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"Best Efforts" Underwriting: What Constitutes Best Efforts?

"Best efforts" financing obligations, in which a party agrees to use its best efforts to raise debt financing, have been commonplace in the financial world. However, the commitment documents for such transactions frequently fail to spell out precisely what those obligations entail. When the financing fails, questions are frequently raised as to whether best efforts were in fact used. Somewhat surprisingly, few courts have addressed the specific issue of what an underwriter must do to satisfy its best efforts obligations. As the tightening of credit markets has most certainly doomed many such financings, and will continue to do so, litigation over best efforts underwriting can be expected to increase in the coming years. We discuss below some recent case law in this area.

The *Deutsche Bank* Case

In one recent decision, *Deutsche Bank Sec., Inc. v. Rhodes*, 578 F. Supp. 2d 652 (S.D.N.Y. 2008), a New York federal district court held that a homebuilder had raised a triable issue of fact with respect to its allegation that its investment bank, retained by the homebuilder to act as its best efforts underwriter in connection with a debt financing, had breached its contractual obligation to use its best efforts to arrange such a financing. Though the court's opinion provides little detail regarding the factual allegations of the

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“Best Efforts” Underwriting

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complaint, the underlying pleadings allege that in October 2004, the homebuilder, Rhodes Homes, entered into an agreement with Deutsche Bank Securities, Inc. (“DBSI”), under which DBSI was given the option to act as the exclusive best efforts underwriter in connection with a proposed $300 million credit facility to be closed on or before December 13, 2005. Rhodes Homes alleged that, while DBSI exercised that option, over the following months it made no significant progress toward securing lenders for the credit facility, despite the fact that Rhodes Homes responded to numerous information requests from DBSI and retained a valuation firm at DBSI’s instruction to perform an appraisal of real estate assets held by Rhodes.

In June 2005, with no progress allegedly made on lining up financing, Rhodes Homes requested that DBSI immediately provide, among other things, a detailed term sheet concerning DBSI’s prior financing proposals, maturity schedules, amortization schedules, and a commitment letter setting forth how much DBSI itself would be willing to subscribe. According to the pleadings, “DBSI’s response made it abundantly clear that it was ill-prepared and lacking the skills and expertise to facilitate a loan to Rhodes Homes . . . .” Soon thereafter, Rhodes Homes executed an engagement letter with Credit Suisse First Boston, which successfully arranged for senior secured credit facilities totaling $500 million for Rhodes Homes.

DBSI subsequently brought suit against Rhodes Homes for breach of contract, seeking to recover the fees allegedly owed to it. Rhodes Homes asserted affirmative defenses based on DBSI’s alleged nonperformance of its contractual obligations, and counterclaimed for breach of the agreement, alleging that DBSI had failed to use its best efforts to obtain the financing.

DBSI moved for summary judgment to dismiss the claim for breach of the best efforts clause. DBSI argued that to establish nonperformance, Rhodes Homes was required to demonstrate that DBSI “simply ignored its responsibilities entirely.” As authority for this proposition, DBSI cited *Chase Manhattan Bank, N.A. v. Remington Products, Inc.*, 865 F. Supp. 194 (S.D.N.Y. 1994), *aff’d*, 71 F.3d 407 (2d Cir. 1995), in which the court found that a party to an investment banking contract sued for a fee payable upon the consummation of a transaction could not defend nonpayment on the ground that the investment bank failed to perform its obligations unless the defendant could demonstrate that the bank “simply ignored its responsibilities entirely.” As DBSI argued, “there can be no genuine contention on the record before this Court that DBSI ignored its responsibilities entirely.” DBSI further argued “even if a higher standard of performance applied, [Rhodes Homes] could not establish a genuinely disputed claim that DBSI breached the contract, as it is undisputed that [Rhodes Homes’] repudiation of the contract a mere six and one-half months into the one-year exclusivity period deprived DBSI of its ability to perform.”

In opposition to DBSI’s summary judgment motion, Rhodes Homes argued that *Chase* was inapposite as the court in that case expressly found that the investment bank had fully performed its contractual obligations by engaging in substantial activity to facilitate the transaction, including contacting potential investors, four of which made proposals to participate in the transaction. As Rhodes Homes pointed out, whereas the investment bank in *Chase* “submitted extensive evidence of advice and representation provided . . . by Chase directed toward the consummation of a transaction the form of which was clearly contemplated in the Engagement Letter,” DBSI failed to perform the services contemplated in the engagement agreement with Rhodes Homes. Rhodes Homes further argued that, prior to terminating the agreement with DBSI, Rhodes Homes “notified Deutsche Bank of its contract failings in June 2005, explored a new agreement with respect to an increased level of financing necessitated by the prior delay, and then ended the relationship (with Deutsche Bank’s acquiescence) when it became apparent that market conditions did not permit a financing through Deutsche Bank that would meet Rhodes Homes’ goals.”

The court declined to dismiss the best efforts contract claim, finding issues of fact on whether best efforts had been used. The court held:

> DBSI had the ‘right but not the obligation to act as exclusive underwriter . . . in connection with any bank or loan financing consisting of institutional and/or pro rata loans of [Rhodes Homes] or its subsidiaries during the term of this Agreement on a best efforts basis.’ [Rhodes Homes] has presented sufficient evidence indicating that DBSI chose to exercise these exclusive rights but failed to use its best efforts in doing so. A reasonable jury could find that DBSI breached the [engagement agreement] in this respect; therefore DBSI’s motion is denied.

The court's decision did not elaborate on precisely what a best efforts clause requires.

Other Precedent

In an earlier decision, *NCNB Nat'l Bank of North Carolina v. Bridgewater Steam Power Co.*, 740 F. Supp. 1140 (W.D.N.C. 1990), a North Carolina federal court found that NCNB National Bank of North Carolina ("NCNB"), which had been retained to act as financial advisor in connection with an effort to obtain financing for an electric generating facility ("Bridgewater Steam"), had in fact exercised its best efforts to obtain financing as required by the engagement letter. Bridgewater Steam alleged that NCNB failed to use its best efforts by deciding to delay publication of a placement memorandum pending the resolution of zoning issues and several other problems related to the project. When the placement memorandum was eventually distributed, NCNB received no definite responses. Though one lender eventually emerged to provide the financing, that lender, CEA, informed NCNB that it preferred to deal with Bridgewater Steam directly. Ultimately, Bridgewater Steam purported to terminate its relationship with NCNB and withheld the advisor fee called for in the engagement letter.

Though the engagement letter was governed by New Hampshire law, the court cited extensively to the general best efforts standard articulated in the seminal New York decision of *Bloor v. Falstaff*, 601 F.2d 609 (2d Cir. 1979), which held that a best efforts clause is satisfied when the parties' efforts are made "in good faith and to the extent of its own total capabilities." Holding that the bank had satisfied this obligation, the *NCNB* court stated:

> NCNB was available to assist Bridgewater Steam with arranging the financing and negotiating with CEA. At Bridgewater Steam's request, NCNB in fact reviewed, analyzed, and gave its opinion to Bridgewater Steam of CEA's . . . financing proposal . . . . CEA and Bridgewater Steam, however limited NCNB's role in the negotiations. Based on all of the evidence introduced at trial, the Court concludes that NCNB performed all of the services required in the Engagement Letter, including the exercise of its best efforts to arrange financing for Bridgewater Steam.

Conclusion

In the current tight credit markets, best efforts underwriters will continue to struggle to place financings. As a result, claims that these underwriters failed to fulfill their obligation to use their best efforts will likely become more frequent. At the same time, the scarcity of market participants may make it easier for underwriters to defend those claims. No matter how the law in this area develops, underwriters would be well advised to keep thorough records of all solicitation efforts made in connection with any best efforts underwriting. ◎

Citing Subprime Crisis, Court Demands Foreclosing Bank Explain Its Acquisition of Nonperforming Loan

In a sign of the times, a New York court has refused to grant a bank summary judgment in a mortgage foreclosure action notwithstanding the fact that the borrower had indisputably ceased making payments and, in fact, did not even oppose the bank's motion. While the court raised appropriate questions concerning the adequacy of the documentation by which the loan had been assigned to the plaintiff bank, it then went much further. For one, the court raised issues concerning the professional ethics of the bank's attorneys. More significantly, the court demanded that the bank explain why it had accepted the assignment of a non-performing loan, positing that perhaps the assignment was part of some accounting manipulation.

Facts

In *Deutsche Bank Nat'l Trust Co. v. Campbell*, 2008 WL 5220543 (N.Y. Kings Co. Dec. 16, 2008), plaintiff Deutsche Bank sought to foreclose a mortgage on a property located in Brooklyn, New York. The defendant Rolando Campbell had allegedly borrowed $420,000 from First Franklin, a division of National City Bank, in May 2006. The note and mortgage were recorded in June 2006 by Mortgage Electronic Registration Systems, Inc. ("MERS"), the nominee

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of First Franklin, for the purpose of recording the mortgage. In April 2007, Campbell allegedly defaulted on his mortgage payments.

In August 2007, MERS assigned the note and mortgage to Deutsche Bank, as trustee for First Franklin Mortgage Loan Trust 2006-FF11. The assignment, which was recorded in September 2007, had been executed by counsel for MERS, purportedly as authorized by a Corporate Resolution dated July 19, 2007. However, no such corporate resolution was recorded with the assignment. Two days after the assignment, Deutsche Bank, represented by the same counsel who allegedly executed the assignment in favor of Deutsche Bank, commenced a foreclosure action against Campbell.

The Court's Decision

The bank moved for summary judgment of foreclosure, which the defendant did not oppose. Notwithstanding this lack of opposition, the court first denied the motion on the grounds that the purported assignment of the mortgage from MERS to Deutsche Bank was defective and, therefore, Deutsche Bank had failed to demonstrate standing to bring the action. To properly assign a mortgage by an authorized agent, proof of the agent's authority is required to show that the agent was vested with the authority to assign the mortgage. In this case, when counsel recorded the assignment, she neglected to include a copy of the corporate resolution or a power of attorney granting her authority to execute the assignment, and no such documentation was submitted with the bank's motion. The court granted Deutsche Bank permission to cure this defect and refile the motion for summary judgment.

Aside from the defect in the assignment documentation, the court expressed concern over the bank's attorney's apparent conflict of interest in violation of 22 NYCRR § 1200.24, the Disciplinary Rule regarding "Simultaneous Representation." When a law firm represents multiple clients in the same transaction who may have conflicting interests, the law firm must fully disclose "the implications of the simultaneous representation and the advantages and risks involved." Because the same counsel represented both MERS as assignor of the mortgage and Deutsche Bank as assignee of the mortgage, the court demanded that counsel provide a sworn statement that both MERS and Deutsche Bank received disclosure of the conflict and consented to the representation.

Finally, and perhaps most significantly, the court demanded that Deutsche Bank provide "a satisfactory explanation . . . as to why in the middle of our national subprime mortgage financial crisis, plaintiff Deutsche Bank purchased from MERS, as nominee of First Franklin, the instant nonperforming loan." The court "wonder[ed]" whether Deutsche Bank violated a corporate fiduciary duty by purchasing the loan to keep the "toxic" mortgage off First Franklin's books. The court cited no legal authority to support its demand for this explanation, nor did the court clarify how the bank's reasoning might mitigate the fact that the defendant had defaulted on the loan in March 2007.

Analysis

Interestingly, in denying the motion for summary judgment, the court raised these issues of its own accord, as the defendant had not opposed the bank's motion. Although a court may always deny a motion for summary judgment even in the absence of any opposition, the court in this case appeared to go unusually far. The defective assignment was certainly a sufficient reason for denying the motion with leave to renew. However, the possible conflict of interest with a non-party to the action and the reasons why the plaintiff purchased the nonperforming mortgage were tangential issues not dispositive of the motion at hand. Indeed, the court's demand for a "satisfactory explanation" for the assignment may signal a coming trend in judicial activism where courts use, in the judge's own words, the "national subprime mortgage financial crisis" to stretch beyond their normal exercise of judicial powers. As foreclosure filings increase, it seems the judiciary is becoming much more proactive in challenging the actions of lenders even where the borrowers themselves do not raise such arguments. ◎

Lender's Attachment Order Does Not Reach Guarantors' Out of State Equity Interests

In *Hotel 71 Mezz Lender LLC v. Falor*, No. 4043N (1st Dep't Dec. 16, 2008), a New York appellate court recently vacated a lender's pre-judgment order of attachment over its guaran-

tors' membership interests in over 20 non-New York limited liability companies on the grounds that the reach of a New York attachment order ends at the state's boundaries. Because the equity interests resided outside of New York, they were beyond the reach of attachment, and the service in New York of the levy on the manager of these LLCs, as garnishee, did not bring those equity interests under the court's jurisdiction.

The Facts

In March 2005, plaintiffs allegedly made a $27 million loan to Chicago H&S Senior Investors, LLC for it to acquire and renovate Hotel 71 in downtown Chicago. The loan was personally guaranteed by six of the developer's principals. The guarantors contractually agreed to submit to the jurisdiction of any federal or state court in the City of New York.

When the borrower defaulted on the loan and filed for bankruptcy in April 2007, plaintiffs commenced an action in New York to enforce the guarantees. In September 2007, after defendants had answered the complaint, plaintiffs moved for an ex parte order of attachment over defendants' equity interest in various Delaware, Florida and Georgia LLCs. Plaintiff moved without notice to the defendants asserting the likelihood that, if defendants were provided with notice, they would avoid entering the jurisdiction to frustrate service of the levy on them as garnishees. The court entered the order, but stayed service of the levy upon defendants to afford them the opportunity to oppose the application at the appropriate time.

In October 2007, one guarantor, defendant Mitchell, and his counsel appeared at the courthouse in New York City for a deposition. They were informed at that time that an order of attachment had been issued four weeks earlier, and that the court was waiting to hear them on the matter. Following the hearing before the judge, plaintiff served the levy on Mitchell, as apparent manager of the LLCs and, thus, as garnishee. One month later, plaintiffs moved to confirm the order of attachment. Subsequently, plaintiff moved for the appointment of a receiver over the defendants' assets based on defendants' alleged refusal to produce documents related to their finances and other discovery non-compliance.

The trial court granted the plaintiff's motion to confirm the order of attachment in the sum of $65 million, determining that plaintiff had met the statutory basis for an order of attachment and that an attachment was necessary to secure the anticipated judgment. The court also appointed a receiver over the guarantors' personal property, identified in the order as their ownership and/or management interests in various out-of-state limited liability companies.

Vacating the Order of Attachment

On appeal, the appellate division reversed and vacated the order of attachment. The majority opinion wrote that the fundamental rule in attachment proceedings is that "the res must be within the jurisdiction of the court issuing the process in order to confer jurisdiction." The court found that an attachment over these out-of-state intangible interests could be effected by service of the levy upon a garnishee in New York only if he or she were domiciled in New York. Service of the order of attachment on defendant Mitchell, a resident and domiciliary of Florida, while he was temporarily in New York solely to attend his deposition, did not establish the situs of the equity interests in the 23 entities in New York.

Plaintiffs contended that, rather than using attachment for jurisdictional purposes, they were using it to secure their anticipated judgment. The court found this to be irrelevant, holding that, whether used for obtaining jurisdiction over the defendant or for security purposes, the essential principles governing attachment and the situs of intangible property are the same. Where the defendant's only apparent assets were interests in LLCs located in Delaware, Georgia and Florida, which owned commercial properties in those states, the court found the granting of an ex parte order of attachment by the lower court in error.

The appellate court also vacated the order appointing a receiver over defendants' assets. As that order regarded the internal affairs of foreign entities, the court held that it "should decline jurisdiction to [to appoint a receiver] because such questions are of local administration, and should be relegated to the courts of the state under the laws of which the corporation was organized." The court ruled that plaintiffs were relegated to the states of the companies' situses, where they could have receivers appointed upon a proper showing of necessity.

The Dissent

The dissenting opinion contended that where a plaintiff's right to a money judgment against a defendant is clear and means exist by which those assets could be treated as located within this state and available for attachment, the

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court should not "bend over backwards to protect such assets from the plaintiff's reach." In the dissent's view, citing to Article 62 of the New York Civil Practice Laws and Rules and *Harris v. Balk*, 198 U.S. 215, 222 (1905), service on a garnishee while he is in New York, even temporarily, is enough to permit the attachment of an intangible assets, the situs of which would otherwise be outside of the state. ◎

Bank Avoids Liability in Dispute Between Joint Bank Account Owners

A federal court recently ruled in *Castorino v. Citibank N.A.*, 07 Civ. 10606 (S.D.N.Y. Dec. 5, 2008), that a bank had no liability for honoring the withdrawal request of one account holder of a joint account, despite the bank's knowledge of a dispute between the account holders.

The Dispute

On September 1, 2005, plaintiff Omar Castorino ("Omar"), his uncle Nelson Castorino ("Nelson") and a third party opened a Joint Account with Citibank N.A. Upon opening the Joint Account, Omar received copies of the Joint Account's opening documents (the "Contract").

After opening the Joint Account, Omar and Nelson became involved in a dispute which led to Nelson terminating Omar's position in the Castorino family business. On June 19, 2007, Omar sent an e-mail to Citibank, requesting that it inform him if Nelson attempted to withdraw funds from the Joint Account, requesting a meeting with the bank to discuss the Joint Account, and asking that Nelson not be informed of these requests. When Omar and a bank representative met on July 9, 2007, the bank revealed that it had already informed Nelson of Omar's requests and had carried out Nelson's instruction to transfer more than one million dollars from the Joint Account to a separate account to which Omar had no access. On September 13, 2007, the bank acceded to Omar's repeated requests for further information by providing Omar with documents confirming the transfer.

Immunity Under Banking Law § 675(a)

Omar commenced a lawsuit against Citibank alleging breach of contract and breach of its common law duty of care. Citibank moved to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure for failure to state a claim.

The court dismissed Omar's breach of contract claim, partially on the ground that the language of the Contract "plainly defeats Plaintiff's claims." The Contract provided that Citibank would "not honor requests to 'block' or 'freeze' the account upon the request of an individual" and that "it is up to the account holders to resolve [any] dispute amongst themselves." The court went on to hold that these terms comported with Section 675(a) of the New York Banking Law, which "immunizes banks from liability for withdrawals made by joint tenants from a joint account."

Section 675(a) includes an exception to this general immunity where a bank has received prior notice of a dispute amongst the joint tenants. But here, the court held that plaintiff's June 19, 2007 e-mail did not constitute proper "notice" under that statute. Rather, the court read Section 675(a) in conjunction with Banking Law Section 134(5) and concluded that such a notice is only effective where the notifying party has either secured a restraining order or injunction from the courts, or provided the bank with a bond indemnifying the bank from any and all liability arising from the bank's denial of the other account holders' access to the funds in the joint account.

The court proceeded to distinguish the New York Surrogate Court's opinion in *Swidow v. Kachkowski*, 2003 WL 175256 (Jan. 16, 2003), which held that Section 675(a) "did not absolve [a] bank of liability because it was aware of the competing claims to [a joint] account's funds." In *Swidow*, "the bank received a formal stop payment request and letter of indemnity," as contemplated by Section 134(5), while in this case "Defendant merely received an e-mail . . . asking that it be notified if Nelson attempted to access the Joint Account." In any event, the court noted that to the extent *Swidow* is factually similar, it "could be viewed as incorrectly applying Section 675(a)."

No Common Law Duty of Reasonable Care

Omar argued that because Citibank was on notice of the dispute between plaintiff and Nelson, it owed Omar a duty of care independent of the contract. Thus, Omar argued he could pursue this claim against Citibank even if the Contract

did not exist. The court rejected this position, finding that such a rule "would have pernicious effects on the banking system." Sensibly, the law does not permit claims of breach of common law fiduciary duty where the plaintiff cannot show how the alleged duty is distinct from the defendant's obligations under the contract itself. Omar's claim failed because his two causes of action were based upon the same facts — Citibank's disclosure of Omar's request for a meeting and its failure to prevent Nelson's subsequent transfer of funds out of the joint account. Thus, Omar was attempting to "transmogrify the contract claim into one for tort," which the law does not permit.

Omar attempted to salvage his common law claim by arguing, alternatively, that Citibank had breached an implied covenant of commercial good faith because it acted "dishonestly or in bad faith, thus becoming a witting or unwitting participant in a fraudulent scheme." The court found this alternative argument no more persuasive. Citibank "never acted dishonestly" or in bad faith. Rather, "it acted in accordance with its contractual obligations by refusing to block or freeze the Joint Account; refusing to withhold information relating to the Joint Account from one account holder at the request of the other; and refusing to involve itself in the dispute."

Protection for Banks

The district court's opinion in *Castorino v. Citibank N.A.* gives banks significant protection when caught in the middle of a dispute between holders of joint bank accounts. As interpreted, Banking Law Section 675(a) provides immunity when a bank honors a withdrawal request unless the bank acts contrary to a formal notice accompanied by a restraining order, injunction or bond of indemnity. Furthermore, this decision rejected the applicability of alternative theories of common law duty. ◎

Derivative Suit by Bear Stearns Shareholders Dismissed

The claims brought by shareholders of Bear Stearns Companies, Inc. arising out of the dramatic collapse of the investment banking and brokerage institution last March, and its subsequent merger with JPMorgan Chase & Co., were recently dismissed by a New York State court. *In re Bear Stearns Litigation*, 600780/08 (N.Y.Co. Dec. 4, 2008).

Ruling on a motion for summary judgment by the defendants, Bear Stearns' directors and JPMorgan Chase, the court held that Bear Stearns' directors were protected by the business judgment rule and exculpatory clauses in the certificate of incorporation. The court also held that the plaintiffs failed to show that JPMorgan breached any duties to Bear Stearns' shareholders.

Background

Over two weeks in March 2008, Bear Stearns fell from the front ranks of the financial industry and was acquired by JPMorgan following desperate merger negotiations brokered by the U.S. government. While the firm had suffered the public collapse of two hedge funds in the summer of 2007, it had over $18 billion in cash reserves and its stock was trading at over $60 per share when, on March 10, 2008, a credit downgrade of certain mortgage-backed securities issued by a corporate affiliate was followed by rumors that the company faced a liquidity crisis. Customers began withdrawing assets from accounts at Bear Stearns, trading partners became reluctant to do business with it, and short-term lenders grew unwilling to fund the firm's daily operations. In the face of this run on the bank, on the night of Thursday, March 13, Bear Stearns officers briefed the board that the company faced a genuine liquidity crisis and would be unable to continue business without a new source of funding. The next morning, Bear Stearns established a short-term, $30 million lending facility with JPMorgan, backed by the New York Federal Reserve, and began to explore merger possibilities.

Over the weekend of March 15-16, Bear Stearns received offers from J.C. Flowers, a private equity firm, and JPMorgan. No other potential buyers were interested in such a large transaction within the narrow time frame required. However, J.C. Flowers was unable to obtain financing, and, on Sunday afternoon, JPMorgan's offer of a stock-for-stock transaction fell from an implied value of $8 to $12 per Bear Stearns share to $2 dollar per share, backed by $30 billion of New York Fed funding. Informed by Bear Stearns management that the alternative to a merger would be an immediate bankruptcy filing likely to wipe out shareholder equity, and provided with a fairness opinion from financial advisers at Lazard Freres & Co., LLC, Bear Stearns' Board approved an initial merger

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Bear Stearns Shareholders Suit Dismissed

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agreement on the terms offered by JPMorgan. The agreement gave JPMorgan an option to purchase 19.9 % of Bear Stearns' stock at $2 per share, as well as an option to purchase the firm's headquarters building in Manhattan for $1.1 billion. Under a "No Solicitation" clause, Bear Stearns could not actively seek competing offers from other companies, and could only negotiate with other bidders if the directors made a good faith determination that their fiduciary duties required them to do so.

Even following the initial agreement, the markets feared the deal might not close, and customers and traders remained reluctant to do business with Bear Stearns. Concerned about Bear Stearns' continuing difficulties, and worried about their potential liability if the deal fell apart, JPMorgan informed Bear Stearns that it might not be willing to extend further credit or guarantee Bear Stearns' loans without a larger equity stake. Over the weekend of March 22, the two parties negotiated an amended merger agreement whereby JPMorgan would purchase Bear Stearns at an implied value of approximately $10 per share, and in the meantime would be permitted to purchase 39.5 % interest in Bear Stearns common stock at $10 per share. The merger closed on May 30, 2008, although if JPMorgan's 49% stockholding interest in Bear Stearns is excluded, a majority of Bear Stearns' voting stockholders voted against the deal, counting abstentions and unvoted shares against the merger.

The Shareholder Suit

The plaintiff shareholders of Bear Stearns filed a Consolidated Amended Class Action Complaint against Bear Stearns' directors and JPMorgan in late March, after the completion of the amended merger agreement, and obtained a court order directing expedited discovery of the defendants as well as third parties Lazard and the New York Fed. Although the plaintiffs amended their complaint in April to seek to enjoin the merger and moved for a preliminary injunction to stop Bear Stearns from treating shares of its stock owned by JPMorgan as validly issued, the plaintiffs later withdrew these aspects of their case. A Third Verified Consolidated Amended Class Action Complaint was filed the same day the merger closed, May 30, 2008. The plaintiffs asserted a claim of breach of fiduciary duty against Bear Stearns' directors, and claims of aiding and abetting a breach of fiduciary duty, breach of fiduciary duty, unjust enrichment and tortious interference against JPMorgan.

Claims Against Bear Stearns' Directors

In ruling on the defendants' motion for summary judgment, the court held that, under Delaware law, the Bear Stearns directors' actions were protected by the Business Judgment Rule. Moreover, Bear Stearns' certificate of incorporation protected the directors from any liability not arising out of deliberate bad faith.

The plaintiffs offered no evidence that the directors acted out of self-interest or in bad faith. The Bear Stearns' board was comprised of a majority of non-management, non-employee directors, and none of the members were affiliated with JPMorgan. The plaintiffs argued that the directors were grossly negligent in pursuing a merger rather than another transaction or bankruptcy. Although the court held that these arguments were precluded by exculpatory provisions in the certificate of incorporation, it addressed them nonetheless, noting that the arguments merely disputed the true value of Bear Stearns at the time of the merger negotiations without demonstrating that the directors' decisions "taken under extreme pressure and crisis conditions" reflected a faulty process. Moreover, the court wrote, the directors had considered filing for bankruptcy, but were advised that the a merger would provide preferable results for Bear Stearns' shareholders and creditors.

In addition, the court pointed out that directors have additional fiduciary duties to creditors when a company is insolvent which must be balanced against those of shareholders. Here, the court found that Bear Stearns was unquestionably insolvent, and the value of its equity was speculative at best. The court noted, then, that the directors were "entitled to consider" that the highest price they could seek from JPMorgan "might reasonably coincide with the lowest price sufficient to induce approval of the merger [by Bear Stearns' shareholders]."

The plaintiffs argued that various deal protection devices accepted by the directors disenfranchised the shareholders and depressed the purchase price, and that the transaction should therefore be reviewed under a heightened standard under Delaware law. In particular, the plaintiffs argued that their rights were violated by the issuance of 39.5% of Bear Stearns common stock to JPMorgan, the "No Solicitation"

clause, and by the option permitting JPMorgan to purchase Bear Stearns' headquarters building. Although such provisions are generally acceptable under Delaware law, the plaintiffs argued that the deal protection measures agreed to by the directors were collectively excessive and required heightened scrutiny.

The court, however, held that none of the heightened standards of review available under Delaware law applied. The board initiated the merger without any hostile third-party threat, negating review under the test established in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Similarly, the directors were not fighting a perceived threat to their control of Bear Stearns from shareholders. *Compare Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). Nor did the transaction involve a cash sale or stock-for-stock purchase by a closely-held company; as a stock-for-stock merger involving two widely-held public corporations, the court found that Bear Stearns' shareholders were not locked out of control. Moreover, the court found that the defendant directors' issuance to JPMorgan of a 39.5% stake in Bear Stearns pursuant to the amended merger agreement, combined with JPMorgan's further acquisition of 10% of Bear Stearns on the open market, still left control of Bear Stearns in the hands of its public shareholders. The court therefore declined to apply the test for pursuing maximum shareholder value under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). More generally, the court found that the merger protection measures were not excessive — Bear Stearns was collapsing and had exhausted its search for viable bidders, and therefore was justified in agreeing to certain provisions to ensure the JPMorgan merger.

Even if the heightened standards had applied, though, the court noted that it would not have found the directors liable. For purposes of the *Unocal* test, the directors responded in a proportionate manner to a genuine threat to the corporation; the directors rejected and moderated some of JPMorgan's proposals in negotiating the merger, thereby showing that they made good faith efforts to preserve the best potential offer and fulfilling their duties under *Blasius*. The approval of the merger by a majority of independent directors also satisfied the directors' duties under *Unocal* and *Blasius*. The directors satisfied their *Revlon* duties by actively negotiating with the benefit of knowledge of the industry, expert advice, and a fairness opinion from their financial adviser. Given that Bear Stearns obtained only one bona fide offer and had to complete a transaction in a matter of days, the court wrote that the board's decisions were reasonable.

The court also rejected the plaintiffs' claims that the directors violated their duty of disclosure by allegedly failing to disclose material facts about the negotiations in a proxy statement, finding that these claims were barred by Bear Stearns' certificate of incorporation. Moreover, the court noted that, despite the plaintiffs' assertions that the proxy statement failed to disclose facts relating to Bear Stearns' funding, alternative transactions, the government's role, and Lazard's actions, Bear Stearns had in fact more than met its obligations by providing "a lengthy account of the merger negotiations and the reasons the Director Defendants ultimately decided to approve the merger." The plaintiffs' arguments "simply restate[d]" their substantive objections to the transaction, and did not identify any omissions that a reasonable shareholder would have been likely to consider in voting on the merger.

Claims Against JPMorgan

The court also dismissed the claims against JPMorgan, finding that these claims derived from the plaintiffs' arguments that the transaction undervalued Bear Stearns. For instance, the plaintiffs asserted that JPMorgan aided and abetted a breach of fiduciary duty by Bear Stearns' directors by knowingly participating in a transaction with terms that were "illegal per se." Because the court found that the terms of the merger were permissible under the circumstances, there was no breach for JPMorgan to aid and abet. The court also suggested that the plaintiffs' claims were insufficient because they did not allege that JPMorgan had wrongfully created conflicts on the Bear Stearns' board or conspired with any Bear Stearns directors. Similarly, the court dismissed the unjust enrichment and tortious interference with the plaintiffs' voting franchise claims on grounds that the terms of the merger agreements were not illegal.

The court likewise dismissed the plaintiffs' claim that JPMorgan directly breached its purported fiduciary duties as the controlling shareholder of Bear Stearns. Although JP Morgan could not be liable for the merger for the same reasons that the Bear Stearns directors were not, the court further noted that JPMorgan was not a controlling shareholder and had no seats on the Bear Stearns board at the time the merger agreements were negotiated. Bear Stearns' board, comprised

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Bear Stearns Shareholders Suit Dismissed

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of a majority of independent directors, "aggressively" negotiated the merger with the advice of counsel and Lazard.

Conclusion

Although many shareholders were outraged by the sudden collapse of Bear Stearns and the dramatic weekend merger negotiations involving JPMorgan and federal officials, the court indicated that Bear Stearns' directors had easily satisfied their fiduciary duties. Given the unique difficulties of negotiating a takeover of Bear Stearns, with its potentially massive book of bad securities and obligations to many trading partners, the court appeared reluctant to second-guess the terms of the agreement under any standard. Rather, the court found that Bear Stearns' directors secured a reasonable merger offer under pressing circumstances. ◎

Court Allows Bank's Claims Against Its Borrower's Auditor to Proceed

In *Sterling National Bank v. Ernst & Young LLP*, No. 121916/03, 2008 WL 5157994 (Sup. Ct. N.Y. Co. Dec. 1, 2008), a New York state court recently allowed Sterling National Bank to proceed with its claims of fraud and negligence against defendants Ernst & Young LLP ("E&Y") and one of its partners based upon E&Y's role as auditor of an alleged criminally fraudulent enterprise, Allied Deals, Inc., to which Sterling had made loans.

The Loans

In July 1999, unaware of the alleged criminal and fraudulent nature of Allied's business, Sterling purchased from Park Avenue Bank loans that it had made to Allied. Allied held itself out to the public as a reputable metals trading company. Following the date of Sterling's purchase of those loans, Sterling advanced 41 additional loans to Allied under a $6 million credit facility. On July 12, 2001, Sterling extended the credit facility for an additional six months. The last nine advances made to Allied were not repaid and were the subject of the lawsuit.

The Litigation

Sterling claimed that its advances to Allied under the credit facility were made in reliance on the "unqualified audit reports" issued by E&Y that certified Allied's financial statements for the fiscal years ending July 31, 1998, 1999 and 2000. The E&Y audit allegedly falsely showed Allied to be a "healthy and growing company," when in reality Allied "had become a more and more fraudulent operation." Sterling's reliance on E&Y's report was allegedly reflected in Sterling's internal Terms of Approval (TOA) and other contemporaneous memoranda. Moreover, Sterling had designated those loans as "C ledger," which indicated that the Sterling had relied on the financial condition of the borrower in its decision to lend.

Sterling alleged that it would not have made the new borrowings under the extended credit facility absent the "clean" opinion of Allied's financials issued by E&Y. By 2001, 90% of Allied's business was allegedly fictitious, meaning that "most, if not all, of Allied's receivables claimed on the financial statements audited by E&Y were really worthless." Sterling further alleged that E&Y's audit was flawed because it did not comport with generally accepted accounting principles including that it allowed Allied to verify its own receivables, did not conduct appropriate verification procedures, and relied on the audit of a subsidiary conducted by another firm. Moreover, Sterling alleged that the E&Y partner responsible for the audit, who was named as a co-defendant, had a "close personal and professional relationship" with Allied and that a $2 million fund for "so-called 'expenses'" may have been used by Allied to bribe him "to look the other way on the audit" and ignore "red flags" and "suspicious facts" that Allied's business was not legitimate.

On December 23, 2003, Sterling commenced litigation, asserting claims against the defendants for fraud, aiding and abetting Allied's fraud, recklessness and gross negligence. Sterling also sought punitive damages. On an earlier motion, the court granted the defendants' motion to dismiss only with respect to the second cause of action or aiding and abetting Allied's fraud. *See Sterling National Bank v. Ernst & Young, LLP,* No. 121916/03, 2005 WL 3076341 (Sup. Ct. N.Y. Co. Jan. 7, 2005).

Discussion

Defendants moved for summary judgment dismissing all claims on the grounds that: (1) Sterling's damages were spec-

ulative, (2) Sterling could not demonstrate either transaction causation or loss causation, (3) Sterling had no basis to justifiably rely on the "clean" opinion and consolidated financial statement issued by E&Y, and (4) Sterling could not claim punitive damages. The court denied the motion in full.

First, the court rejected the defense argument that Sterling's damages were speculative. Defendants argued that, because Allied's business was allegedly fraudulent, Sterling would have been in no better position had it learned of the fraud in July 2001 and called the loans then. However, because Allied had made payments on the prior loans and the balance owed to Sterling decreased by nearly $900,000 from June 2001 to July 2001, it appeared that Allied in fact had funds at that time to repay Sterling. Additionally, after the renewal of the credit facility, Allied paid another creditor $9 million and paid $100,000 to Sterling — again indicating that Sterling had funds. Sterling claimed that, had it refused to grant the final nine advances that it made in reliance on E&Y's certification, it would have been better off financially. The court rejected the defendants' argument based on speculativeness, determining that Sterling's "loss is real" and, in any event, the alleged speculativeness of Sterling's damages "presents a factual issue for a jury trial."

Second, the court determined that Sterling had provided sufficient evidence to raise issues of fact with regard to both transaction causation and loss causation. The court cited to the New York appellate decision *Laub v. Faessel*, 297 A.D.2d 28, 31 (1st Dep't 2002), for the proposition that "in cases of fraud, '[t]o establish causation, plaintiff must show both that defendant's misrepresentation induced plaintiff to engage in the transaction in question (transaction causation) and that the misrepresentations directly caused the loss about which plaintiff complains (loss causation).'"

With regard to transaction causation, the court determined that Sterling's documentation in support of its claim that it would not have advanced the final nine loans absent the "clean" E&Y opinion, as well as the loan documentation which indicated that the audit contained an "unqualified opinion" by E&Y, "contradicts defendants' allegation that transaction causation is not present and, at the least, creates an issue of fact which cannot be decided on a motion." As to loss causation, the court also determined that Sterling had raised an issue of fact. Sterling argued that, even if the loss predated the renewal of the facility as the defendants alleged, the advances would have been made in reliance on earlier E&Y audited financials and still attributable to E&Y. Defendants asserted that, had the fraud been exposed earlier, Allied would not have had the funds to pay Sterling because of the fraudulent nature of its business. However, Sterling demonstrated that, in an earlier time period, Allied had money to pay other creditors. Therefore, the court determined that an issue of fact existed.

Third, the court found there was "not a sufficient basis upon which to grant summary judgment" on the defendants' arguments that Sterling could not have justifiably relied on the 2000 audited financial statement with the unqualified opinion. Specifically, the court found that "[t]here is no factual support for their allegation that a stand-alone financial statement would be the preferred method of evaluating Allied" whereas "[t]he same is true for defendants' claim that the 2000 financial statement is outdated." The court further acknowledged that Sterling "put into contention both . . . theories . . . creating further issues of fact."

Finally, the court refused to dismiss Sterling's claim for punitive damages. The court found that "the issue of whether defendants' conduct is so egregious as to warrant the imposition of punitive damages is a factual issue" and "[g]enerally punitive damages are a jury question." The court concluded that although Sterling "has a long road to prove its claim for punitive damages . . . enough has been presented to permit plaintiff to present it to the jury."

Conclusion

The court's denial of the defendants' motion demonstrates a judicial tolerance for fraud claims by banks against auditors, at least at the summary judgment stage. While the court appeared to accept Sterling's arguments that the loans would not have been issued absent the "clean" E&Y opinion, the court indicated only that Sterling had provided sufficient evidence to raise issues of fact to defeat the summary judgment motion. It is unclear how the augments will fair in front of a jury, but, at least with regard to punitive damages, this court cautioned that Sterling has "a long road" ahead. ◎

Hedge Fund's Bond Acceleration Effort Based on Issuer's Failure to Make SEC Filings Is Rejected

In a December 2008 ruling, the United States Court of Appeals for the Eighth Circuit held that a hedge fund could not accelerate payment on a bond indebtedness based on the issuer's late filing of its annual report with the SEC. The court found that the issuer had no implied contractual duty to file timely with the SEC, and further that the issuer's contractual obligation to provide the trustee with copies of its SEC reports within 15 days of their filing did not mandate that those filings be made timely with the SEC.

Background

This saga begins in March of 2006 when United Health Group Inc. ("UHG") issued certain notes to Wilmington Trust. These publicly issued $850 million of 5.800% senior notes were due March 2036. The Bank of New York acted as trustee under the indenture, and was obligated to enforce required provisions thereof against UHG. UHG had made all required interest payments on the notes and, except for the SEC filings discussed below, appears otherwise to have been in compliance with all of its obligations.

Under the notes, UHG was required to provide the trustee with copies of its SEC filings within 15 days of their filing. While investigating allegations of backdating employee stock options in 2006, UHG had admittedly delayed filing its annual report. Wilmington Trust asserted that UHG's late filing with the SEC violated its note obligations. Under the notes, in the event of a default by UHG, Wilmington Trust had the right to redeem the notes at par value. As such, Wilmington Trust asserted that it was owed immediate payment on the notes at par value. When Wilmington asserted its default claim in 2006, the notes in question were trading at 65 cents on the dollar, 35 cents below par, thereby making a successful claim for payment at par value quite advantageous to Wilmington Trust.

Case Details

In *United Health Group Inc. v. Wilmington Trust Co.*, 2008 WL 5047669 (8th Cir., Dec. 1, 2008), UHG brought a complaint for a declaratory judgment that its failure to file SEC reports on time was not in violation of its obligations under the notes and related indenture. UHG prevailed, the Eighth Circuit ruling that Wilmington Trust was not entitled to accelerate payment due to UHG's failure to file its annual report in time.

Wilmington Trust argued that UHG had an implied obligation, based on its express obligation to provide copies of its SEC filings to the trustee, to timely file with the SEC. In addition, Wilmington Trust asserted that UHG's failure to file SEC reports within the specified time frame of the SEC's rules violated the Trust Indenture Act of 1939, and that this failure violated UHG's implied obligation of good faith and fair dealing to noteholders. UHG responded that its only obligation to noteholders under the terms of the agreement was to send copies of SEC filings to the trustee within 15 days of filing, and it had no independent requirement to file on time.

In evaluating Wilmington Trust's claims, the court first noted that the issues at hand dealt purely with contract interpretation and statutory construction. The first issue was whether of the indenture imposed an express obligation to file SEC reports on time. While the indenture expressly required that UHG provide its SEC filing to the trustee, it was silent on the issue of filing with the SEC:

> The Company shall cause copies of ... financial reports ... which the Company is then required to file with the Commission pursuant to Section 13 or 15(d) of the Exchange Act to be filed with the Trustee ... within fifteen days of filing with the Commission.

The court agreed with UHG that, while this language constrained the time frame in which to send a copy of SEC reports to the trustee, it did not impose time limits on when to file such reports.

The court also rejected Wilmington Trust's argument that the requirement to file timely with the SEC was implied. Wilmington Trust argued that, without an implied requirement to file timely, the 15-day provision would be meaningless; because technology allows noteholders to view SEC reports on the internet once filed, under UHG's interpretation the agreement to send copies to the trustee within fifteen days would be practically worthless. The court found that such technology advances alone would not act to imply terms to make the contractual obligations more relevant to today's society. The court noted that the parties were sophisticated,

that they chosen the language of their agreement and that they were represented by seasoned counsel in doing such. The court observed that rigid timetables regarding submissions of reports to the SEC surely could have been contractually spelled out had that been the intent of the parties.

The court likewise rejected Wilmington Trust's argument that UHG's failure to file SEC reports timely breached its implied covenant of good faith and fair dealing with the noteholders. The court found that UHG had not acted in bad faith in failing to file with the SEC on time, and in fact it undertook to provide as much information to the noteholders as it could under the circumstances. In addition, throughout the time in question UHG continued to make all required payments on the notes.

Other Precedent

While this was a case of first impression in the Eighth Circuit, several other courts have recently dealt with the same issues based on similar facts, and reached differing conclusions. In *Bank of New York v. BearingPoint, Inc.*, No. 600169/06, 2006 WL 2670143 (N.Y. Sup. Ct., Sept. 18, 2006), a New York state court reached the opposite conclusion. The *BearingPoint* court rejected a debt issuer's argument that a comparable 15-day provision in an indenture "made SEC filings optional under the Indenture." Section 5.02 of that indenture provided in relevant part:

> [T]he Company shall file with the Trustee , within 15 days after it files such annual or quarterly reports, information, documents, and other reports with the SEC copies of its annual report and information, documents, and other reports with the SEC (or copies of such portions of any of the foregoing the SEC may by rules and regulations prescribe) which the company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall comply with other provisions of the TIA Section 314(a).

The *BearingPoint* court concluded that the mandatory language above, that the company "shall file with the Trustee" all reports which it "is required to file with the SEC," reflected a clear intention that the company was obligated to make SEC filings. Unlike the *UHG* case, where the SEC filings were late, the issuer in *Bearing Point* had not made its SEC filings, thus clearly depriving the bondholders of essential information.

Thereafter, three federal district court cases rejected the holding in *BearingPoint*. *Finisar Corp. v. U.S. Bank Trust Nat'l Ass'n*, No. C 07-4052, 2008 WL 3916050 (N.D. Cal., Aug. 25, 2008); *Affiliated Computer Servs., Inc. v. Wilmington Trust Co.*, No. 3:06-CV-1770-D, 2008 WL 373162 (N.D. Tex., Feb. 12, 2008); *Cyberonics, Inc. v. Wells Fargo Bank Nat'l Ass'n*, No. H-07-121, 2007 WL 1729977 (S.D. Tex., June 13, 2007). In each of these cases, the courts held that the only duty owed was to send copies of reports within the contractual time frame and that there was no independent duty to file SEC reports in a timely manner. In *Finisar*, the court granted partial summary judgment to Finisar, finding no obligation to file SEC reports on time as such language was not included in the indenture. In *Affiliated Computer Servs.* ("ACS"), the court also granted summary judgment for ACS, stating that the language of the agreement was clear and there was no requirement to file SEC reports on time. In *Cyberonics*, the court granted Cyberonics' motion for summary judgment on its claim for declaratory relief, as the indenture agreement on its face did not require timely filing of SEC reports and therefore Cyberonics was not in breach of its agreement with Wells Fargo. The court in the *UHG* case followed in the reasoning of these three district court cases.

Implications for Hedge Funds

Wilmington Trust is surely not the first hedge fund to have tried to take advantage of a perceived technical default to exercise remedies under a bond indenture. Savvy investors have been known to acquire bonds of publicly traded companies trading at below par value where a technical violation might easily be found, to claim then the existence of a default entitling the noteholder to collect the entire note amount at par value. The cases discussed above largely reduce the prospects of success of such strategies that are based on the failure to file SEC reports in a timely fashion. ◎

Securities Fraud Class Action Against BankAtlantic Dismissed

In a recent decision dismissing a shareholder securities fraud lawsuit against a Florida bank and its executives and directors, the United States District Court for the Southern District

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Securities Fraud Class Action Dismissed

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of Florida indicated the difficulties plaintiffs face in satisfying the heightened standards for pleading fraudulent intent under federal law. *Hubbard v. BankAtlantic Bancorp, Inc.*, No. 07-61542-CIV-UNGARO (S.D. Fla. Dec. 12, 2008).

In *BankAtlantic*, the plaintiff shareholder alleged that BankAtlantic had failed to disclose its lax underwriting standards for real estate development loans, and falsely reported its cash reserves and liabilities, all of which artificially inflated the market price of the bank's stock. Nonetheless, the court found that the complaint had failed sufficiently to connect these allegations of fraud to defendants' alleged intent to defraud, and dismissed the complaint.

Background

The shareholder's complaint alleged that during the class period between November 9, 2005 and October 25, 2007 — in the midst of a bubble in the Florida real estate market — BankAtlantic allegedly increased its lending to commercial real estate developers, without informing investors of the extent of its exposure to high-risk borrowers. The plaintiff alleged that, to generate more loans, BankAtlantic permitted loan officers to underwrite loans without review by the bank's credit department, in contravention of the bank's lending procedures. The plaintiff further alleged that the bank had ignored negative factors in loan applications, including the lack of documentation and incomplete appraisals, and relied on "character lending" instead of examining the merits of the loan applications themselves. Additionally, the plaintiff alleged that the bank inflated its reported earnings by reducing its loan-loss reserves, even as it took on more risk. In statements to investors, the bank allegedly concealed its exposure to these questionable loans, understating the size of its risky real estate portfolios by more than $300 million. The plaintiff asserted claims under Section 10(b) of the Securities Exchange Act and individual liability against the bank's officers and directors under Section 20(a) of the Exchange Act.

The Decision

In ruling on defendants' motion to dismiss, the court found that the complaint had adequately pleaded material misrepresentations and omissions with the specificity required by law by describing the "who, what, when, where, and how." Specifically, the plaintiff singled out BankAtlantic's commercial real estate groups, asserted that those groups' undisclosed lending practices increased the bank's risk, and pointed to particular statements by bank executives which it alleged to have been false. In addition, the court found that the complaint adequately pleaded loss causation by asserting that the bank had concealed its high-risk lending practices, and that the eventual disclosure of those practices led to a drop in the company's stock price. Because the plaintiff highlighted specific public disclosures made by BankAtlantic and the decline in stock price that followed, the allegations provided notice of the alleged causal relationship between the losses claimed by the plaintiff and the defendants' alleged misrepresentations and omissions.

Scienter Difficulties

While finding that the plaintiff satisfied the other pleading requirements, the court found that the plaintiff's allegations of scienter were largely conclusory and grounds for dismissal (with leave to replead). Under the Private Securities Litigation Reform Act ("PSLRA"), plaintiffs must allege "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The U.S. Supreme Court has held that a "strong inference" is "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007). In *BankAtlantic*, the Florida court applied Eleventh Circuit precedent requiring plaintiffs to meet the pleading requirements for each defendant, and allowing the plaintiff to show scienter by proving either an intent to defraud or severe recklessness. *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1238 (11th Cir. 2008) ("[T]he complaint must allege facts supporting a strong inference of scienter for each defendant with respect to each violation.") (citation omitted); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1284 (11th Cir. 1999) (finding proof of severe recklessness sufficient to prove securities fraud under the PSLRA).

Significantly, many of the complaint's allegations were alleged to have been based on statements made to plaintiff's counsel by confidential witnesses who were former employees of the bank. Specifically, such witnesses allegedly stated that three of the individual defendants knew of or consciously disregarded the bank's allegedly deficient lending practices by virtue of their positions on a

bank committee responsible for approving every commercial development loan greater than $3 million. The witnesses noted that monthly reports provided to the same three individual defendants described inadequacies in the company's lending policies, and that in any case it was "common knowledge" that the bank held a number of high-risk loans but had not set aside the appropriate reserves. The complaint asserted that one witness allegedly stated that BankAtlantic "intentionally mischaracterized loans into less risky categories."

The court gave no weight to these allegations based on information allegedly provided by confidential witnesses. The court noted that the complaint failed to describe the confidential witnesses' positions within the bank, their duties or how close they were to the conduct they described. Without such allegations, the court found it impossible to measure the basis of the witnesses' knowledge. Moreover, the court found that specific statements that were attributable to the confidential witnesses — such as "it was common practice during the Class Period for the Major Loan Committee ... to override the Credit Department and direct that loans be funded anyway despite obvious underwriting deficiencies" — were vague and conclusory, and would not have given rise to a strong inference of scienter even if the court had accorded them weight. The court also found statements attributable to confidential witnesses regarding what was allegedly "common knowledge" within the bank were not particular enough for the purposes of the PSLRA.

Further, the allegations that some of the bank's top officers and directors — who were named as defendants — knew about the bank's lax lending practices because of their high-level positions and receipt of internal reports failed to create the required strong inference of scienter under the PSLRA. The court noted that any corporate officer or director can be alleged to have knowledge of questionable corporate activity simply due to his or her position, and therefore such allegations by themselves cannot create a strong inference that the individual acted with scienter. The plaintiff's allegations that internal reporting put the executives on notice failed because the complaint did not specify which loans were described in those reports, and failed to describe time frames when those reports were issued. Thus, the court found that these allegations were not particular enough to demonstrate intent or extreme recklessness on the part of the defendants.

The court also ruled that the allegations regarding the bank's loan reserve levels did not provide sufficient evidence of scienter. Allegations that the bank's executives failed to set aside sufficient reserves were either based on statements by confidential witnesses, or relied on vague and conclusory inferences that inadequate levels reflected an intent to defraud. Without more particular allegations of "red flag" indicators, such as financial restatements or auditor resignations, the court refused to find that the plaintiff had properly alleged an intent to defraud or severe recklessness with regard to the bank's reporting.

Conclusion

The *BankAtlantic* case reflects the difficulties plaintiffs face in bringing securities fraud suits against lenders whose stock values have dropped as a result of the collapse of the real estate market. Even where plaintiffs can describe particular fraudulent actions with specificity and plead causation, the requirements for pleading scienter are frequently difficult to meet. Without specific, well-sourced allegations of intent, such cases are subject to dismissal at the complaint stage. ◎

FDIC to Pay $90 Million to Settle Sub-Prime Mortgage Dispute with Beal Bank

As recently reported, the Federal Deposit Insurance Corp. ("FDIC") and Beal Bank, S.S.B. ("Beal") have entered into a settlement agreement whereby the FDIC has agreed to pay Beal $90 million to settle a sub-prime mortgage dispute.

The Claims

On October 31, 2002, Beal brought suit against the FDIC, as receiver for Superior Federal Bank FSB, in the United States District Court for the District of Columbia asserting claims for breach of warranty and breach of contract. In an amended complaint filed in April 2007, Beal added claims for breach of indemnity, loss of funds opportunity, declaratory judgment and attorneys' fees.

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FDIC Settlement with Beal Bank

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The case arose from Mortgage Loan Purchase Agreements entered into by Beal in late 2001 and early 2002. At the time of these agreements, the FDIC was acting as conservator for Superior Federal Bank FSB, and receiver for Superior Federal's predecessor, Superior Bank FSB. Subsequent to the execution of these agreements, the FDIC was appointed as receiver for Superior Federal.

Under the Purchase Agreements, Beal purchased residential fixed and adjustable rate sub-prime mortgage loans from Superior Federal. In its amended complaint, Beal asserted that it was "induce[d]" to buy the loans because the FDIC Receiver "made specific representations and warranties about the loans' quality and underwriting procedures." Beal also claimed that the agreements required the FDIC to repurchase loans "for which there was a representation or warranty breach that had a material or adverse effect on the loans' value (or to cure the breach if possible)." Beal asserted that it paid "substantially more" for the loans than it would have had it not been for the representations and warranties made by the FDIC receiver.

Shortly after purchasing the loans, Beal claimed that it discovered "critical and widespread representation and warranty breaches" including that the loans did not meet underwriting standards. Beal alleged that these breaches were "material, adverse, and greatly reduced the value" of the loans and the portfolio as a whole. Subsequently, the FDIC did not "honor its promise" to repurchase the loans. In addition to losses and out-of-pocket expenses, Beal asserted it was entitled to an election of remedies and sought damages in the larger amount of: (1) the diminished value of its portfolio due to the FDIC receiver's breaches of representation and warranty, or (2) the repurchase amount of the defective loans.

The Settlement

The lawsuit spanned more than six years of litigation before resolution by virtue of the $90 million settlement to be paid by the FDIC. Although the settlement was not publicly announced until January 2009, Beal filed a stipulation of dismissal pursuant to the Federal Rules of Civil Procedure 41(a)(1)(A)(ii) "and the agreement of the parties" on December 12, 2008 dismissing the action with prejudice. ◎

Collateralized Debt Obligations: When the Documents Contain Conflicting Terms

A federal district court recently ruled on conflicting terms found in an indenture and in a hedge agreement for a collateralized debt obligation ("CDO"). In *Cooperatieve Centrale Raffeisen-Boerenleenbank BA v. Brookville CDO I Ltd.*, 08 Civ. 9565 (SDNY), the court denied a motion for a preliminary injunction because the plaintiff Cooperatieve Centrale Raffeisen-Boerenleenbank BA ("Rabobank") had failed to show a likelihood of success on the merits of its contention that the sale of a portion of the defendant's collateral constituted a liquidation of collateral, as defined in the agreements, which would have triggered Rabobank's right to terminate its hedge agreement with the defendant and to receive a $9.5 million termination payment.

The Contractual Structure

Created as a CDO in 2007, defendant Brookville CDO I Ltd. ("Brookville") issued several tranches of notes secured by collateralized debt securities, mostly in the form of bonds. Wells Fargo served as the trustee of the Brookville Indenture Agreement and oversaw the distribution of payments under the collateralized debt securities.

In addition to executing an Indenture Agreement, Rabobank and Brookville entered into a Hedge Agreement pursuant to which Rabobank provided Brookville with an interest rate hedge. As consideration for this hedge, Brookville agreed to make monthly payments to Rabobank. Further, the Hedge Agreement provided that, if certain events occurred, Rabobank had the right to terminate the Hedge Agreement and receive a $9.5 million termination payment. Specifically, the Hedge Agreement provided Rabobank's termination rights would be triggered by (1) the occurrence of an Event of Default under the Indenture Agreement, (2) the acceleration of the notes, and (3) *a "liquidation of any or all of the collateral*." It was this liquidation of the collateral requirement under the Hedge Agreement that became the center of the dispute between the parties.

The *Rabobank* Lawsuit

In February 2008, Wells Fargo announced that an Event of Default under the Indenture Agreement had occurred. Shortly thereafter, Wells Fargo issued a notice accelerating Brookville's repayment of the notes. Thus, two of the three preconditions under the Hedge Agreement to Rabobank's right to terminate had occurred.

In June 2008, a new investor purchased the most senior tranche of Brookville notes and directed the reclassification of a large number of the collateral securities as either Defaulted Securities or Credit Risk Securities. According to Wells Fargo and Brookville, this reclassification gave Wells Fargo the right to liquidate the reclassified securities, which it began to do. When Wells Fargo began to sell off the reclassified securities, Rabobank asserted that this sale constituted a "liquidation of any or all of the collateral," thereby satisfying the third and final requirement for termination under the Hedge Agreement. As such, Rabobank notified Wells Fargo that it wanted to terminate the Hedge Agreement and receive its termination payment.

Wells Fargo refused, and continued to sell off the reclassified securities. Wells Fargo asserted that such liquidation did not trigger Rabobank's right to terminate the Hedge Agreement and receive its termination payment because, to determine whether a liquidation of the collateral had occurred under the Hedge Agreement, it was necessary to consider the definition of "liquidation" set forth in the Indenture. The Terms Supplement to the Indenture set forth three requirements for a liquidation to occur: (1) an Event of Default; (2) an acceleration of the notes; and (3) *one of several types of votes taken by shareholders that directs the collateral manager to liquidate the collateral in part or in its entirety*. Wells Fargo asserted that the third requirement, a shareholder vote directing liquidation, had not occurred.

Rabobank brought suit in federal district court, seeking a declaration that, because the three conditions to termination set forth in the Hedge Agreement had occurred, its right to terminate had been triggered. It also moved for a preliminary injunction to prohibit Wells Fargo from distributing the proceeds from the sale of the reclassified assets before Rabobank received its termination payment.

Preliminary Injunction Analysis

In denying Rabobank's motion for a preliminary injunction, the court found that Rabobank had failed to make a sufficient showing that it was likely to succeed on the merits of the dispute. The court rejected Rabobank's argument that, to determine whether liquidation had occurred, the court should look only to the provisions of the Hedge Agreement and should ignore the definition of liquidation in the Indenture.

As the Hedge Agreement and Indenture Agreement were executed on the same day as part of the same transaction, the court found they must be read together. To look only to the Hedge Agreement would render meaningless the definition of liquidation in the Indenture, in contravention of well recognized rules of contract construction. The court stated:

> 'An interpretation of a contract that has the effect of rendering at least one clause superfluous or meaningless is not preferred and will be avoided if possible.' *LaSalle Bank Nat'l Ass'n v. Nomura Asset Capital Corp.*, 424 F.3d 195, 206 (2d Cir. 2005) (citation omitted). When a transaction involves multiple writings that 'form part of a single transaction and are designed to effectuate the same purpose, [they] must be read together, even though they were executed on different dates and were not all between the same parties.' *TVT Records v. Island Def Jam Music Group*, 412 F.3d 82, 89 (2d Cir. 2005) (citation omitted).

Therefore, without a vote as required by the Indenture, no liquidation could have occurred to trigger Rabobank's right to termination.

Conclusion

Where separate agreements in a CDO appear to be in conflict, courts will usually attempt to harmonize them. Here, the term liquidation was defined more specifically and stringently in the Indenture. By ruling that this more specific term was incorporated into the Hedge Agreement, the court was able to give full force and effect to all contractual provisions, as the definition of liquidation in the Indenture was not inconsistent with the Hedge Agreement, just more specific. ◎

Suit to Rescind Credit Default Swap Transaction Rejected

A New York federal court recently dismissed a suit brought against Citibank by a protection seller under a credit default swap ("CDS") transaction. The case, *VCG Special Opportunities Master Fund Ltd. v. Citibank N.A.*, 08 CV 01563 (S.D.N.Y.), arose after Citibank announced an event under the parties' contract that triggered the payment obligation of the protection seller, VCG Special Opportunities Master Fund Ltd. ("VCG"), to Citibank, which VCG disputed. The court rejected VCG's claim that, if Citibank's interpretation of VCG's payment obligation was correct, the transaction should be rescinded because VCG did not understand at the time it entered into the transaction that it was assuming the risk of the daily value fluctuations of the underlying obligations.

Background

The parties, whose relationship began in late 2006, based their contractual arrangement on several standard form agreements and a terms supplement issued by the International Swap Dealers Association, as well as a confirming letter. Under these agreements, VCG agreed to provide credit protection to Citibank with respect to a collateralized debt obligation ("CDO"), in effect insuring Citibank against a negative credit event affecting the CDO's assets. VCG provided Citibank with collateral to secure this obligation.

Within the first year of the relationship, Citibank demanded additional collateral from VCG as a result of a downward movement in the market value of the CDO's assets. While VCG complied with Citibank's demand, it subsequently maintained that it disagreed with Citibank's evaluation of the CDO's credit risk. In January 2008, following further market losses, Citibank sent VCG a notice that a "Floating Amount Event" had occurred under the agreement by reason of an Implied Writedown of $10 million dollars with respect to the value of the notes issued by the CDOs. Citibank asserted that the Implied Writedown and resulting Floating Amount Event required VCG to make a Floating Amount Payment to Citibank. VCG disagreed, maintaining that Citibank had improperly interpreted the contract as allowing an Implied Writedown in these circumstances. VCG commenced suit, seeking a declaration that Citibank's notice of a Floating Amount Event and demand for additional collateral were improper.

VCG's Claims

VCG disputed Citibank's interpretation of the contract as to when an Implied Writedown occurs in an amount sufficient to give rise to VCG's payment obligation. VCG noted that the Standard Terms Supplement provided that, where the CDO's Indenture "expressly provides" for writedowns, the amount of any Implied Writedown is to be zero. VCG maintained that the Indenture here contained such an express provision which, if true, would mean that the Writedown was zero. As such, it alleged Citibank had improperly declared a Floating Amount Event.

The Court's Contractual Interpretation

The court examined the relevant Indenture to determine if it expressly provided for a writedown, as VCG had contended, such that no Implied Writedown should have been declared. While the court agreed with VCG that the Indenture did in fact expressly address writedowns, the court found that VCG misunderstood as to which obligations the Indenture writedown provision applied. The court ruled that the writedown provision in the Indenture applied, not to the securities issued by the CDO as VCG had asserted, but to the securities serving as collateral for VCG's obligations. The court determined that it was proper for Citibank to declare an Implied Writedown greater than zero and a resulting Floating Amount Event, allowing Citibank to receive its payment under the CDS agreement with VCG.

The court further found that it was not improper for Citibank to demand additional collateral from VCG. Examining the relevant contractual provisions, the court determined that they permitted Citibank to request additional collateral based on its own calculations of its exposure under the CDO. The court noted, however, that even if the contract did not explicitly allow Citibank to demand additional collateral, VCG, as a matter of contract law, had waived any right to challenge the demand. VCG's waiver arose from its continued agreement to transfer additional collateral to Citibank, and its failure to invoke the dispute resolution mechanism provided for in the contract to dispute Citibank's demands for additional collateral.

VCG's Mistake Claims

VCG's remaining four claims for rescission, breach of the implied covenant of good faith, unjust enrichment and conversion also failed. The gravamen of these four claims was that VCG was mistaken as to the level and type of credit protection it agreed to provide Citibank and therefore the transaction should be rescinded and VCG's collateral returned. VCG asserted that it believed it was agreeing "to sell credit protection on a credit default swap" and "not to take the risk of daily mark-to-market movement in the value of the reference obligation."

The court found VCG's unilateral mistake did not constitute a valid basis for rescission of the contract, however, as it was the result of VCG's own negligence in not carefully considering the contract before executing it. VCG's sophisticated market knowledge and the plain language of the contract, which contradicted VCG's understanding, provided proof of this negligence. The court noted that "VCG, a sophisticated hedge fund, simply failed to review carefully the terms of the parties' agreement."

Finally, the Court granted Citibank judgment on the pleadings for its sole counterclaim, for breach of contract based on VCG's failure to pay the Floating Payment under the CDS agreement. The court rejected VCG's argument that the amount Citibank sought was "commercially unreasonable."

Conclusion

Despite the complicated contractual structure at issue in this case, the court applied basic principles of contract construction and refused to allow VCG to avoid its obligations under the CDS. While VCG asserted it did not understand what it was getting into when it signed onto this transaction, as a sophisticated party it was held bound to the contractual terms. ◎

Mortgage Fraud Probe of Royal Bank of Canada Ends in Settlement

In an agreement announced in late 2008, RBC Mortgage Company ("RBC"), a subsidiary of the Royal Bank of Canada and formerly known as Prism Mortgage, settled claims arising from charges that it gave the U.S. government false information about borrowers on over 200 home loans that eventually ended in foreclosure. This mortgage fraud settlement appears to end the prospect of civil lawsuits by state attorneys general against RBC. The charges are related to a separate federal criminal probe that resulted in the convictions of 25 defendants, including three RBC officers.

The HUD Program

The government contended that during the period from at least February 2001 through April 2004, RBC allegedly submitted fraudulent statements to the U.S. Department of Housing and Urban Development ("HUD"), in violation of the False Claims Act, 31 U.S.C. §§ 3729-3733. An audit by the HUD Office of Inspector General identified numerous loans it contended were improperly certified by RBC as being current. RBC responded to the audit by agreeing that certain loans were incorrectly certified, but contesting the other HUD claims.

The government asserted that RBC improperly used its "direct endorsement" authority to underwrite HUD-insured mortgage loans and submitted false claims to the Federal Housing Administration ("FHA") mortgage insurance program. The FHA, which became one of several of HUD's nationally administered programs in 1965, has insured over 35 million home mortgages in conjunction with HUD since its inception.

For a small fee, lenders can obtain insurance from HUD covering 97% of the appraised value of the home or building. This insurance program allows high-performing lenders, such as RBC, to insure FHA homeowner mortgages with HUD insurance without a pre-insurance review. Instead, the lender performs its own pre-insurance review and submits loan-level data to FHA, which performs an automated verification process to check the data for accuracy and completeness. Loans passing the process are then automatically insured.

An integral part of the process is direct endorsement, which allows pre-approved lenders, such as RBC, to extend FHA insured mortgage loans to low and moderate income borrowers. To qualify for such loans, borrowers are required to have valid social security numbers and good credit. Borrowers must also show that they have adequate gross income to meet the monthly mortgage payments. In evaluating this requirement, the direct endorsement lender is required to obtain an employment verification form from the

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Mortgage Fraud Probe of Royal Bank of Canada

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prospective borrower's employer to determine the adequacy of the borrower's income.

After 219 of the loans extended by RBC, and insured by HUD, ended in foreclosure, RBC allegedly submitted mortgage insurance claims to HUD, which the agency paid. Thereafter, the government claimed that RBC, using its direct endorsement authority in the insurance program, had falsely certified that 219 covered mortgage loans met FHA's lending requirement. Among other false statements, the government asserted that RBC's certifications contained false verifications of borrower's employment and income.

The Settlement

The U.S. Attorney for the Northern District of Illinois announced that, as part of its settlement, RBC will pay the United States just under $11 million to settle civil allegations that the lender submitted false information to HUD in violation of the federal False Claims Act. Additionally, the agreement includes another payment of over $264,000 for numerous loans that HUD claims were improperly certified by RBC as being current.

RBC negotiated the agreement with U.S. government, acting through the DOJ on behalf of HUD, and the settlement was reached without litigation. An RBC spokesperson noted that RBC cooperated fully with the government and that in 2005, RBC had sold the unit where the alleged misconduct took place. In his press release, Patrick Fitzgerald, U.S. Attorney for the Northern District of Illinois, announced that "lenders should know that they must maintain the integrity of the lending process so that federally-insured mortgages will be available to worthy borrowers and not based on fraud and deceit." ◎

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