentation, successor and vicarious liability, and violations / continued page 22

AIG Suit

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of Sections 11, 12(a)(2), and Section 15 of the Securities Act of 1933.

The Decision

After plaintiffs filed their complaint in New York state court, defendants removed the case to federal district court claiming federal jurisdiction existed pursuant to the Edge Act, as well as under 28 U.S.C. §§ 1334(b) and 1452 because the case was related to bankruptcy proceedings. Plaintiffs' argument for jurisdiction under the Edge Act hinged on the fact that Bank of America is a national bank, organized under the laws of the United States, and plaintiffs' claim concerned defendants' mortgage lending practices in dependencies and insular possessions of the United States, which are specifically covered by the Edge Act. Defendants also pointed out that subsidiaries of foreign banks originated some of the mortgage loans included in the loan pools in question, and in some instances these banks issued or underwrote the RMBS plaintiffs purchased.

Following removal, plaintiffs filed a motion to remand to state court. The court denied the motion to remand, rejecting plaintiffs' argument that the involvement of only a small number of mortgages in U.S. territories created a connection to U.S. territories too tenuous to implicate the Edge Act.

The court first disagreed with plaintiffs' argument that Edge Act jurisdiction is barred based on the well-pleaded complaint rule because the complaint, on its face, does not mention any loans originated in U.S. dependencies or insular possessions, or any other foreign banking transactions. It cited to Second Circuit case law for the proposition that Section 632 provides an explicit statutory exception to the well pleaded complaint rule. *See Westmoreland Capital Corp. v. Findlay,* 100 F.3d 263, 268-69 (2d Cir. 1996).

The court also held that, although plaintiffs' complaint challenges the RMBS and not the underlying mortgage transactions which took place in U.S. territories, this distinction does not prevent the suit from implicating foreign banking. The opinion emphasized that the suit need only arise out of transactions "involving" international banking, and courts have held this involvement may be incidental. Additionally, because plaintiffs' claims challenge the quality and value of the RMBS, their resolution will turn, at least in part, on whether the underlying mortgage loans complied with the underwriting standards described in defendants' offering materials. Therefore, the claims do directly implicate the mortgage transactions.

Next, the court rejected the argument that there was no "banking in" a dependency or insular possession because there was no banking activity actually conducted in a U.S. territory. The judge agreed with defendants that lending on a property in a jurisdiction constitutes banking there, particularly in a case like this one in which, for at least two of the loans, the borrowers and their homes were both located in a U.S. territory. The court also disagreed that because only four of the 349 RMBS were located in U.S. territories, the case does not "arise out of" banking in the territorial U.S. The decision cited case law which held that only a small portion of the challenged transactions need to lie in a foreign state or territory in order to provide Edge Act jurisdiction. *See Pinto v. Bank One Corp.,* No. 02 Civ.8477 NRB, 2003 WL 21297300, at *3 (S.D.N.Y. June 4, 2003).

Lastly, the court rejected plaintiffs' argument that Bank of America was not a party to any of their claims on RMBS involving territorial U.S. mortgages, and therefore the Edge Act's two-fold requirement of: (1) a transaction involving a national bank, and (2) a foreign transaction, was not met. The court was not convinced that the Edge Act requires a perfect match between the particular entity involved in the territorial transaction and the party against whom the claim is brought. It also held that because Bank of America was being sued as a successor to Countrywide with respect to its territorial loans, this creates a sufficient relationship between the national bank and the territorial banking. Because the court decided it had jurisdiction under the Edge Act, it declined to address whether jurisdiction was also proper under the "related to" doctrine.

Conclusion

Am. Int'l Grp., Inc. v. Bank of Am. Corp. is the most recent case in a line of decisions out of the Southern District of New York creating a more expansive scope for federal jurisdiction under the Edge Act, for national banks involved with international or foreign banking and financial operations. For national banks that are parties to litigation involving foreign transactions, the Edge Act is a useful tool where a bank believes its case would be appropriately resolved in federal court. ◎

MBIA's Fraud Claim Against Credit Suisse Reinstated but Court Signals Claim is Fatally Flawed

By Emily Abrahams

In 2009, MBIA, a company that insures financial products including financial risk, commenced an action against Credit Suisse Securities USA LLC ("Credit Suisse"), DLJ Mortgage Capital, Inc. ("DLJ") and Select Portfolio Servicing, Inc. ("SPS") claiming fraudulent inducement and breach of contract in connection with its insurance of a pool of mortgage-backed securities. The securities, insured by MBIA, were comprised of an aggregate of over 15,000 second lien residential mortgage loans, also referred to as HELOCs.

The Dispute

MBIA's insurance policy, issued pursuant to a contract it entered into with defendants DLJ and SPS, guaranteed certain payments on the securities. Credit Suisse was not a party to that contract, but served as the underwriter of the public offering of the securities, which it marketed to investors. MBIA's fraud claim against Credit Suisse is premised on allegations of certain pre-contractual representations by Credit Suisse. Specifically, MBIA claims that Credit Suisse (1) provided a loan tape, which contained false and misleading disclosures about the HELOCs, (2) assured MBIA that the loans were underwritten to strict guidelines created or approved by Credit Suisse, (3) touted the due diligence it conducted on the loans, including depicting an individualized review of thousands of loans in the pool, (4) claimed that it was backing the loans originated by New Century, and (5) boasted that performance of its prior securitizations was far superior to other similarly structured transactions. Ambac Assurance Corporation ("Ambac"), another insurer of financial risk, commenced a parallel action against the same defendants (the "Ambac Action").

The Earlier Dismissal of MBIA's Fraudulent Inducement Claim

In August 2010, Judge Shirley Werner Kornreich of the Commercial Division of New York's trial court in Manhattan denied Credit Suisse's motion to dismiss MBIA's fraud claim against it. In June 2011, Justice Kornreich reversed that decision and dismissed that claim (the "June Dismissal Order"). In the June Dismissal Order, the court found that MBIA's fraudulent inducement claim was duplicative of its breach of contract claims because the fraud claim was based on representations made by Credit Suisse that were addressed by express contractual representations and warranties. The court's reversal of its initial determination to allow MBIA's fraud claim to proceed followed its decision to dismiss the fraudulent inducement claim against Credit Suisse in the Ambac Action on the same grounds, that Ambac's fraudulent inducement claim was duplicative of its breach of contract claims.

MBIA's Fraud Claim Reinstated

A month later, in July 2011, in an unrelated case brought by MBIA against Bank of America Corporation's Countrywide Financial Unit, New York's Appellate Division issued a decision reversing the dismissal of MBIA's fraud claims, *MBIA v. Countrywide,* 2011 NY App. Div. LEXIS 5509 ("*Countrywide*"). In that case, the Appellate Division held that MBIA's fraud claims were not duplicative of its breach of contract claims merely because "some of the allegedly false representations are also contained in the agreements as warranties that form the basis of the breach of contract claim."

Under New York's state procedural rules, where there is a change in the law that would change a court's prior determination, a motion to renew or reargue may be brought. In light of the Appellate Division's decision, which is binding on the trial court and which squarely addressed the legal issue on which Judge Kornreich had based her dismissal of MBIA's fraud claim against Credit Suisse in June, MBIA sought leave to reargue the motion to dismiss. Upon reargument, Judge Kornreich granted MBIA's motion, found that an application of the *Countrywide* decision to the facts of MBIA's case against Credit Suisse mandated a determination that MBIA's fraud claim did not duplicate its breach of contract claim, and allowed the fraud claim to proceed.

Court Signals MBIA's Fraud Claim Victory Is Temporary

While MBIA appears to have finally won the battle concerning its fraudulent inducement claim at the motion to dismiss stage of the litigation, the court left little doubt as to which party it believes will win the ultimate war. Indeed, after summarily granting reinstating MBIA's fraudulent inducement claim with just two paragraphs of discussion, the / *continued page 24*

MBIA Fraud Claim

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court dedicated twenty-pages to analyzing "justifiable reliance," a requisite element of MBIA's fraud claim. The essence of the court's analysis is that MBIA will not be able to establish justifiable reliance on Credit Suisse's alleged misrepresentations when it could have requested and reviewed information that was material to the transaction, but chose not to. A failure to satisfy the justifiable reliance element would be fatal to MBIA's fraud claim.

Specifically, the court found that "MBIA's reliance on [Credit Suisse's] alleged representations . . . would be unreasonable as a matter of law" because MBIA did not request or review the loan files in the pool. According to the decision, MBIA's failure to make use of the means of verification available to it prevents MBIA from arguing that it entered into the arm's length transaction in justifiable reliance on the alleged misrepresentations. The court made abundantly clear that this is particularly true for sophisticated parties like MBIA whose primary business is insuring precisely the kind of financial risk in dispute in this case. Further, the court expressly rejected arguments by MBIA that the means of verification were not available to it because of the large number of loans and the limited amount of time available to complete the transaction. The court observed that MBIA's time limitations were self-imposed and that it could have declined issuing the policy if it did not have enough time to conduct thorough due diligence.

Following the extensive discussion of MBIA's inability to demonstrate that it justifiably relied on the alleged misrepresentations underlying its fraud claim against Credit Suisse, the court concluded that "[i]t would benefit from a complete record created after the completion of the parties' discovery."

Conclusion

In addition to reinstating MBIA's fraudulent inducement claim, the court reinstated MBIA's demand for consequential and punitive damages. The court, however, adhered to its decision granting defendants' motion to strike MBIA's demand for a jury trial in light of the express contractual waiver of that right by the parties, which means that Judge Kornreich will likely be the ultimately finder of fact in this case. While the trial court is bound to follow the Appellate Division's decision and allow MBIA's fraud claim to survive at the motion to dismiss stage, Judge Kornreich's analysis strongly suggests that MBIA's fraud claim will face other, more fatal, defenses. ◎

Fraud Claims Against CDO Arranger Fail Absent Misrepresentations to Plaintiff

By Gerald D. Silver and Nicolas Stebinger

Judge Barbara S. Jones of the United States District Court for the Southern District of New York recently dismissed claims of fraud and unjust enrichment against Morgan Stanley, the arranger of a collateralized debt obligation ("CDO") that allegedly had a hand in procuring a false and misleading Triple-A rating for the CDO. *Emps. Ret. Sys. of Gov't of V.I. v. Morgan Stanley & Co., Inc.*, No. 09 Civ. 10532 (BSJ) (THK), 2011 U.S. Dist. LEXIS 112300 (S.D.N.Y. 2011). In dismissing the claims, Judge Jones focused heavily upon the missing link between Morgan Stanley and allegedly fraudulent statements made to the plaintiff. The opinion reemphasizes that, although a plaintiff may see the scope of a fraudulent scheme as encompassing multiple actors, New York's law generally limits fraud liability to those who actually made the fraudulent statements to the plaintiffs.

Background

The plaintiff's allegations revolved around the sale of notes issued by the Libertas CDO investment fund. Libertas CDO notes were created by entering into credit default swaps built upon residential mortgage-backed securities. Morgan Stanley arranged and promoted the Libertas CDO.

The plaintiff alleged, however, that Morgan Stanley knew that the lenders originating the underlying mortgages applied poor underwriting standards, and the mortgages were thus "far riskier than presented and were impaired when the Libertas CDO was created." The complaint buttressed its allegation of Morgan Stanley's knowledge of the risk by alleging that Morgan Stanley took a short position on the assets included in the Libertas CDO.

Notwithstanding the risk involved in the mortgages, the complaint alleged that Morgan Stanley collaborated with the ratings agencies Moody's Investors Service, Inc. ("Moody's") and Standard & Poors ("S&P") to produce false Triple-A ratings for the CDO. Further, the plaintiff alleged that Morgan Stanley circulated an Offering Memorandum, prepared by the issuers of the CDO, that promoted the false ratings.

The Fraud Claims

Judge Jones first addressed the heart of the complaint, the claim for common-law fraud under New York law. To establish such a claim for fraud, a plaintiff must allege that: (1) the defendant made a misrepresentation or material omission of fact that was false and known to be false by the defendant; (2) the misrepresentation or omission was made for the purpose of inducing the other party's reliance; (3) the other party justifiably relied upon the misrepresentation or omission; and (4) injury resulted.

The court first rejected the plaintiff's argument that Morgan Stanley was somehow legally responsible for the issuance of allegedly false Triple-A ratings. The court observed that the plaintiff's complaint made only general statements that a relationship existed between Morgan Stanley and the ratings agencies, none of which pertained specifically to the Libertas CDO. Absent such specific factual allegations, the plaintiff could not support the inference of Morgan Stanley's involvement in creating the ratings sufficient to comply with the pleading requirements of *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), or Federal Rule of Civil Procedure 9(b).

Judge Jones disagreed that the Offering Memorandum containing the allegedly false ratings constituted a statement by Morgan Stanley. Judge Jones noted that the Memorandum stated that it was prepared by the CDO's issuer, Libertas, and further that Morgan Stanley had not verified the information therein. Judge Jones therefore ruled that, as a matter of law, the Offering Memorandum was not a statement by Morgan Stanley.

Finally, the court found that, although the plaintiff alleged that Morgan Stanley made false statements during a presentation to investors, the complaint did not allege that the plaintiff had received the presentation. Because common law fraud requires the defendant itself to make a fraudulent statement to the plaintiff, the court dismissed the claim.

Unjust Enrichment

The court also dismissed the plaintiff's unjust enrichment claims. Under New York's Martin Act, any common law claim based on deceptive practices in the sale of securities that does not require proof of scienter is preempted. Judge Jones therefore found that the plaintiff's unjust enrichment claims—which did not require a showing of scienter—preempted by the Martin Act.

The Takeaway

In sum, Judge Jones's decision in *Morgan Stanley & Co.* demonstrates that mere involvement in the allegedly fraudulent sale of securities may be insufficient to support a claim for fraud under New York law. Instead, a defendant itself must have made the misrepresentations at issue to the plaintiff; only then can such a claim survive. ◎

In sum, Judge Jones's decision in *Morgan Stanley & Co.* demonstrates that mere involvement in the allegedly fraudulent sale of securities may be insufficient to support a claim for fraud under New York law. Instead, a defendant itself must have made the misrepresentations at issue to the plaintiff; only then can such a claim survive.

Investment Bank Settles Claim of Conflict of Interest in Leveraged Buyout Deal

By Robert Kirby

Del Monte Corporation ("Del Monte") and its financial advisor Barclays Capital ("Barclays") recently agreed to the payment of $89.4 million as part of a settlement, now subject to court approval, of a putative shareholder class action challenging the $5.3 billion leveraged buyout of Del Monte by a group of private equity firms. The settlement followed a decision earlier this year by Delaware Chancery Court Judge J. Travis Laster that granted a preliminary injunction temporarily staying the consummation of the Del Monte merger. *In re Del Monte Foods Co. Shareholders Litig.*, 25 A.3d 813 (Del. Ch. 2011). The Chancery Court's decision and the proposed settlement highlight the potential litigation risks to an investment bank when it both advises the target of an acquisition and participates in the buy-side financing of the deal.

The Deal

On November 25, 2010, Del Monte Foods Company announced that it had agreed to be acquired by a group of private equity firms including Kohlberg Kravis Roberts & Co. L.P. ("KKR"), Vestar Capital Partners ("Vestar") and Centerview Partners (collectively, the "Buyers"). Barclays was a financial adviser to Del Monte and was also among several lenders that financed the acquisition of Del Monte. If the merger were approved by a vote of Del Monte's shareholders, which was scheduled for February 15, 2011, each share of Del Monte stock would be purchased for $19 in cash.

Between November 30 and December 21, 2010, a series of putative shareholder class actions were filed alleging in part that Del Monte's directors had breached their fiduciary duties in approving the merger. The plaintiffs sought, among other things, to enjoin the merger. The plaintiffs primarily challenged two decisions by the Board, namely (i) allowing Vestar to join KKR for a joint bid even though Vestar had been "the high bidder in a previous solicitation of interest," and (ii) authorizing Del Monte's advisor Barclays to participate in the financing of that winning bid.

The Preliminary Injunction

On February 14, 2011, the day before the scheduled shareholder vote on approval of the merger, the Chancery Court granted in part the plaintiffs' motion for a preliminary injunction. The Chancery Court enjoined Del Monte from proceeding with the shareholder vote for a period of 20 days in order to provide "a final window during which a topping bid could emerge."

The Chancery Court held that injunctive relief was appropriate because the plaintiffs had "established a reasonable probability of success on the merits of a claim for breach of fiduciary duty against the individual defendants." The Chancery Court emphasized that, as in all cases, here "the buck stops with the Board," the members of which were required to and allegedly did not take "active and direct roles in the sale process." That said, the Court preliminarily found based on the incomplete record before it that Barclays had failed to disclose to the Board its alleged goal of "providing buy-side financing to the acquirer" and had "manipulated the sale process" to reach that goal.

First, Barclays "steered Vestar into a club bid with KKR, the potential bidder with whom Barclays had the strongest relationship." A non-conflicted advisor, by contrast, may have "teamed Vestar with a different sponsor." According to the Chancery Court, "[t]he record does not reflect meaningful Board consideration or informed decision making with respect to the Vestar pairing" and "[t]here are no minutes that suggest hard thinking about how acceding to KKR's request might affect Del Monte." As a result, "the prospect of price competition for Del Monte" was "materially reduced."

Then, "Barclays asked KKR for a third of the buy-side financing" and, "[o]nce KKR agreed, Barclays sought and obtained Del Monte's permission." Barclays' participation "as a co-lead bank was not necessary to secure sufficient financing for the Merger, nor did it generate a higher price for the Company." The apparent result, according to the Chancery Court, was that Barclays would earn fees from providing buy-side financing to the Buyers while Del Monte paid an additional $3 million "to obtain a last-minute fairness opinion from a second bank." In addition, the Board's decision to allow Barclays to participate in the financing may have "taint[ed] the final negotiations" of the deal. The Chancery Court explained: "Without some justification reasonably related to advancing stockholder interests, it was unreasonable for the Board to permit Barclays to take on a direct conflict when still negotiating price. It is impossible to

know how the negotiations would have turned out if handled by a representative that did not have a direct conflict."

In the view of the Chancery Court, it was "not possible to remedy fully" the alleged breaches of fiduciary duty at this stage. The Chancery Court was not prepared to issue a more aggressive injunction to "split up the Vestar/KKR team and induce a topping bid from Vestar and a different partner," because such an injunction would essentially block the proposed deal and send Del Monte "back to the drawing board." Though the Chancery Court stated it was not a perfect solution, the 20-day "window" mandated by the preliminary injunction was designed to go "part of the way" by "limiting KKR's leg-up and providing a final window during which a topping bid could emerge."

The Chancery Court's preliminary injunction further enjoined the parties to the merger from enforcing the "deal protection measures" set forth in their agreement until the 20-day window had passed and a rescheduled shareholder vote had been held. Those measures included a $120 million termination fee that the Buyers would have been entitled to in the event that Del Monte received a topping bid and terminated the existing merger agreement. The Chancery Court noted that such defensive measures would be "quite reasonable" in an "arms' length deal untainted by self-interest." In this case, however, it appeared that the Buyers "secured the deal protection measures as part of a negotiation that was tainted." The preliminary injunction would ensure that the Buyers would "not benefit from the misconduct in which [they] participated."

The Proposed Settlement

During the 20-day "window" ordered by the Chancery Court, Del Monte contacted 70 third-parties but did not receive a "topping bid." On March 7, 2011, Del Monte shareholders approved the merger, with 75.15% of the outstanding shares voting in favor. Thereafter, Del Monte completed the merger.

Meanwhile, the plaintiffs amended their complaint to add Barclays as a defendant and to seek damages from it for allegedly aiding and abetting the breaches of fiduciary duties by Del Monte's directors. After conducting some discovery and participating in a series of mediation sessions, all parties agreed to settle the lawsuit and, on October 5, 2011, requested approval of their settlement from the Chancery Court. Pursuant to that settlement, Del Monte and Barclays have agreed to pay $65.7 million and $23.7 million, respectively, for a total settlement of $89.4 million. The Chancery Court's approval of the settlement remains pending.

> The Chancery Court's decision and the proposed settlement highlight the potential litigation risks to an investment bank when it both advises the target of an acquisition and participates in the buy-side financing of the deal.

Conclusion

The claims against Barclays were not litigated to conclusion and the Chancery Court's findings on the preliminary injunction motion were necessarily based on an incomplete record. And, because the defendants in the Settlement Agreement denied any wrongdoing, it will never be known whether the plaintiffs could actually have proven any of their claims against Barclays. Nevertheless, this case demonstrates the risks that arise, and the types of allegations that can be made, when an investment bank advising the target of a potential acquisition also participates in the financing of that acquisition. ◎

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