CHADBOURNE & PARKE LLP

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Madoff Feeder Fund Litigation Update

While Bernie Madoff's criminal case has drawn to a close, the number and diversity of the civil lawsuits arising from the collapse of Madoff's Ponzi scheme continues to grow. The so-called "feeder" funds, which channeled investors' money to Madoff, have recently faced a wave of litigation brought by, among others, their investors, state regulators and attorneys general, and the bankruptcy trustee of Madoff's defunct firm. Investors have also sued the investment advisors that recommended those feeder funds, the independent accountants responsible for auditing them, and even the bank at which Madoff opened the account he used to accept cash investments. We discuss below examples of each of these types of lawsuits.

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Investors Sue Feeder Funds

Investors have filed both class action and individual lawsuits against the feeder funds in which they invested in a variety of jurisdictions. In Anwar, et al. v. Fairfield Greenwich Limited, et al., No. 09-118 (S.D.N.Y.), for example, a group of investors brought a class action against the feeder funds managed by the Fairfield Greenwich Group, which allegedly channeled over $7 billion to Madoff and collected hundreds of millions of dollars in fees from their investors. As alleged in the amended complaint, "Madoff perpetrated a massive Ponzi scheme" whereby he "fraudulently distributed new investors' assets to prior investors to create the illusion of profits." Madoff created "entirely fictitious" account statements that purported to reflect trades in equities and options and

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securities holdings, when in truth no such trades had been executed for years.

The plaintiffs assert seventeen counts against the defendant funds, including fraud, negligent misrepresentation and breach of fiduciary duty, seeking among other relief the imposition of a constructive trust to preserve the funds' assets, disgorgement of fees collected by the funds, and compensatory and punitive damages. The plaintiffs assert that the funds misled investors by, among other things, falsely representing that they followed a "split-strike conversion" investment strategy with a "historical track record" of returns, and that they were engaged in "daily monitoring" of Madoff's operations when in fact the funds did not conduct any meaningful due diligence.

Further, the funds allegedly failed to disclose numerous "red flags" to investors, including Madoff's lack of transparency, inadequate auditing and too consistent returns. For example, the funds allegedly ignored that Madoff "failed to trade through an independent broker and, instead, self-cleared all Fund activities through his wholly owned company," which plaintiffs claim "greatly increased the risk of Madoff perpetrating a fraud." And, when investors began raising questions about Madoff's operations, the funds allegedly offered knowingly false assurances that the investors had "nothing to worry about."

In a separate lawsuit captioned *Cocchi, et al. v. Tremont Group Holdings, Inc., et al*., No. 502009CA016230 (Fla. Cir. Ct. Palm Beach Co.), a different group of investors has sued Tremont Group Holdings and the feeder funds that it managed. Those investors allegedly lost approximately $13 million while the defendants collected tens of millions of dollars in fees. According to the complaint, the defendants collected those fees despite "simply turn[ing] Plaintiffs' money over to Bernard L. Madoff and his affiliated companies" and a "complete lack of effort to safeguard or monitor Plaintiffs' investments." The plaintiffs assert thirteen causes of action against the defendants seeking compensatory damages. As in the *Anwar* lawsuit, plaintiffs claim fraud, negligent misrepresentation and breach of fiduciary duty. In addition, plaintiffs bring several claims under Florida law, including a claim under Florida's Deceptive and Unfair Trade Practices Act for allegedly engaging in "unconscionable" and "deceptive" acts or practices.

State Governments Sue Feeder Funds

State regulators and attorneys general have also targeted the feeder funds and their managers. On April 1, 2009, the Securities Division of the Massachusetts Secretary of the Commonwealth filed an administrative complaint commencing an adjudicatory proceeding captioned *In re Fairfield Greenwich Advisors LLC, et al.*, No. 2009-0028. That complaint alleges that respondents Fairfield Greenwich Advisors LLC and Fairfield Greenwich (Bermuda) Ltd. violated Massachusetts securities laws by "in essence, serv[ing] as an outside marketing agent for Madoff, as opposed to an independent investment adviser that was looking for and evaluating the best investments for its investors." According to the complaint, respondents failed to satisfy their fiduciary duties as investment advisors registered with the SEC by not conducting adequate due diligence of Madoff's operations and exaggerating the extent of that due diligence to potential and actual investors.

For example, respondents allegedly replied to an investor's concerns about Friehling & Horowitz, Madoff's internal auditor, by stating that "[t]hey have hundreds of clients and are well respected in the local community." However, the only source of that information was allegedly a brief phone call with an employee of that accounting firm. And, in truth, according to the Division, Friehling & Horowitz had only one employee, recorded just $180,000 in annual revenues, and operated out of a strip mall in New City, New York.

Among other relief, the Division seeks restitution for the losses of Massachusetts investors, the disgorgement of performance fees paid to respondents by investors, and the assessment of an administrative fine. Respondents have reportedly answered the complaint, denying that they violated Massachusetts securities laws and asserting that their due diligence satisfied industry standards.

The New York Attorney General has filed a complaint against Ezra Merkin, the manager of several Madoff feeder funds, in an action captioned *People v. Merkin, et al.* (Sup. Ct. N.Y. Co. 2009). That complaint alleges that Merkin committed fraud and breached his fiduciary duties to investors by failing to "disclose that, rather than earning his management fee by actively managing these investments, he simply turned over all or a significant portion of those investments to [Madoff]," thereby losing approximately $2.4 billion. The offering memoranda for Merkin's funds allegedly failed to disclose that they were in fact feeder funds to Madoff, and Merkin falsely told

investors that he, rather than Madoff, directly managed those funds. Approximately 85% of the investors in one of Merkin's funds interviewed by the office of the Attorney General were allegedly unaware until Madoff's arrest that Madoff had controlled nearly all of that fund's assets.

Among other relief, the Attorney General seeks an accounting of all fees collected by Merkin, restitution for the losses of New York investors, and a permanent injunction barring Merkin from managing the investments of others. Merkin has reportedly agreed to the Attorney General's requests that he turn over control of the feeder funds to court-appointed receivers, and that he sell his personal art collection and deposit the proceeds of the sale in escrow pending the resolution of the lawsuit.

The Bankruptcy Trustee Sues Feeder Funds

In addition to claims by individual investors and state governments seeking restitution on the behalf of investors, the feeder funds also face efforts by Irving H. Picard, the bankruptcy trustee for Madoff's firm, to claw back payments the firm made to the funds. For example, in *Picard v. Kingate Global Fund, Ltd., et al.*, Adv. Pro. No. 09-1161 (Bankr. S.D.N.Y.), the trustee sued the Kingate Global Fund, Ltd. and Kingate Euro Fund, Ltd., which feeder funds allegedly received several hundred million dollars in avoidable transfers from Madoff in the two years prior to its bankruptcy. The trustee seeks to recover those transfers from the Kingate Funds under federal bankruptcy and fraudulent transfer laws. As alleged in the trustee's amended complaint filed on May 8, 2009, the Kingate Funds were "sophisticated investors" who knew or should have known that Madoff's business was predicated on fraud.

On May 18, 2009, the trustee brought a similar action against feeder funds of the aforementioned Fairfield Greenwich Group captioned *Picard v. Fairfield Sentry Limited, et al.*, Adv. Pro. No. 09-01239 (Bankr. S.D.N.Y.). The trustee alleges that these funds "worked closely with [Madoff] throughout a nearly twenty year relationship," raising money to perpetuate Madoff's Ponzi scheme and coordinating their responses to an SEC investigation. The trustee seeks to recover approximately $3.2 billion in avoidable transfers from the defendants. Unlike the *Kingate Funds* litigation, here the trustee asserts claims under New York's Debtor & Creditor Law in order to reach transfers allegedly made up to six years prior to the bankruptcy.

Investors Sue Advisors that Recommended Feeder Funds

Some investors have brought claims against those investment advisors who recommended that they place their money with Madoff feeder funds. In *Headway Investment Corp. v. American Express Bank Ltd., et al.*, No. 09-21395 (S.D. Fla.), plaintiff Headway seeks damages for the loss of over $10 million allegedly invested in feeder funds controlled by the Fairfield Greenwich Group. Headway not only sued the feeder funds and their managers and auditors, but also American Express Bank Ltd., which allegedly committed negligence and breached its fiduciary duties when it recommended an investment in the feeder funds to its client Headway.

According to the complaint, American Express held itself out as having "the skills and expertise necessary to research, analyze, and monitor the investments recommended to Headway." American Express allegedly recommended and placed several investments with Fairfield Greenwich Group on behalf of Headway and acted "as an intermediary between [Fairfield Greenwich Group] and Headway to continually justify collecting commissions." Despite its "superior knowledge, judgment, skill, and years of experience," American Express failed to conduct appropriate due diligence and "failed to discover, or simply disregarded, the countless red flags surrounding [Madoff and the feeder funds]."

On June 22, 2009, the Court stayed the lawsuit pending the Fairfield Greenwich Group's motion to consolidate it with the *Anwar* litigation in New York.

Investors Sue Auditors of Feeder Funds

Aggrieved investors suing Madoff feeder funds have been naming the accounting firms that audited the feeder funds as defendants. One example is the aforementioned lawsuit, *Headway Investment Corp. v. American Express Bank Ltd., et al.*, No. 09-21395 (S.D. Fla.), in which Headway brought a claim for damages caused by the purported negligence of PricewaterhouseCoopers LLP ("PWC"). According to the complaint, PWC was responsible for conducting independent audits of the financial statements issued by the Fairfield Greenwich Group feeder fund in which Headway invested. Headway alleges that PWC's audits "constituted an extreme departure from the standards of the accounting and auditing profession" because PWC failed to investigate numerous "red flags" regarding the feeder funds' and Madoff's operations. Moreover, if PWC had conducted an appropriate investigation

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it allegedly would have revealed "serious deficiencies in the [feeder funds'] own internal controls" and "raised questions regarding the true value and existence of [those funds'] reported invested assets."

Investors Sue Bank used by Madoff

Interestingly, one victim of Madoff's Ponzi scheme has sued JP Morgan Chase & Co. ("Chase") for its alleged role in facilitating that scheme. In *MLSMK Investments Company v. JP Morgan Chase & Co., et al.*, No. 09-4049 (S.D.N.Y.), plaintiff MLSMK alleges that it lost the $12.8 million it deposited in Madoff's account at Chase in October through December 2008. In addition to claims for aiding and abetting breach of fiduciary duty, negligence and commercial bad faith, MLSMK asserts a claim against Chase under the federal RICO statute. According to the complaint, "[Chase] knowingly and purposely conspired to violate 18 U.S.C. § 1962(c) by providing Madoff with banking services that were integral to the functioning of the racketeering enterprise," even after Chase supposedly discovered Madoff's fraud. Pursuant to the RICO statute, MLSMK seeks to recover treble its alleged $12.8 million in actual damages.

Beginning no later that 1992, Madoff allegedly used accounts at Chase to receive all the money invested by his victims. By 2006, Madoff allegedly held billions of dollars in cash in those Chase accounts. Chase allegedly offered a note to investors that was tied to investments in a feeder fund managed by Fairfield Greenwich Group, and by the summer of 2008 Chase had deposited $250 million with that fund. At that time, most investment funds were reporting losses of nearly 30%, while the feeder fund continued to report 5% gains. Chase allegedly "began to grow suspicious of Madoff's results," and supposedly conducted due diligence including meeting with Madoff and reviewing his account records at Chase. By September 2008, Chase allegedly "knew that Madoff's business was a fraud," and "liquidated its entire $250 million cash position in the [feeder] fund." Nonetheless, according to the complaint, "Chase continued to provide Madoff with banking services . . . thereby facilitating Madoff's fraudulent enterprise which continued to lure additional victim contributions, including those of the plaintiff."

On June 5, 2009, Chase filed a motion to dismiss the complaint in its entirety. Among other arguments, Chase claims that plaintiff's RICO claim must be dismissed because "civil RICO claims cannot be based on allegations of securities fraud."

Future Developments

In the coming weeks and months, the number of lawsuits filed by investors ensnared in Madoff's Ponzi scheme is likely to continue to grow. And, as demonstrated by the wide-ranging nature of the claims brought to date, any party with a connection to Madoff's scheme, no matter how seemingly attenuated, should consider itself a possible defendant. ◎

Private Parties Lack Standing to Challenge Government Bailout of Financial Institutions

Recently, a group of New York corporations and resident homeowners joined as plaintiffs and brought suit against the United States, the former Secretary of the Treasury, and various financial institutions, challenging as unconstitutional the federal government's bailout of certain financial institutions. In their complaint filed in federal district court in Brooklyn, New York, plaintiffs alleged that the Emergency Economic Stabilization Act of 2008 (H.R. 1424; Pub. L. 110-343) (the "EESA"), which authorized the Treasury Secretary to purchase or insure troubled assets held by financial institutions, violated equal protection principles, as plaintiffs were ineligible for similar relief under the Act. *Henry Builders, Inc. v. U.S.*, No. 09-CV-0288, 2009 WL 185419 at *1 (E.D.N.Y. Jan. 26, 2009). In granting the defendant's motion to dismiss the complaint, the court found that the plaintiffs lacked standing to bring a constitutional challenge.

The EESA

The EESA was enacted in response to the growing global financial crisis of 2008. It allows the United States Secretary of the Treasury to purchase distressed assets (particularly mortgage-backed securities) and to provide banks with more capital in order to help such continue to provide necessary financial services to individuals and institutions. President Bush signed the bill into law on October 3, 2008. Tom Raum,

Bush signs $700 billion bailout bill, NPR, Oct. 3, 2008, http://www-cdn.npr.org/templates/story/story.php?storyId=95336601. Proponents of the EESA argued that the Act authorized critical measures which would prevent the further deterioration of the United States financial markets. Secretary of the Treaury Henry Paulson stated that the relief provided through the Act would help to stabilize the economy, improve liquidity, and obtain fast results that would have a far-reaching impact. Henry M. Paulson Jr., Secretary of the Treasury, Testimony by Secretary Henry M. Pauson, Jr. before Senate Banking Committee on Turmoil in U.S. Credit Markets; Recent Actions regarding Government Sponsored Entities, Investment Banks, and other Financial Insitutions (Sept. 23, 2008) http://www.treas.gov/press/releases/hp1153.htm.

The Complaint

In *Henry Builders, Inc. v. U.S.*, plaintiffs alleged that the EESA, and specifically the Troubled Assets Relief Program ("TARP") created under the EESA, violated the Fifth and Fourteenth Amendments to the United States Constitution. The Fifth Amendment prohibits individuals from being deprived of life, liberty, or property without being provided with due process under the law and the Fourteenth Amendment requires states to provide equal protection under the law to all citizens. The Fourteenth Amendment additionally applies the Bill of Rights to the states and provides citizens with substantive and procedural rights. Plaintiffs' equal protection claim was based on the assertion that, in addition to the financial institutions benefiting from TARP, they too were "significantly impacted" by the dire condition of the economy. They asserted that to provide relief to financial institutions and not to others violated the guarantee of equal protection under the Constitution. Additionally, because plaintiffs allegedly were indebted to the defendant financial institutions, JPMorgan Chase, Bayview Loan Servicing LLC, Option One Mortgage Corporation and American Home Mortgage Servicing Inc., they brought their case as a putative class action on behalf of all others similarly situated.

The plaintiffs, Henry Builders, Inc., Avery Enterprises, Inc., HKL Enterprises, LLC, Stanley Henry, Julie Henry, Emily S. Henry, Julie Ann Henry and Hilda Robbins, each had a mortgage loan outstanding to one of the defendant financial institutions. Most of those mortgage loans were in amounts greater than the real estate securing those loans and plaintiffs alleged they were not able to continue making payments thereon without government assistance. Additionally, Henry Builders, Inc. alleged that it could not obtain "adequate financial resources for its day-to-day operations" and had to reduce staffing and consequently forego job opportunities.

The Relief Sought

Plaintiffs requested that the court enjoin the effectiveness of the Act, and also sought damages because the "provisions of the 2008 Act exclude plaintiff[s]... nor are any of the act's benefits available to plaintiff[s]." The complaint alleged that the Act's effect was to (1) exclude all but the financial sector from the Act's benefits, (2) "burden, penalize, and obstruct all others but the financial sector from receiving governmental financial aid in the midst of a once in a lifetime financial disaster...," (3) arbitrarily and unreasonably discriminate between the financial sector and all others, constituting invidious discrimination under the Equal Protection Clause of the Fourteenth and/or Fifth Amendment, and (4) leave plaintiffs with no adequate remedy at law other than an injunction, as the plaintiffs will suffer irreparable harm without such.

The relief plaintiffs requested included: (1) a declaration that Sections 101 and 102 of the Act were unconstitutional, (2) a temporary and preliminary injunction (and after a hearing, a permanent injunction), restraining the Secretary of the Treasury from implementing the Act, (3) a preliminary injunction against named defendant financial institutions preventing such from taking steps to enforce mortgages under their current conditions, and (4) recovery of damages for "economic consequences to plaintiffs, and those similarly situated, as a result of" the Act.

Standing to Bring the Claim

To meet the case-or-controversy requirement of Article III of the U.S. Constitution, a plaintiff must have standing to bring a claim. As articulated by the U.S. Supreme Court in *Lujan v. Defenders of Wildlife*, 504 U.S. 555 (1992), there are three elements that plaintiffs must meet to have standing. First, the plaintiff must have suffered an "injury in fact," which must be "concrete and particularized," and "actual or imminent, not conjectural or hypothetical." Second, there must be a causal connection between the injury and the conduct. And third, it has to be likely that the injury will be rectified by a favorable decision. If a plaintiff fails to demonstrate any of these requirements, he lacks standing and a federal court will not have subject matter jurisdiction over the action, mandating dismissal.

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The Decision

In a January 2009 decision, district court Judge Eric Vitaliano ruled that plaintiffs had failed to establish standing to bring these claims. For one, the court found there was no "concrete and particularized" injury, as the injury suffered by plaintiffs was common to all people and organizations that were not assisted by the Act. The court held that plaintiffs' claimed injury was "no different in kind than that which is worked on all Americans any time the Congress exercises its power over the national fisc to fund one program or policy but not others," and that therefore such a claim was "not judicially cognizable." The court also found that there was not a "hint on the face of the totality of their pleading that plaintiffs have been excluded from TARP based upon a suspect classification that treats them differently than everyone else TARP purportedly excludes." The court noted that the plaintiffs did not plead that they actually attempted to apply for TARP funds. Because an amendment to the complaint to attempt to prove standing would be futile, the court did not afford leave to amend the complaint and dismissed the action with prejudice. ◎

Ninth Circuit Reinstates Truth in Lending Act Claims

In a class action lawsuit filed in the federal district court in Oregon, holders of a credit card issued by Chase Bank USA, N.A. ("Chase") alleged that Chase failed to disclose adequately in their cardmember agreement the grounds on which the Annual Percentage Rate ("APR") on interest charged could be increased. *Barrer v. Chase Bank USA, N.A.*, No. 07-35414. Following the district court's dismissal of that case, in May 2009 the United States Court of Appeals for the Ninth Circuit reversed and remanded, finding that Chase had failed to make clear and conspicuous disclosure of the reasons why the APR might be increased as required by the Truth in Lending Act ("the Act"), 15 U.S.C. §§ 1601, *et seq.*, and Regulation Z, 12 C.F.R. § 226 ("the Regulation"). 2009 WL 1382865.

Background of Claims

In late 2004, Chase provided the plaintiff cardholders with a cardmember agreement, which was modified in February 2005 when Chase mailed a Change in Terms Notice. That Notice included a significant increase in the APR. While the cardholders had the right to reject that amendment in writing by a certain date, they failed to do so and the new higher APR became effective.

The cardholders initially enjoyed a preferred APR of 8.99%. The agreement provided that, in the event of default, Chase could increase the APR on the balance up to a stated default rate. The agreement listed the events of default that could give rise to such increase. Under the agreement, Chase was permitted periodically to obtain and review the credit history of the customer from credit bureaus and others. Separately, Chase had the general right to change the terms of agreement at any time, including by adding, deleting or modifying any provision.

Around April 2005, the cardholders allegedly noticed that their APR changed substantially from the initial 8.99% preferred rate to a 24.24% default rate. Such increase was based on information Chase allegedly obtained in a credit report from a consumer reporting agency. Chase's receipt of negative credit information was not, however, one of the events of default listed in the agreement that permitted imposition of a default rate.

The Class Action Suit

After three months of paying interest at the default rate, the cardholders filed a class action lawsuit on their own behalf and on behalf of all Chase credit card customers similarly harmed and situated. They alleged that, at the time of the agreement, Chase had a pre-existing plan to raise their APR if certain risk factors appeared in the cardholder's credit profile, and that Chase failed to disclose this plan and failed to disclose that Chase might increase the APR if the cardholder's credit report revealed certain risk factors.

In response, Chase argued that the agreement effectively permitted the increase in APR based on the risk factors in the credit report, by virtue of the general reservation of rights provision by which Chase reserved the right to change terms in the agreement. Chase also contended that the disclosure of that contractual right, together with the disclosure that Chase would periodically review the customer's credit history, satisfied its disclosure obligations.

The Required Disclosure To Creditors

The Act regulates credit card disclosures at numerous

moments in the commercial arrangement between the creditor and consumer, specifically at the time of solicitation and application, at the time of each billing cycle, and at the point the parties renew their arrangement. Under the Act, creditors must disclose: (i) the conditions under which a finance charge may be imposed, (ii) the method of determining the amount of finance charge, (iii) where one or more periodic rates may be used to compute the finance charge, (iv) each such rate, and (v) the corresponding nominal annual percentage rage.

The Regulation, prescribed by the Board of Governors of the Federal Reserve System to carry out the purposes of the Act, provides two disclosure obligations that creditors must meet: (i) the disclosures must be complete disclosing all the information required by the Act, and (ii) the disclosures must be true and accurate representations of the legal obligations of the parties at the time the agreement was made. The Regulation also establishes a creditor's initial disclosure obligations as, among them, to disclose each periodic rate that may be used to compute the finance charge, and the corresponding annual percentage rate. In a an earlier opinion, the Board had ruled that "[i]f the initial rate may increase upon the occurrence of one or more specific events, . . . the creditor must disclose the initial rate and the increased penalty rate that may apply." *Id.* at *3, citing 12 C.F.R. § 226 Supp. I, ¶ 6(a)(2), cmt. 11. The disclosure has to be "clearly and conspicuously in writing" and must "reflect the terms of the legal obligation between the parties." *Id.,* citing 12 C.F.R. § 226.5(a)(1), 226.5(c). The Board has also recognized that the creditors may reserve the general right to change the credit agreement, as Chase did in this case.

The Ninth Circuit's Analysis

The Ninth Circuit considered that neither the Act nor the Regulation "demands clairvoyance" from a creditor to foresee and describe all possible subsequent events that might render the initial disclosures inaccurate. The Court acknowledged that Chase disclosed the new APR to the cardholders before it went into effect, and that it had reserved its right to change the agreement. The Court found it irrelevant, for purpose of the adequacy of the disclosure, that Chase had not disclosed any pre-existing plan to raise the APR if certain risk factors appeared.

Nevertheless, the Court found that Chase had to make a full, clear and conspicuous disclosure required by law, and that its disclosure suggested it would raise the APR only for the events of default listed. The Court found disclosures must be reasonably understandable from the perspective of a reasonable cardholder. The Court of Appeals concluded that Chase failed to make clear in the Agreement that it could raise the APR for any reason, particularly given that the change-in-terms provision was "five dense pages after the disclosure of the APR" and that the provision was "buried too deeply in the fine print for a reasonable cardholder to realize that, in addition to the specific grounds for increasing the APR listed in the 'Finance Charges' section, Chase could raise the APR for other reasons." The district court's dismissal for failure to state a claim was reversed and the case remanded for further proceedings.

The Dissenting Opinion

Apparently concerned that the majority's interpretation could open the door for creditors to adjust the terms of credit agreements for any reason, "however bizarre or unexpected," Judge Graber dissented, opining that the disclosures were not only unclear and inconspicuous, but also substantively insufficient. The dissent argued that the reservation of right to change the terms of the Agreement is not an adequate disclosure, as the majority interpreted. Disagreeing with the majority, he said Chase was required to disclose any pre-existing program under which it would raise the cardholders' APR in the occurrence of certain risk factors. Even if the change-in-terms provision and the credit history monitoring term were together in the agreement, they would not have made clear that Chase could raise the APR based on information from credit monitoring. The dissent concluded that the agreement was too vague and general and that Chase's reservation of rights could not have allowed a reasonable understanding of it.

Conclusion

While this case was remanded for further proceedings, the Ninth Circuit decision sets a standard that creditors need to follow when disclosing the reasons for raising credit card rates. The disclosures need to be clear and conspicuous, making disclosures that are reasonable and understandable to a cardholder. General reservation of rights language and other legalese may not satisfy the affirmative disclosure requirements, especially where buried deep in the document. ◎

Claims Against Issuers of Notes Secured By Mortgage-Backed Securities Allowed to Proceed

In *M&T Bank Corp. v. Gemstone CDO VII Ltd.*, No. 7064-08 (N.Y. Sup. Ct. Erie Co., Apr. 7, 2009), the plaintiff asserted claims against the issuers of notes secured by a collateralized debt obligation ("CDO"), holding residential mortgage backed securities, for fraud, negligent misrepresentation, breach of fiduciary duty and breach of contract arising out of purported misrepresentations in offering materials and oral statements. Ruling on a motion to dismiss, a New York trial court has allowed claims to proceed with respect to certain defendants alleged to have made specific misrepresentations and concealments of material facts. However, the court dismissed claims against the other defendants who, although involved in the issuance and management of the CDO, were not alleged to have made any of the misrepresentations.

The Securities

The instrument at the heart of this case was a collateralized debt obligation issued by defendants Gemstone CDO VII, Ltd. and Gemstone CDO VII Corp., both alleged to be affiliates of Deutsche Bank. The CDO was secured primarily with residential mortgage-backed securities ("RMBS"), with some commercial mortgage-backed securities and credit default swaps. The swaps were sold to defendant Deutsche Bank AG ("DBAG"), which paid Gemstone, Ltd. premiums that funded the CDO. The collateral was held in trust by defendant Deutsche Bank Trust Company Americas ("Deutsche Bank Trust"), and defendant HBK Investments, LP ("HBK") selected and managed the collateral. The Gemstone defendants issued approximately $1.1 billion in preference shares and notes, which were purchased by defendant Deutsche Bank Securities, Inc. ("DBSI"). DBSI in turn sold $82 million in notes to the plaintiff in March 2007 as part of a private placement offering.

The plaintiff's $82 million in notes were split between $42 million of Class A-2 notes and $40 million of Class B notes. At the time the offering closed, Standard & Poors ("S&P") had rated the Class A-2 notes AAA, and the Class B notes AA. Thereafter, the value of the underlying securities suffered from falling housing values and rising mortgage defaults associated with the national sub-prime mortgage crisis. In July 2007, S&P placed the plaintiff's notes on a negative credit watch, and in November 2007 in February 2008, downgraded them further. By April 30, 2008, the plaintiff had written down the value of the notes on its books to about $1 million.

Fraudulent Misrepresentation

The plaintiff filed its complaint on June 16, 2008. The plaintiff alleged that, in connection with its purchase of the notes, several of the defendants made written and oral misrepresentations, including in documents prepared for the private placement offering, that allegedly assured purchasers of the notes safety and low risk given their high ratings from S&P and Moody's. In addition, the plaintiff alleged that certain defendants made oral misrepresentations that the notes were low risk. Based on these alleged statements, the plaintiff asserted claims of fraudulent misrepresentation, fraudulent concealment and negligent misrepresentation.

The plaintiff further alleged that defendants DBSI and HBK had used written offering materials to highlight the high ratings of the notes, to promote HBK's expertise as a manager of the collateral, and to misrepresent the quality and condition of the CDO. In particular, the plaintiff alleged that the emphasis DBSI and HBK placed on the high ratings was fraudulent because, through late 2006 and early 2007, the defendants concealed from the rating agencies low quality and default problems in the subprime collateral underlying the CDO and disputes with subprime originators who refused to perform according to the terms of contractual warranties. The plaintiff also alleged that DBSI and HBK employees made oral misrepresentations with regard to HBK's ongoing monitoring of broader markets and the quality of the collateral. DBSI allegedly made comments through July 2007 about the quality of the collateral that induced the plaintiff to continue holding the notes even as the subprime mortgage crisis expanded.

Defendants Move To Dismiss

On the defendants' motion to dismiss, the court held that these allegations stated a cause of action for fraudulent misrepresentation. The court rejected defense arguments that DBSI's alleged misrepresentations were mere opinion. By allegedly providing false information to the ratings agencies, DBSI had manipulated a "present analysis of current valuation" that was "highly regarded" as reliable by investors. Thus, by

touting the false ratings in offering materials DBSI could be found to have made fraudulent misrepresentations of material facts. Similarly, oral statements about the quality of the notes and HBK's expertise may have reflected "puffing" but were also based on facts that were falsely stated by HBK.

However, the court dismissed the claims of fraudulent misrepresentation against defendant DBSI, the broker-dealer, to the extent that the claims were based on written misrepresentations in the offering materials as these claims were barred as duplicative of the plaintiff's breach of contract claim against DBSI. The court also dismissed claims of fraudulent misrepresentation as against the Gemstone defendants, on the grounds that the complaint had failed to specify any representations by the entities.

Fraudulent Concealment and Negligent Misrepresentation

The court denied the motion to dismiss the claims of fraudulent concealment and negligent misrepresentation as against defendants HBK and DBSI. The complaint alleged that HBK and DBSI were aware that the rating agencies had false information and that the notes were improperly valued, and that the plaintiff could not have detected this information. Although the defendants argued that the plaintiff was a sophisticated investor capable of investigating the allegedly concealed information, the plaintiff's allegations that they had explored other CDO offerings and examined the defendants' offering materials were sufficient demonstration of reasonable reliance for purposes of the motion to dismiss, especially in light of the complexity of the Gemstone CDO. Similarly, the court held the plaintiff's allegations of the expertise of HBK and DBSI sufficiently asserted a "special relationship" to state a cause of action for negligent misrepresentation.

However, the court granted the motion to dismiss the claim of negligent misrepresentation against the Gemstone defendants. The court held that the plaintiff had failed to allege any special expertise by the issuing entities — their "sole role in this transaction is as the issuer of the Notes."

Breach of Fiduciary Duty

The court refused to dismiss the claim of breach of fiduciary duty as against HBK, given the plaintiff's allegations that HBK had special expertise in the CDO, while dismissing the claim against Deustche Bank Trust, the trustee of the trust administering the CDO collateral, because the plaintiff's rights with respect to Deustche Bank Trust were governed by the trust's indenture agreement. The plaintiff alleged no facts that could give rise to any breach by Deutsche Bank Trust of a duty not governed by the terms of the Indenture.

Aiding and Abetting

The plaintiff had also brought claims for aiding and abetting fraud against Deutsche Bank Trust and the credit default swap counterparty, DBAG, as well as claims for aiding and abetting breach of fiduciary duty against DBAG and DBSI. The court dismissed the claims for aiding and abetting fraud, holding that the complaint made only conclusory allegations of knowledge of fraudulent concealment by Deutsche Bank Trust and DBAG. This knowledge, the plaintiff alleged, arose from their close business relationship with HBK. The court held that an alleged business relationship alone is insufficient to demonstrate the knowledge purposes of the claim. The court granted the plaintiff leave to amend its complaint if sufficient facts were found during discovery.

The court also dismissed the claim of aiding and abetting breach of fiduciary duty against DBAG, but denied the motion to dismiss those claims as against DBSI. The plaintiff's only allegation of DBAG's "substantial assistance" of any breach of fiduciary duty was DBAG's role as a counterparty to the credit default swap contracts with the Gemstone defendants. The court held generally that an allegation that a party entered into a credit default swap agreement does not by itself support a claim that the party "substantially assisted" a breach of fiduciary duty. However, the court held that the plaintiff's allegations of DBSI's participation in a fraudulent scheme and its concealment of superior knowledge with respect to the collateral and underwriting standards were sufficient to support the claim that DBSI "substantially assisted" a breach of fiduciary duty.

Breach of Contract and Rescissionary Damages

The court denied the motion to dismiss the plaintiff's breach of contract claim as against DBSI, rejecting the defendant's argument that the plaintiff was required to specify the provisions of the contract alleged to have been breached. However, the court dismissed the breach of contract claims as against Deutsche Bank Trust as vague and conclusory; assuming the plaintiff was a third-party beneficiary of the Indenture, the claims were refuted under the terms of the agreement governing all rights and remedies between the parties.

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M&T Bank

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The court denied the motion to dismiss the claims for rescission against DBSI based on fraud and mutual mistake. Given the allegations of fraudulent misrepresentation and concealment, the plaintiff was held to have made out a claim for recessionary damages. The court further held that the plaintiff was entitled to argue rescission based on mutual mistake on the alternative grounds that DBSI was alleged to have been unaware of a scheme by the collateral manager, HBK, to intentionally defraud the plaintiff. However, the court dismissed the plaintiff's claim for rescission based on illegality and dismissed the other state law clauses deceptive acts and practices clauses, false advertising clauses and clauses under the state securities statutes.

Conclusion

In *M&T Bank Corp.*, the court carefully distinguished the roles of the affiliated defendants in a complex CDO offering. The court focused on the plaintiff's allegations that certain defendants — the broker-dealer offering the CDO in a private placement and the limited partnership managing the collateral underlying the CDO — had made specific misrepresentations to and concealed material information from investors and rating agencies, and dismissed the claims as against other defendants who were merely involved in the sale or management of the collateralized debt obligation. The decision suggests that investors in residential mortgage-backed securities need to allege particularized facts, as to each defendant, even though separate defendants may be corporate affiliates and closely involved in the sale of complex financial instruments. ◎

Bank Not Liable For Payment Order Resulting In Double Payment

In *Phil & Kathy's Inc. v. Safra National Bank of New York*, 555 F.3d 103 (2d Cir. 2009), the Second Circuit Court of Appeals affirmed a district court's holding that, pursuant to Section 4-A-211 of the New York Uniform Commercial Code, a bank receiving a payment order directing payment to a non-existent customer is not void where the customer timely amends the payment order to substitute an identifiable customer.

The Facts

Phil & Kathy's is an Illinois corporation that repackages and sells prescription drugs. Safra National Bank of New York ("Safra") is a national banking association with its main office in New York City. On July 2, 3003, Phil & Kathy's authorized agent went to its bank, Harris Trust and Savings Bank ("Harris"), and issued a payment order requesting that $1.5 million be wire transferred from its account to Safra, for a beneficiary named "Banco Do Brasil SA/Proteknika Do Brasil." Harris processed that payment order that very day and wire transferred the funds to Safra. Safra, however, did not have an account owner in the name of an owner named "Banco Do Brasil SA/Proteknika Do Brasil." As such, the transaction was not completed.

On July 3, 2003, the beneficiary informed Phil & Kathy's that it had not received the money and insisted on payment that day. It also directed Phil & Kathy's to change the beneficiary name from "Banco Do Brasil SA/Proteknika Do Brasil," to "Blue Vale." Upon receipt of those instructions, Phil & Kathy's agent returned to Harris and spoke to a branch manager, who noted that the July 2 Payment Order had not cleared. The agent then issued a second payment order in the amount of $1.5 million, this time naming "Blue Vale" as the beneficiary.

After Phil & Kathy's agent left the bank on July 3, Harris sent an urgent wire to Safra requesting that the July 2 Payment Order be amended to change the named beneficiary to Blue Vale. This request to amend the July Payment Order was in addition to the new July 3 Payment Order. The following business day, Safra processed the July 3 Payment Order and credited $1.5 million to Blue Vale's account. A few days later, Safra credited an additional $1.5 million to Blue Vale as a result of Phil & Kathy's amended July 2 Payment Order. Double payment of the $1.5 million apparently was not what Phil & Kathy's intended.

Upholding the Payment Order

Phil & Kathy's filed suit against Safra in the United States District Court for the Southern District of New York, alleging that the July 2 Payment Order had been cancelled by operation of law because it did not name an identifiable beneficiary. In their complaint, plaintiffs relied on Section 4-A-207(1) of the New York Uniform Commercial Code ("N.Y.U.C.C.") which

provides, in part, that if a payment order is received by a bank and "the name, bank account number or other identification of the beneficiary refers to a nonexistent or unidentifiable person or account, no person has rights as a beneficiary . . . and acceptance of the order cannot occur." As such, plaintiffs claimed that Harris's purported amendment of the July 2 Payment Order to substantiate an identifiable beneficiary was without effect and Safra had no authority to accept the order as amended and distribute the second installment of $1.5 million to Blue Vale. In its complaint, Phil & Kathy's sought recovery of the $1.5 million duplicate payment, plus expenses and interest from Safra.

Safra moved to dismiss the complaint, pursuant to Federal Rule of Civil Procedure ("FRCP") 12(b)(6), arguing that Section 4-A-211(2) of the N.Y.U.C.C. allows the sender to amend a payment order and that such amendment can transform an otherwise void payment order into a valid one, which is exactly what occurred when Harris requested Safra amend the beneficiary's name to Blue Vale. Safra cited that portion of Section 4-A-211(2) that provides a "communication by the sender cancelling or amending a payment order is effective to cancel or amend the order if notice of the communication is received at a time and in a manner affording the receiving bank a reasonable opportunity to act on the communication before the bank accepts the payment order." Safra also claimed there was no legal authority to support the proposition that a sender's ability to amend a payment order under Section 4-A-211 does not extend to those orders that initially name an unidentifiable beneficiary, as Phil & Kathy's complaint alleged. Moreover, Safra asserted that the only provision in Article 4A of the N.Y.U.C.C. that actually addressed the circumstances under which a payment order is cancelled by operation of law is Section 4A-211(4), which states that an "unaccepted payment order is cancelled by operation of law at the close of the fifth funds-transfer business day of the receiving bank after the execution date or payment date of the order." Based on Section 4-A-211(4), Safra alleged that it properly accepted the amended July 2 Payment Order within the five business days of its receipt of Phil & Kathy's payment order.

The District Court Decision

In its opinion, the district court began its analysis by noting that N.Y.U.C.C. Article 4A is a "comprehensive scheme enacted to govern electronic wire transfers of the sort engaged in here." *Phil & Kathy's Inc. v. Safra Nat'l Bank of New York*, 595 F. Supp. 2d 330, 332 (S.D.N.Y. Feb. 2, 2009), amending and superseding *Phil & Kathy's Inc. v. Safra Nat. Bank of New York,* 2006 WL 3208587 (S.D.N.Y. Nov. 06, 2006). The court held that Safra was correct in contending that simply because a payment order contains an unidentifiable beneficiary, that does not serve to "eradicate the order itself, as the order can be freely amended cancelled."

While the first payment order of July 2 contained an unidentifiable beneficiary, the sender was free to amend or cancel the payment order prior to its acceptance. Harris, acting as sender, wired Phil & Kathy's three separate times asking it to amend the payment order, which it subsequently did. Once that order was amended to include an identifiable beneficiary, Blue Vale, Safra was free to accept the payment order and credit Blue Vale with the $1.5 million. The N.Y.U.C.C. gives banks five business days within which they can accept a payment order and Harris could have either cancelled the payment order or allowed the five-day period to lapse, neither of which were done. Instead, it chose to amend the July 2 payment order of $1.5 million.

The court acknowledged that Phil & Kathy had paid out $1.5 million more than it wanted to when its initial order was amended and a second $1.5 million payment order was issued. However, the court found that any excess outlay was "not the result of the defendant's conduct, which comported entirely with the UCC." As a result of finding that Safra's actions were in U.C.C. compliance, the district court concluded that Phil & Kathy's failed to prove any set of facts that would entitle it to relief and, as such, granted Safra's motion to motion to dismiss for failure to state a claim.

The Second Circuit Opinion

In a February 2009 opinion, the Second Circuit agreed and affirmed based on the District Court's "thorough and well reasoned opinion." *Phil & Kathy's Inc.* 555 F.3d. at 105. The Court agreed that the first wired payment order was not an unamendable nullity, and thus bank's payment of first and second orders did not constitute a violation of the N.Y.U.C.C.

Separate Action Against Harris

Phil & Kathy's also filed a separate action against Harris Bank concerning the refusal of Harris to "correct its erroneously executed $1,500,000 wire transfer..." *Phil & Kathy's, Inc. v. Harris Bankcorp, Inc.*, No. 2004 L 7329 (Ill. Cir. June 29, 2004). In that complaint, which demanded a jury trial of all triable issues, Phil

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& Kathy's alleged that Harris breached a strict duty to issue payment orders per Phil & Kathy's instructions. Phil & Kathy's then stated that as sender of an erroneously executed payment order on July 2, 3003, it was not obligated to pay the payment order that was issued. Notwithstanding the excusal of its obligation, its account was debited by Harris in the amount of $1,500,000. As a result of "Harris's improper debiting" of its account, Phil & Kathy's sought a refund of $1,500,000, in addition to expenses and attorneys' fees. As the likely result of a settlement between the parties, the complaint was subsequently dismissed by stipulation on May 7, 2008. *Phil & Kathy's, Inc. v. Harris Bankcorp, Inc.*, No. 2004 L 7329 (Ill. Cir. *dismissed* May 7, 2008). ◎

Citigroup v. Wachovia: Emergency Economic Stabilization Act Does Not Preempt State Law

In March 2009, Judge Shira Scheindlin of the United States District Court for the Southern District of New York ruled that the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 126(c), 122 Stat. 3765 (2008) (the "EESA"), enacted to stabilize the nation's banking system, does not preempt state law regarding exclusive merger agreements between banks. *Citigroup, Inc. v. Wachovia Corp.* (08 Civ. 8668). In awarding $10,000 in legal fees to Citigroup for its expenses incurred in moving to remand, Judge Scheindlin further decided that defendants' arguments that EESA preempted state law were not "objectively reasonable."

The Citigroup — Wachovia — Wells Fargo Dispute

This case arose from the much publicized failure of the late 2008 merger negotiations between Citigroup and Wachovia and the subsequent unexpected acquisition of Wachovia by Wells Fargo. Following a September 2008 Wells Fargo rejection of a potential buy-out of Wachovia, Citigroup began negotiating to acquire Wachovia. The parties signed an exclusivity agreement, by which Wachovia agreed not to "negotiate or enter into any competing acquisition agreement" for a set period of time. Negotiations between the parties continued and Citigroup and Wachovia moved closer to an agreement. Nevertheless, on October 3, 2008, three days before the exclusivity period's end, Wachovia publicly announced that it had received a purchase offer from Wells Fargo and intended to accept it. Citigroup claimed that, by so doing, Wachovia had breached the exclusive negotiation agreement.

The Emergency Economic Stabilization Act

The EESA was enacted to address the turbulence in the banking sector in late 2008 and, among other things, created the Troubled Asset Relief Program. Important to the Citigroup-Wachovia dispute was Section 126(c) of the EESA which renders unenforceable on public policy grounds agreements that limit the ability of any person to acquire an insured depository institution:

> No provision contained in any existing or future . . . agreement that, directly or indirectly — (A) affects, restricts, or limits the ability of any person to offer to acquire or acquire, (B) prohibits any person from offering to acquire or acquiring . . . all or part of any insured depository institution . . . shall be enforceable against or impose any liability on such person, as such enforcement or liability shall be contrary to public policy.

The purpose of Section 126(c) was to amend the Federal Deposit Insurance Act to allow the Federal Deposit Insurance Corporation greater latitude and authority in intervening to assist troubled banking institutions.

The Initial Lawsuit

On October 4, 2008, one day after Wachovia announced its planned merger with Wells Fargo, Citigroup filed suit against Wachovia and Wells Fargo in New York state court, seeking to invalidate the Wachovia-Wells Fargo merger pursuant to Section 126(c) of the EESA, quoted above. Specifically, Citigroup asserted causes of action for breach of contract, tortious interference with contract, and violation of Section 126 of the EESA. Later in the day on October 4, Wachovia and Wells Fargo removed the case to federal court on the basis of the federal question presented by the claim under EESA. A few hours later, Citigroup voluntarily dismissed its complaint.

The Second Lawsuit

Later on October 4, Citigroup filed a new complaint against Wachovia and Wells Fargo in New York state court. This new complaint was based on the same facts as the first complaint, but asserted only state law causes of action for breach of contract and tortious interference with contract on the basis of Citigroup's September 2008 exclusive negotiation agreement with Wachovia. In this second complaint, Citigroup dropped the claim under the EESA that had appeared in its first complaint, no doubt motivated by a desire to keep the case in state court by avoiding claims under federal law that would give rise to federal court jurisdiction. While Citigroup pled only state law causes of action, the prayer for relief in its complaint contained a reference to EESA, requesting "[a] judgment invalidating the proposed agreement between Wells Fargo and Wachovia as contrary to EESA § 126(c)." According to papers later filed by Citigroup, this reference was an inadvertent remnant of the first complaint that had contained a cause of action under EESA.

Relying on this reference, Wachovia and Wells Fargo removed the case to federal court, asserting two bases for federal court jurisdiction: (1) that the complaint asserted a cause of action under EESA, based on the reference in the prayer for relief, and thus established federal question jurisdiction; and (2) that EESA preempted state contract law with respect to such exclusive negotiation agreements to banks, precluding disputes over such contracts from being litigated in state court.

Ruling on Citigroup's motion to remand, Judge Scheindlin initially rejected the argument that the mere reference to EESA in the prayer for relief constituted a cause of action, thus holding that reference did not provide a basis for federal jurisdiction. The court found that it would "not base subject matter jurisdiction on a typographical error." The jurisdiction issue then turned on whether EESA preempted state law claims with respect to banks involved in merger discussions covered under Section 126(c) of EESA.

EESA Does Not Preempt State Contract Law

On the issue of preemption, Judge Scheindlin found that Section 126(c) of EESA does not preclude the assertion of state law causes of action on contracts that are covered thereunder. If a federal statute does not provide an exclusive remedy for a particular type of dispute, it does not preempt state law. As a result, Citigroup was free to litigate its action on the exclusive negotiation contract in New York state court by asserting claims arising under New York state law, as it had done here.

Wachovia and Wells Fargo further argued that the framework of the United States Supreme Court decision in *Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 545 U.S. 308 (2005), applied. *Grable* held that, where an "essential element" of a state law claim is dependent on the interpretation of a federal statute, federal courts may exercise jurisdiction over that claim. Judge Scheindlin rejected this argument, holding that "it would be erroneous . . . to say that Citigroup's right to relief turns on section 126(c) of the EESA."

Judge Scheindlin acknowledged that Wachovia and Wells Fargo might have viable defenses based on Section 126(c) of EESA. The court noted, however, that the existence of a federal defense does not give rise to federal question jurisdiction. Federal question jurisdiction must arise by virtue of the claims asserted by the plaintiff, and Judge Scheindlin reasoned that Citigroup's proof of the elements of its state law claims did not involve any federal questions, including those arising under EESA. Therefore, as Citigroup could prove its state law claims without requiring the New York state court to rule on EESA, despite the fact that defenses under EESA might need to be litigated, federal jurisdiction under *Grable* was precluded.

Citigroup Awarded Attorneys' Fees

Finally, turning to Citigroup's request for an award of costs and attorneys' fees for wrongful removal, Judge Scheindlin awarded Citigroup $10,000. In making this award, Judge Scheindlin noted that Wachovia and Wells Fargo should have proceeded to litigate the case in state court once they had been informed by opposing counsel that the reference to EESA in Citigroup's prayer for relief was a mistake. Further, Judge Scheindlin ruled that, because defendants "argued federal preemption even though preemption does not apply in this case," there was no "objectively reasonable" basis for Wachovia and Wells Fargo to remove the case to federal court. Therefore, Judge Scheindlin exercised discretion and awarded Citigroup, as the prevailing party, $10,000 towards its attorneys' fees and costs.

Conclusion

Citigroup v. Wachovia establishes that state law claims arising from contracts covered by EESA may be brought in state court. The ruling does not foreclose, however, the assertion of federal defenses based on Section 126(c) of EESA against the enforce-

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ment in state court of exclusive negotiating contracts with banks. Finally, as this case demonstrates, the removal of a state law contract action on the basis of EESA, without the existence of an independent basis for federal jurisdiction, may result in the imposition of fees and costs against the removing party. ◎

Accelerated State Procedure for Judgment on Promissory Note

A recent decision in the New York state court illustrates the efficiencies offered to lenders by the state procedural mechanism known as summary judgment in lieu of complaint. In *Nussdorf v. Lekach*, No. 10466-08, N.Y.L.J., Feb. 5, 2009, at 30, col. 1 (Nassau Co., Jan. 16, 2009), the plaintiff sought entry of judgment based on the defendant borrower's alleged default on a promissory note. Without the need to even file a complaint, the court issued judgment in favor of the plaintiff on his motion for summary judgment in lieu of complaint against a defendant who offered no evidence establishing the existence of a triable issue of fact.

The Promissory Notes

In *Nussdorf*, defendant Ilia Lekach allegedly executed a $3.5 million promissory note in favor of plaintiff Stephen Nussdorf on July 14, 2003. Ilia executed amended and restated notes on February 6, 2007 and February 27, 2008. The Second Amended Note required Ilia to make a $5,000 payment on the first of each month, with the balance of the loan due on December 31, 2008. In addition, defendant Deborah Lekach was alleged to have executed a personal Guaranty in which she promised absolutely and unconditionally to pay all amounts due to the plaintiff under the promissory note.

Ilia made two payments under the terms of the Second Amended Note. However, his $5,000 check for the payment due May 1, 2008 was returned by his bank for insufficient funds. Stephen alleged that Ilia's missed payment constituted a default on the note. Under the terms of the Second Amended Note, this alleged default triggered an increase in the interest rate to ten percent, the imposition of late charges, and an immediate acceleration of the balance of debt without notice or demand to the plaintiff, and permitted recovery of costs, fees and expenses incurred by Stephen in the collection on the debt. Stephen filed a motion pursuant to Section 3213 of the New York's Civil Practice Laws and Rules ("CPLR") seeking a judgment of the total amount due under the Second Amended Note, including over $4.5 million in unpaid principal and accrued and unpaid interest, plus fees and expenses.

The Procedural Mechanism

Under CPLR Section 3213, plaintiffs may move for summary judgment in their initial pleading, without the need for a complaint, when they seek recovery on an instrument for the payment of money only:

> When an action is based upon an instrument for the payment of money only or upon any judgment, the plaintiff may serve with the summons a notice of motion for summary judgment and the supporting papers in lieu of a complaint.

Defendants are entitled to submit answering papers raising defenses sufficient to defeat the motion for summary judgment. If the court denies the plaintiff's motion for summary judgment finding the existence of issues of fact, the motion papers and the defendant's answering papers are treated as the complaint and answer, unless the court directs otherwise.

A promissory note is generally considered to be an instrument for the payment of money falling within the ambit of this CPLR provision. A personal guaranty of a debt may similarly fall within the provision if it indicates on its face an unconditional promise to pay a debt, even if the guaranty itself does not recite a sum certain.

Borrower's Defenses Insufficient

In his answering papers, Ilia argued that, following the return of the check, the plaintiff's brother, Glenn Nussdorf, had assured Ilia in a phone conversation that the insufficient balance was not a problem and that Glenn would redeposit the bounced check. Ilia argued that, in reliance on this statement, he did not issue a replacement check in a timely manner but, instead, he allegedly deposited funds into his account sufficient to cover the check. Ilia also alleged that he timely sent the interest payment due June 10, which plaintiff rejected and returned. In addition, Ilia argued that plaintiff had at times

accepted late monthly payments over the prior five years.

The court held that these defenses were insufficient to defeat the motion for summary judgment in lieu of complaint. As an initial matter, the court noted that because oral modifications were prohibited under the terms of the Second Amended Note, the statements allegedly made by the plaintiff's brother did not give rise to a defense. In addition, the court found that Ilia offered no evidence that the plaintiff's brother was the plaintiff's agent authorized to speak for plaintiff. And even if there were evidence of an agency relationship, Ilia had offered no documentary evidence supporting the assertion that Glenn had stated he would redeposit the bounced May check, or that Ilia had deposited more money in his bank account. The plaintiff's brother, on the other hand, submitted an affidavit stating that the purported phone conversation was a "total fabrication."

The court also rejected Ilia's other arguments against summary judgment. Although Ilia argued that the plaintiff had an obligation of good faith under the Uniform Commercial Code in performing and enforcing the Second Amended Note, the court declined to apply such a standard to the Note in this case and noted that Ilia had failed to indicate any case applying a good faith requirement to the enforcement of a debt owing under a promissory note. In addition, the plaintiff was not equitably estopped or estopped by laches from accelerating the full amount due after the missed payment based on his brother's alleged statements because his brother was not a party to the Second Amended Note and Ilia failed to assert that the plaintiff himself had engaged in any conduct supporting an estoppel defense.

Further, the court held that Ilia had offered no evidence to support his assertion that the plaintiff had accepted late payments over the previous five years. The court held that Ilia's "conclusory assertion" of previous late payments did not "establish a pattern of acceptance of late payments under the Second Amended Note" that could support his waiver defense. The court granted summary judgment against Ilia for the full amount of the requested damages.

Guarantor Established Triable Issue of Fact

The court then turned to the plaintiff's request for summary judgment in lieu of complaint against the guarantor of the note. The court found that the plaintiff made out a prima facie case against the guarantor by establishing the existence of the Second Amended Note and the Guaranty, as well as a default under the note. In her answering papers, Deborah asserted two defenses, first that the signature alleged to be hers on the Guaranty was a forgery, and second that she was not subject to personal jurisdiction in New York State.

To support her claim that her alleged signature on the Guaranty was a forgery, Deborah submitted the affidavit of a forensic document examiner who asserted that "there are multiple indications that the signature on the Guaranty was not signed by . . . Deborah Lekach." While the examiner stated that she could not give an "absolute, unqualified opinion" because she had only a copy of the Guaranty which was of poor quality, the court held that the examiner's affidavit created a triable issue of fact sufficient to defeat the motion for summary judgment. Because the examiner offered evidence contrary to plaintiff's allegation that Deborah Lekach had signed the Guaranty, the court found that the examiner should have the opportunity to inspect the original document. Moreover, the plaintiff offered no direct evidence that the guarantor had actually signed the Guaranty.

In addition, the guarantor argued that she had never conducted any business in New York, and that consequently New York courts had no personal jurisdiction over her. The plaintiff asserted that a choice-of-forum clause in the Guaranty itself subjected the guarantor to the jurisdiction of New York courts. Because the validity of the Guaranty was in question, the court left open the personal jurisdiction question until the forgery issue was resolved, and denied plaintiff's motion for summary judgment against the guarantor.

Conclusion

In the proper circumstances, summary judgment in lieu of a complaint provides lenders a speedy, relatively low-cost means to collect certain debts in New York state courts. The *Nussdorf* decision indicates that courts will rule against defendants who can provide only "bald, conclusory allegations" in opposition to such motions. Rather, to defeat such a motion, defendants responding to a motion for summary judgment in lieu of a complaint must submit in their initial response evidence sufficient to create a triable issue of fact. ◎

Credit Card Agreement Provision Defeats Accord And Satisfaction Defense

A New York state court has recently rejected the cardholder's defense of accord and satisfaction to a collection action. A provision in the credit card agreement providing that the bank could accept partial payment without prejudice to its right to recover the balance was found to be enforceable even where the cardholder's partial payment was accompanied by a letter saying that the partial payment was in full satisfaction of the balance due. *Citibank (South Dakota) NA v. Maniaci*, Index No. 11582/07 (Dist. Ct., Nassau Co.).

Background

Defendant Maniaci defaulted on a credit card issued to him by Citibank. He owed nearly $5,000 and Citibank retained a collection agency to collect the debt. Thereafter, Maniaci's attorney sent a check in the amount of $925 to the collection agency along with a letter asserting that the check was tendered "in full settlement of the amounts claimed" and that negotiation of the enclosed check would "constitute a full Accord and Satisfaction" of the debt. Without otherwise responding to Maniaci's attorney, the collection agency cashed the check. Shortly thereafter, Citibank filed suit against Maniaci for the balance due on the card. In response, Maniaci asserted an affirmative defense of accord and satisfaction claiming that Citibank's acceptance of the check was in full satisfaction of all amounts due.

Accord and Satisfaction

An accord and satisfaction occurs when one party to a contract tenders, and the other party accepts, partial or modified performance in satisfaction of the original duty. *Restatement (Second) of Contracts* § 281 (1981). Under New York law, where the tendering party has clearly indicated that the tender constitutes a discharge of the entire outstanding obligation, cashing a check generally creates an accord and a satisfaction of the original debt unless the receiving party specifically reserves its rights. *Uniform Commercial Code* § 1-207; *Horn Waterproofing Corp. v. Bushwick Iron & Steel Co.*, 66 N.Y.2d 321 (1985). Here, the collection agency apparently did not send a notice or take other steps to reserve rights before cashing the check.

The Summary Judgment Motion

Citibank moved for summary judgment, arguing that there was no issue of material fact, as Maniaci admitted that he used the card and incurred the debt at issue. Maniaci cross moved for summary judgment against Citibank, arguing that the check and letter sent by his attorney constituted an accord and satisfaction when it was negotiated by the collection agency and thus expunged his debt. In addressing the accord and satisfaction defense, Citibank relied on the provision in the credit card agreement between Maniaci and Citibank that Citibank "can accept late or partial payments, as well as payments that reflect 'paid in full' or other restrictive endorsements" without prejudicing Citibank's right to recover the full amount due.

In rejecting Maniaci's accord and satisfaction defense, the court noted that the relationship between a credit card holder and the card issuer should be enforced according to the plain meaning of the provisions of the credit card agreement, provided that those provisions are "clear, complete, and unambiguous." The court determined that Maniaci had not satisfied all of the requirements of the Uniform Commercial Code to create an accord and satisfaction of his debt with Citibank. Maniaci did remit partial payment of a debt with an expression that constituted a "clear manifestation of intent" that the payment was offered only upon the condition of its acceptance as payment in full of the debt. The court found, however, that the "clear and unequivocal terms" of the credit card agreement between the parties precluded Maniaci from consummating the accord and satisfaction. The court held that "where the credit card agreement states the credit card company may accept later or partial payment without forfeiting any rights, receipt and acceptance of partial payment does not constitute an accord and satisfaction unless the credit card holder establishes the credit card issuer expressly agrees to accept the partial payment in lieu of defendant's obligations under the credit agreement."

No Waiver Found

The court found that Maniaci had failed to demonstrate that Citibank intended to waive the express provisions of the credit card agreement or that the collection agency expressly agreed to accept the tendered payment as satisfaction in full of Maniaci's debt. Because Citibank made a showing sufficient to warrant judgment as a matter of law, and because the parties also did not dispute any material facts, the court awarded

Citibank judgment against Maniaci in the amount owed on the credit card. In addition, the court held that the provision in the credit card agreement providing that Citibank should recover its legal fees from the cardholder was enforceable, and ordered that Maniaci reimburse Citibank for such fees.

Court Denies Bank's Request for Setoff in Lehman Bankruptcy

In *In re Lehman Brothers Holding Inc.*, No. 08-13555, 2009 WL 1302881 (Bankr. S.D.N.Y. May 12, 2009), the Bankruptcy Court for the Southern District of New York recently denied the request by DnB NOR Bank ASA ("DnB NOR") for setoff against funds transferred into the account of Lehman Brothers Holdings, Inc. ("Lehman"). The court found that, although the instructions for the intrabank transfer were given pre-petition, because the funds were not actually transferred until after Lehman filed for bankruptcy, setoff was not permitted.

Facts

Lehman maintained a general deposit account at DnB NOR. On March 1, 2008, DnB NOR and Lehman entered into a $25 million dollar revolving credit facility, with DnB NOR as lender and Lehman as borrower. The funds that are the subject of this dispute were in Norwegian Kroner ("NOK"). On Friday, September 12, 2008, those funds were held at DnB NOR in an account maintained by Lehman Brothers Commercial Corporation ("LBCC"). The procedures for the transfer of funds were governed by DnB NOR's Terms and Conditions including that any instruction for a domestic bank transfer received after 3:00 p.m. Central European Standard Time (CEST) would not be executed until the next business day. The Terms and Conditions permitted the party transferring the funds to cancel the instructions prior to 10:00 a.m. CEST on the next business day.

After 6:00 p.m. CEST on Friday, September 12, 2008, LBCC issued two transfer instructions directing DnB NOR to transfer approximately 6.8 million NOK and 200,000 NOK, respectively, into the Lehman account on the next business day, Monday, September 15. LBCC did not exercise its right pursuant to the Terms and Conditions to modify the transfer instructions prior to 10:00 a.m. CEST on September 15, 2008. The funds remained on deposit at DnB NOR and the transfer was to be recorded by electronic bookkeeping entries.

The court noted: "The transaction was completely routine and unremarkable. Funds simply were being moved internally from the account of one Lehman-related entity to another." However, because the instructions to transfer the funds were received after 3:00 p.m. CEST on Friday, September 12, 2008, the funds were not credited to the Lehman account until Monday, September 15, 2008 (the next business day) at 12:54 p.m CEST. Lehman filed for bankruptcy five hours earlier. On September 15, 2008, DnB NOR had a claim against Lehman under the Credit Facility for "not less than the funds held" in Lehman's general deposit account at DnB NOR.

Discussion

Section 553 of the Bankruptcy Code recognizes and preserves the right of setoff as it exists under applicable non-bankruptcy law provided the conditions of Section 553 are met. The "central premise of the right of setoff is the adjustment of mutual obligations." Specifically, "[t]he right of setoff . . . allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'" (quoting *Citizens Bank of Maryland v. Strumpf*, 116 U.S. 286, 289 (1995) (ellipsis in original)). However, the Bankruptcy Code makes clear that setoff is permissible from mutual obligations only if the right arose prior to the commencement of the bankruptcy case. 11 U.S.C. § 553(a).

Because the credit facility here was governed by English law and the Terms and Conditions of the Lehman account were documented in England, the court applied English law as the applicable non-bankruptcy law. English law permits setoff under the same circumstances as Section 553. Thus, the court analyzed whether the requirements of Section 553 were met, specifically "(1) the amount owed by the debtor must be a prepetition debt; (2) the debtor's claim against the creditor must also be pre-petition; and (3) the debtor's claim against the creditor and the debt owed the creditor must be mutual." *See In re BOUSA Inc.,* 2006 WL 2864964, at *3 (Bankr.S.D.N.Y.2006).

The court acknowledged that the amount owed by Lehman pursuant to the revolving credit facility was "quite obviously" prepetition debt whereas "[t]he challenge for DnB NOR is to persuasively characterize the claim to funds in the Lehman Account as a pre-petition claim." DnB NOR had the burden of establishing mutuality and the court identified that the diffi-

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Court Denies Bank's Request for Setoff

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culty for DnB NOR is that the funds in the Lehman account were contingent upon an intrabank transfer that was initiated pre-petition but not completed until post-petition.

DnB NOR and Lehman were in a debtor-creditor relationship by virtue of Lehman (creditor)'s deposit of cash into a bank account maintained at DnB NOR (debtor). As to mutuality, the court relied on the Second Circuit Decision in *In re Bennett Funding Group, Inc.,* 146 F.3d 136, 139 (2d Cir. 1998), which identified that "the proper test of mutuality with respect to bank accounts is . . . an examination of the total circumstances of the establishment and maintenance of the account." (ellipsis in original). The court relied on *Delbrueck & Co. v. Manufacturers Hanover Trust Co.*, 609 F.2d 1047, 1051 (2d Cir. 1979), for the proposition that "[t]he practices associated with banking transactions can be conclusive evidence of the legal effect of those transactions."

Relying on the Terms and Conditions, the court determined that because the instructions for transfer were received after 3:00 p.m., "[c]consistent with [DnB NOR's] stated practices, the transfer of funds, therefore, could be effected no earlier than the next business day, September 15, 2008." Specifically, the court discussed that the right to reverse the transfer instructions prior to 10:00 a.m. the next business day "made the transfer conditional as a result of the built-in delay in execution" and therefore "the transfer in fact was not completed until after the expiration of the cancellation period, which occurred after Lehman filed its bankruptcy petition." The court rejected DnB NOR's argument that it could have completed the transfer prior to September 15 because, "[w]hat matters is the actual conduct of the Bank consistent with its own Terms and Conditions and ordinary course of internal practices."

Having determined that the transfer was completed post-petition, the court next addressed "whether the Transfer Instructions themselves might be sufficient to give rise to a pre-petition claim that may be subject to setoff." To analyze this argument, the court pointed to the earlier decision of *In re BOUSA, Inc.*, 2006 WL 2864964 at *3, where the same court determined that "[f]or purposes of setoff, a debt arises when all transactions necessary for liability have occurred, regardless of whether the claim was contingent when the petition was filed." DnB NOR argued that the only thing left to complete the transaction was "the need for a book entry and the passage of time." The court disagreed, concluding that DnB had not demonstrated the requisite mutuality required for setoff because "DnB NOR needed to take action and formally accept the Transfer Instructions as a necessary condition to complete the transfer" and the "book entry" was a "critical condition to the effective transfer of the funds" because until the transfer was complete the funds were not property of Lehman. The court reiterated that the "funds must be traceable to an identified account as a pre-petition deposit before such funds can be available for setoff." Therefore, DnB NOR's argument that the "contemplated" transfer was equivalent to a completed transfer, "fails for the obvious reason that funds can only be in one account at a time, and at the time Lehman commenced its case, the funds were held in the account of LBCC."

Conclusion

Although in many instances the transfer of funds happens at "the speed of light," this case addressed — apparently for the first time — whether setoff should be permitted when the instructions for transfer predate the bankruptcy, but the transfer is not complete until after the bankruptcy case has commenced because of a delay between the instruction for the transfer and the actual transfer of the funds. Although the court addressed the legal arguments relevant to setoff, the court also appeared particularly troubled by the "broader implications of DnB NOR's position regarding setoff." The court emphasized the need for bright line rules pertaining to cash management procedures. The court stressed the need for such certainty and predictability in the context of complex global transactions such as the Lehman case where there was "regular movement of vast sums among affiliated entities." Therefore, quite simply, because the funds were not credited to Lehman until the bankruptcy case began, there could be no setoff. ◎

SEC Settles Fraud Suit with Ex-CEO of American Home Mortgage

The former Chairman of American Home Mortgage Investment Corporation ("American"), Michael Strauss, agreed to settle a federal civil suit brought against him for alleged accounting fraud and concealment of his company's collapsing finances during the first part of 2007. In addition to paying $2.2

in restitution and another $250,000 in fines, Strauss has been barred from serving as either an officer or director of any public company for the next five years.

American Home — Company Profile

As alleged by the Securities and Exchange Commission ("SEC"), by 2006, American was one of the country's largest mortgage companies. Under the leadership of Strauss, the chief financial officer Stephen Hozie, and the controller Robert Bernstein, American allegedly "enjoyed a reputation as a successful and fast-growing company." *SEC v. Strauss*, No. 09 Civ. 4150 (S.D.N.Y. filed Apr. 28, 2009). Allegedly due to risky business practices, however, the once profitable company was forced to file for bankruptcy protection.

For seven years following its initial public offering in 1999, American reported a profit every quarter. This was due in large part to the company's ability to maximize its production of new mortgages. By 2006, American was originating billions of dollars of mortgages purportedly without verifying the income of the borrower. Eventually, the SEC contended this "highly risky practice" exposed the company to liquidity problems when the pace of defaults on these loans accelerated tremendously. Instead of disclosing the detrimental impact of those defaults on the company, Strauss and Hozie allegedly set materially understated reserves that transformed American's first ever losing quarter to a profitable quarter. As lenders eventually started demanding more collateral for their loans, American was forced to file for bankruptcy protection and is now in liquidation.

SEC Civil Action

On April 28, 2009, the SEC filed a complaint against Strauss, Hozie and Bernstein in the United States District Court for the Southern District of New York. The complaint contended that Strauss and Hozie violated the antifraud provisions of the federal securities laws, specifically Section 17(a) of the Securities Act of 1933 and Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Additionally, the complaint charged Strauss, Hozie and Bernstein with aiding and abetting American's violations of the reporting, books and records, and internal control provisions under Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder, and direct violations under Section 13(b)(5) of the Exchange Act and 13b2-1 and 13b2-2.

The complaint alleged that Strauss and Hozie fraudulently understated American's first quarter 2007 loan loss reserves by tens of millions of dollars, despite the fact that they knew that the company needed at least $38 million in additional reserves, by converting the company's losses into profits. According to the complaint, both Hozie and Strauss knew that the company's own analysis showed that losses on its delinquent second liens were mounting rapidly and the company stood to lose at least 72% of the value of those loans once those properties went through foreclosure. Additionally, the SEC charged Strauss, Hozie and Bernstein with misleading American's auditor about the adequacy of American's reserves against losses on mortgages. They accomplished this by misrepresenting the adequacy of reserves and concealing the existence of approximately $20 million in aged receivables that should have been written off by the end of the first quarter of 2007.

The SEC also claimed that Strauss and Hozie made deceiving disclosures which misled investors about the company's liquidity, including failing to disclose that American was forced to sell the majority of its multi-billion mortgage backed securities portfolio in April 2007 to meet pressing liquidity demands. In an April 28, 2009, SEC Press Release, James Clarkson, Acting Director of the SEC's New York Regional Office said, "[a]s alleged in our complaint, these defendants suppressed the warning signs of the mortgage crisis and its impact on American Home Mortgage's business to the detriment of investors and the broader market." Press Release, *SEC Charges Former American Home Mortgage Executives for Misleading Investors About Company's Financial Condition* (Apr. 28, 2009). Moreover, Strauss and Hozie were alleged to have made misleading disclosures about the riskiness of mortgages that American originated and held. American originated the majority of its loans in 2006 on a "stated income" basis, without verifying the borrower's stated income. That information was not adequately disclosed to investors, however, as the company disclosed that it only held between 8% and 10% of the riskier type of loans when in fact, the percentage was much higher and close to 67% of loans held.

In its complaint, the SEC sought a judgment permanently enjoining the defendants from future violations of the federal securities laws. In addition, the complaint sought disgorgement of any ill-gotten gains, the imposition of penalties and prejudgment interest. Finally, the complaint sought to bar Strauss and Hozie from serving as officers or directors of any public company. In the SEC's Press Release, Robert Khuzami, Director of the SEC's Division of Enforcement noted that,

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Fraud Suit Settled with American Home Mortgage Ex-CEO

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"[t]hese senior executives did not just occupy a front row seat to the mortgage meltdown — they were part of the show." In noting the damaging effect that the housing market meltdown had on the company, Khuzami noted that "[a]s the housing market imploded, these executives kept secret that the company's holdings were collapsing like a house of cards."

The Settlement

As announced by the SEC, Strauss agreed to settle the SEC's civil suit without admitting or denying the allegations found within the complaint. As a part of the settlement, Strauss has been permanently enjoined from violating the antifraud, reporting, recordkeeping and internal controls provisions of the federal securities laws. Additionally, Strauss has agreed to pay $2.2 million in disgorgement and prejudgment interest, along with a $250,000 penalty. Finally, Strauss has agreed to be barred from serving as either an officer of director of a public company for five years.

While Strauss settled his suit, litigation against both Hozie and Bernstein is still ongoing. ◎

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