Norddeutsche Landesbank Girozentrale v Tilton
2018 NY Slip Op 33386(U)
December 27, 2018
Supreme Court, New York County
Docket Number: 651695/2015
Judge: Eileen Bransten

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 3

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NORDDEUTSCHE LANDESBANK GIROZENTRALE, HANNOVER FUNDING COMPANY LLC,

Plaintiffs,

- v -

LYNN TILTON, PATRIARCH PARTNERS, LLC, PATRIARCH PARTNERS XIV, LLC, PATRIARCH PARTNERS XV, LLC,

Defendants.

Index No. 651695/2015

Motion Date: 2/23/2018

Motion Seq. No. 009

DECISION AND ORDER

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BRANSTEN, J.

In this action, Plaintiffs Norddeutsche Landesbank Girozentrale ("NORD/LB") and Hannover Funding Company LLC allege Defendants Lynn Tilton, Patriarch Partners, LLC, Patriarch Partners XIV, LLC, and Patriarch Partners XV, LLC committed fraud in connection with their management of two collateralized debt obligation ("CDO") funds: Zohar II 2005-1, Limited and Zohar III, Limited (collectively, the "Zohar Funds" or the "Funds"). Presently before the Court is Defendants' motion to dismiss the Amended Complaint. For the following reasons, Defendants' motion is denied.

I. BACKGROUND

A. Plaintiffs' Investment in the Zohar Funds

According to the marketing materials and other transaction documents that governed the Zohar Funds' creation, management, and operation, the Zohar Funds were CDO funds, whose assets were primarily loans made to third-party borrower companies. (Amended Complaint ("Am. Compl.") ¶ 25.) The Zohar Funds issued and sold Class A notes (the "Notes") to investors that were secured by the loans held in the Funds. (*Id.*) The Zohar Funds were blind funds, which are common investment structures where investors are not informed of the specific borrowers to which the loans are extended; instead, investors depend upon the Collateral Manager to provide detailed and accurate information about the characteristics of the borrowers and loans. (*Id.* ¶ 26.) Tilton was the principal and controlling member of Patriarch Partners, Patriarch Partners XIV and Patriarch Partners XV. (Am. Compl. ¶ 19.) Patriarch Partners XIV and Patriarch Partners XV were the contractually defined Collateral Managers of Zohar II and Zohar III, respectively. (*Id.* ¶¶ 21-22.)

On or about January 13 and February 18, 2005, NORD/LB purchased $50 million and $25 million face value, respectively, of Class A-1 Notes issued by Zohar II. (*Id.* ¶ 157.) On or about April 11, 2007, NORD/LB purchased $60 million face value of the Class A2 and A3 Notes issued by Zohar III. (*Id.*) Plaintiffs allege NORD/LB relied on numerous representations made by Defendants in the marketing materials and transaction documents, including, but not limited to, the representations about the collateral that the

Funds would purchase, how that collateral would be managed, how Defendants, as Collateral Managers, would provide collateral information to noteholders and how Defendants would conduct themselves as Collateral Managers. (*Id.* ¶ 158.) Plaintiffs further allege these representations were false and misleading.

Plaintiffs allege Defendants used the Zohar Funds to finance leveraged buyouts and buy equity in the name of the Funds instead of buying CDOs. Defendants allegedly used the Funds' proceeds to purchase controlling interests in risky manufacturing companies ("Portfolio Companies"), made loans to those companies to fund subsequent operations, and hid these investments from the Funds' investors. Instead of operating like private equity funds, which purchase distressed companies, work to improve them, and sell them within a few years, Defendants allegedly purchased Portfolio Companies, extracted fees for lengthy periods of time, and had the Funds assume the risk of these companies. (*Id.* ¶¶ 40-43.) Ultimately, NORD/LB sold its entire investment in the Zohar Funds for a loss of over $45 million. (*Id.* ¶ 161.)

B. The SEC Proceeding

Plaintiffs allegedly learned of Defendants' fraudulent scheme on March 31, 2015, when the United States Securities & Exchange Commission ("SEC") issued an order commencing an administrative proceeding against Defendants (the "SEC Proceeding"). (Am. Compl. ¶ 11.) The SEC alleged that Defendants violated the antifraud provisions of the Investment Advisers Act of 1940 by (1) reporting misleading values for the assets

held by the Funds and thus collecting unearned management fees, (2) breaching fiduciary duties by failing to disclose a conflict of interest arising from Tilton's approach to categorization of assets, and (3) issuing false and misleading financial statements relating to impairment and fair valuing of assets. (Maloney Affirm. Ex. 2 at 2.)

On September 27, 2017, following a three-week trial, the Administrative Law Judge rendered an Initial Decision in the SEC Proceeding. The Initial Decision dismissed all fraud charges against Defendants, holding that the violations alleged in the Order Initiating Proceedings were unproven. (*Id.* at 57.) On November 28, 2017, SEC Secretary Brent J. Fields issued a Notice that the Initial Decision had become final and binding. (Maloney Affirm. Ex. 3.)

C. The Instant Action

Plaintiffs commenced this action in May 2015 by Summons with Notice and filed their Complaint on October 5, 2015, asserting two causes of action for (1) fraudulent misrepresentation and concealment and (2) negligent misrepresentation (the "Original Complaint"). Defendants moved to dismiss the Original Complaint and on March 17, 2016, this Court issued a Decision and Order granting Defendants' motion to dismiss the negligent misrepresentation claim and denying the motion as to the fraudulent misrepresentation claim. The First Department subsequently affirmed this Court's order on February 23, 2017.

Plaintiffs then moved to amend the Complaint, which was granted by Decision and Order dated January 9, 2018. On January 11, 2018, Plaintiffs filed their Amended Complaint. The Amended Complaint contains a single cause of action for fraudulent misrepresentation.

II. DISCUSSION

Defendants now move to dismiss the Amended Complaint pursuant to CPLR 3211(a)(1), (5), and (7). As an initial matter, Plaintiffs argue Defendants' motion is barred by the doctrine of law of the case arising from this Court's March 17, 2016 Decision and Order on Defendants' motion to dismiss, as affirmed by the First Department on February 23, 2017. The doctrine of law of the case only applies to legal determinations resolved on the merits. *See Thompson v. Cooper*, 24 A.D.3d 203, 205 (1st Dep't 2005). It is well settled that an amended complaint supersedes the original complaint, and thus, any previous determination regarding the sufficiency of allegations contained in the original complaint are rendered academic. *See id.* (rejecting argument that law of the case precluded motion to dismiss second amended complaint). Accordingly, the Court will analyze the merits of Defendants' motion.

Defendants argue the Amended Complaint should be dismissed because (1) Plaintiffs' claim is barred by the statute of limitations; (2) this action is barred by collateral estoppel; and (3) Plaintiffs fail to state a claim for fraudulent misrepresentation.

A. Statute of Limitations

Defendants argue Plaintiffs' claim is time barred under CPLR 213(8). A fraud-based action must be commenced within six years of the fraudulent act or two years from the time plaintiff discovered the fraud, or with reasonable diligence could have discovered it. *See Sargiss v. Magarelli*, 12 N.Y.3d 527, 532 (2009). Defendants argue Plaintiffs had all the information required to know of the alleged fraud as early as 2005 because Plaintiffs had the indentures, offering documents, and trustee reports. Defendants further argue Tilton made numerous disclosures regarding the unusual nature of the Zohar Funds on an investor call.

Plaintiffs argue Defendants make the same argument that was rejected by this Court and the First Department on their previous motion to dismiss. The First Department held that the indentures and offering documents did not put Plaintiffs on notice that Defendants "intended to use their investment as a vehicle to acquire companies for their own benefit." 149 A.D.3d 152, 159-60. Moreover, the indentures provided that the Zohar Funds were permitted to hold equity "kickers" or equity given by the lender in a workout of an under-performing loan. *Id.* Thus, the existence of equity in the funds should not have surprised or alerted Plaintiffs to Defendants' alleged scheme.

Similarly, the First Department rejected Defendants argument regarding the investor call. While the First Department recognized that Tilton opined on the call that the CDOs were not typical, the statement was far different from a statement consistent

with Plaintiffs' theory of the case and did not hint that Defendants had misrepresented the nature of the Funds. *Id.* at 160.

Under the CPLR 213(8) discovery inquiry, "where it does not conclusively appear that a plaintiff had knowledge of facts from which the alleged fraud might be reasonably inferred, the cause of action should not be disposed of summarily on statute of limitations grounds." *Saphir Int'l, SA v. UBS PaineWebber Inc.*, 25 A.D.3d 315, 316 (1st Dept 2006). Therefore, Defendants' motion to dismiss based on the statute of limitations is denied.

B. Collateral Estoppel

Next, Defendants argue this action is barred by collateral estoppel because the SEC Proceeding decided the issues in this action. Collateral estoppel applies where a prior action resolved an identical issue that is decisive in the instant action and the party to be precluded, or a party in privity with it, had a full and fair opportunity to contest the prior determination. *See Kaufman v. Eli Lilly & Co.*, 65 N.Y.2d 449, 455 (1985). The party seeking the benefit of collateral estoppel bears the burden of demonstrating identity of issues, whereas the party opposing its application has the burden of establishing the absence of a full and fair opportunity to litigate. *Id.*

In the SEC Proceeding, Defendants were charged with violations of the Advisers Act Sections 206(1), (2), and (4), and Rule 206(4)(8) thereunder. Specifically, the Commission alleged: (1) Ms. Tilton improperly categorized and overvalued loans, such

that Zohar II and III never failed their OC Ratio Tests, enabling Defendants to collect fees and other payments, and these departures from the indentures were not disclosed to investor; and (2) the Funds financial statements were false and misleading and did not comply with GAAP, in respect to impairment and fair valuing of assets. (Maloney Affirm. Ex. 2 at 47-48.) The SEC Proceeding was primarily concerned with whether Tilton misled investors about the fees they owed by making the Zohar Funds appear more valuable than they actually were.

In this action, Plaintiffs allege Defendants made misrepresentations to investors about the purpose, operation and management of the Zohar Funds and concealed the risks associated with the Zohar Funds in order to induce Plaintiffs to invest. Therefore, the SEC Proceeding did not necessarily reach the issue of whether Defendants misrepresented the purpose, operation and management of the Zohar Funds.

Furthermore, Plaintiffs argue they did not have a full and fair opportunity to litigate the issue. The mere fact that Plaintiffs would have benefitted from a ruling against Defendants in the SEC Proceeding and the fact that the SEC planned to call NORD/LB as a witness does not establish Plaintiffs were in privity with the SEC. Accordingly, Defendants' motion to dismiss based on collateral estoppel is denied.

C. Failure to State a Claim

Finally, Defendants argue Plaintiffs fail to state a claim for fraudulent misrepresentation. On a motion to dismiss a complaint for failure to state a cause of action pursuant to CPLR 3211(a)(7), the complaint must be construed in a light most favorable to the plaintiffs, all factual allegations must be accepted as true and all inferences which reasonably flow therefrom must be resolved in favor of the plaintiff. *See Allianz Underwriters Ins. Co. v. Landmark Ins. Co.*, 13 A.D.3d 172, 174 (1st Dep't 2004). However, the Court is not required to accept factual allegations that are contradicted by documentary evidence or legal conclusions that are unsupported in the face of undisputed facts. *See Zanett Lombardier, Ltd. v. Maslow*, 29 A.D.3d 495, 495 (1st Dep't 2006). Moreover, dismissal pursuant to CPLR 3211(a)(1) is warranted only if the documentary evidence submitted "utterly refutes plaintiff's factual allegations." *Goshen v. Mut. Life Ins. Co. of N.Y.*, 98 N.Y.2d 314, 326 (2002).

To state a claim for fraudulent misrepresentation, Plaintiffs must allege a "material misrepresentation of a fact, knowledge of its falsity, an intent to induce reliance, justifiable reliance by the plaintiff and damages." *Eurycleia Partners LP v. Seward & Kissel, LLP*, 12 N.Y.3d 553, 559 (2009). Furthermore, Plaintiffs must plead the circumstances constituting the wrong with particularity pursuant to CPLR 3016(b). Defendants argue Plaintiffs fail to allege (1) loss causation, (2) reasonable reliance, and (3) misrepresentations.

1. *Loss Causation*

Defendants argue any losses Plaintiffs suffered resulted from NORD/LB's business decision to sell off its interest in the Zohar Funds in 2012 prior to the Notes' maturity. "To 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)." *Laub v. Faessel*, 297 A.D.2d 28, 31 (1st Dep't 2002). Loss causation is "the causal link between the alleged misconduct and the economic harm ultimately suffered by plaintiff." *Fin. Guar. Ins. Co. v. Putnam Advisory Co.*, 783 F.3d 395, 402 (2d Cir. 2015).

Defendants argue that if Plaintiffs had held the Notes, they would have been guaranteed recovery of their investments either through liquidation of the Zohar Funds or an insurance payout from MBIA. Thus, NORD/LB's decision to sell the Notes was an "intervening direct cause" of their injury, precluding Plaintiffs' recovery based on Defendants' alleged fraudulent conduct. *See Saleh Holdings Grp., Inc. v. Chernov*, 30 Misc. 3d 1220(A), 3-4 (Sup. Ct. N.Y. Cnty. 2011) (holding plaintiff's own conduct in modifying note without defendant's consent and failing to pursue its right to enforce the guaranty within the statute of limitations was an intervening cause of plaintiff's injury). MBIA provided a financial guaranty that it would pay certain senior classes of the Zohar II funds in January 2017. In support of their argument, Defendants annex a 10-K from

MBIA, which provides MBIA paid $770 million on the Zohar Notes on January 20, 2017. (Maloney Affirm. Ex. 5 at 26.)

The allegations contained in the Amended Complaint, which are identical to the Original Complaint, are sufficient to link the poor performance of the Zohar Fund Notes to the core of Defendants' misrepresentations: *i.e.* that the Funds were not being operated as CDO funds but were operated as risky private equity funds for Defendants' enrichment. The fact intensive nature of loss causation renders resolution of these issues inappropriate on a motion to dismiss. *See Metro. Life Ins. Co. v. Morgan Stanley*, 2013 WL 3724938, at *18 (Sup. Ct. N.Y. Cnty. June 8, 2013) (Bransten J.) (holding proximate cause was not sustainable issue on motion to dismiss); *see also Schroeder v. Pinterest Inc.*, 133 A.D.3d 12, 26 n.7 (1st Dep't 2015) (noting issues of proximate cause are for the trier of fact). Therefore, Defendants' motion to dismiss based on Plaintiffs' failure to allege causation is denied.

2. *Justifiable Reliance*

Next, Defendants argue Plaintiffs fail to adequately plead justifiable reliance because they failed to conduct sufficient diligence into the structure and operation of the Funds prior to investing. As sophisticated investors, Plaintiffs had an obligation to conduct their own diligence. *See Rodas v. Manitaran*, 159 A.D.2d 341, 343 (1st Dep't 1990). "However, a sophisticated plaintiff's fraud claim will not be precluded where it has sufficiently alleged that [defendant] possessed peculiar knowledge of the facts

underlying the fraud, and the circumstances present would preclude any investigation by [plaintiff] conducted with due diligence." *NRAM PLC v. Societe Generale Corporate & Inv. Banking*, 2014 WL 3924619, at *11 (Sup. Ct. N.Y. Cnty. Aug. 5, 2014) (internal quotation marks omitted).

Here, Plaintiffs allege the Zohar Funds were owners of the Portfolio Companies and Tilton hid these facts from Plaintiffs. Moreover, as discussed above, the transaction documents and marketing materials provided to Plaintiffs did not put Plaintiffs on notice of Defendants' alleged fraud in 2005.

Defendants also argue that the Administrative Law Judge in the SEC Proceeding noted that information relating to loan performance and categorization could be calculated from Trustee Reports using "basic math." (Maloney Affirm. Ex. 2 at 26 n.36.) However, the SEC Proceeding concerned Defendants alleged fraud in overcharging investors for management fees, whereby Defendants allegedly miscategorized certain loans in order to value them higher than they were actually worth. The Administrative Law Judge's determination that investors could have figured out the actual interest rate that had been paid on each individual loan using basic math does not necessarily mean that Plaintiffs in this action should have figured out the Funds were not investing in CDOs. Therefore, Defendants' motion to dismiss based on failure to allege justifiable reliance is denied.

3. *Misrepresentations*

Finally, Defendants argue Plaintiffs fail to allege Ms. Tilton personally made any representations to Plaintiffs. Here, as on the prior motion to dismiss, Plaintiffs assert the group pleading doctrine. Under the group pleading doctrine, "defendants are responsible for the documents they prepare and distribute because no specific connection between fraudulent representations in an offering memorandum and particular defendants is necessary where . . . defendants are insiders or affiliates participating in the offer of the securities in question." *NRAM PLC v Societe Generale Corporate and Inv. Banking*, 2014 WL 3924619, at *9 (Sup. Ct. N.Y. Cnty. Aug. 05, 2014) (internal quotation marks omitted). Tilton was the principal and controlling member of the Collateral Managers of the Zohar Funds. (Am. Compl. ¶¶ 19-22.) Plaintiffs allege they relied on prospectuses, registration and other group published information in making the decision to invest in the Zohar Funds. Therefore, Plaintiffs sufficiently plead a claim against Tilton pursuant to the group-pleading doctrine.

III. CONCLUSION

Accordingly, Defendants' motion to dismiss is DENIED.

Dated: New York, New York
December 27, 2018

ENTER

HON. EILEEN BRANSTEN
J.S.C.