NRAM PLC v Societe Generale Corp.

2014 NY Slip Op 32155(U)

August 5, 2014

Supreme Court, New York County

Docket Number: 652033/2013

Judge: Melvin L. Schweitzer

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : PART 45

NRAM PLC (f/k/a NORTHERN ROCK (ASSET MANAGEMENT) PLC), Plaintiff,	Index No. 652033/2013
-against-	DECISION AND ORDER
SOCIÉTÉ GÉNÉRALE CORPORATE AND INVESTMENT BANKING, COHEN & COMPANY SECURITIES, and CIRA SCM, LLC (f/k/a STRATEGOS CAPITAL MANAGEMENT, LLC), Defendants.	Motion Sequence No. 003

MELVIN L. SCHWEITZER, J.:

NRAM plc (Northern Rock) asserts claims against Société Générale Corporate and Investment Banking (SGCIB), Cohen & Company Securities (Cohen), and Cira SCM, LLC (collectively, defendants). Northern Rock alleges causes of action for fraud, breach of contract, and unjust enrichment in relation to a collateralized debt obligation (CDO) named Kleros Preferred Funding VIII, Ltd. (Kleros VIII), structured and marketed by defendants and purchased by Northern Rock. Defendant SGCIB moves to dismiss the complaint pursuant to CPLR 3211(a) (1) and (7) and CPLR 3016 (b).

Background

The allegations are taken from the complaint.

Northern Rock is a regional English bank which had experience in mortgage finance and securitization in the United Kingdom, but not in the United States. SGCIB is the corporate and investment banking arm of its parent, France-based international financial services company, Société Générale (SocGen). Cohen is a prominent structurer and placement agent of CDOs.

Cira functions as collateral manager in connection with real estate securities, and is a subsidiary of Cohen.

At issue are the notes (Notes) issued by Kleros VIII, the accuracy of their ratings and the value of the collateral undergirding them. Kleros VIII and the Notes were structured and marketed by SGCIB, which, with Cohen, acted as Co-Placement Agents of the Notes. Kleros VIII's assets were managed by Cira. Northern Rock agreed to purchase $34,000,000 of the Notes in June 2007. On April 27, 2007, defendants provided Northern Rock with a pitchbook (Pitchbook) marketing Kleros VIII. The Pitchbook was a preliminary marketing document, which contained information as to terms, structure, and assets. The purchase took place on June 26, 2007 pursuant to an Offering Circular (OC), which was the final marketing document for the Notes.

SGCIB, Cohen, and Cira were highly knowledgeable and connected participants in the market for residential mortgage-backed securities (RMBS) and CDOs backed by RMBS and other structured finance securities. Defendants' efforts were aided by their diverse roles in the market, and in the many steps of the process leading from securitization of mortgage loans through the structuring, marketing and sale, and collateral management of a CDO. SGCIB was a major securitizer of mortgage loans and an underwriter of RMBS and CDO securities, and its sister company, TCW, was a leading collateral manager. Cohen participated in the creation of dozens of CDOs. Cohen's affiliate, Cira, was another leading collateral manager.

Each defendant had a ground-level view of mortgage practices that were endemic in the United States in 2005 and 2006, including mortgages made without verification of employment, asset checks, credit histories, or other indicators of likelihood of repayment. This gave them

special knowledge about the quality and performance of subprime loans, even RMBS issued by their competitors. Some of these RMBS ended up as collateral in Kleros VIII.

SGCIB had specific, proprietary access to loan-level information regarding the deterioration of mortgage loan quality through the reports it commissioned from Clayton Holdings (Clayton). During the relevant period Clayton assembled and regularly provided SGCIB with data on mortgage loan attributes and performance, both in aggregated form and at the granular level of individual loans. Clayton told SGCIB that many loans were defective, but nonetheless, SGCIB securitized and sold them to investors as RMBS.

In performing due diligence, Clayton gave loans that deviated from underwriting guidelines, and did not have any compensating factors, a failing grade of 3. Clayton reported these grades, and the basis for them, to SGCIB, providing SGCIB the ability to see in real time how many defective loans it was purchasing. The Clayton Trending Reports confirm that Clayton reviewed securitizations for SGCIB during the second quarter of 2006 through the first quarter of 2007. The reports that Clayton regularly provided to SGCIB gave the investment bank definitive and quantitative knowledge of the poor quality of the mortgage loans in the RMBS it securitized, critical information that was not available to investors. From the second quarter of 2006 to the first quarter of 2007, Clayton rejected 46 percent of the loans submitted for review by SGCIB. The latter waived 33 percent of those substandard loans into RMBS. SGCIB was fully aware that mortgage loans that it and other investment banks were securitizing into RMBS were defective and the securities were highly likely to default.

SGCIB secretly concluded in the latter part of 2006 and 2007 that a market free-fall was on the horizon, and that shorting the RMBS and CDO market – *i.e.,* taking positions that would profit from a collapse in the market – would benefit it financially. SGCIB's secret short strategy

is evidenced by its collaboration with the Magnetar hedge fund, which became known as one of the most active short investors in the run-up to the financial crisis. Magnetar shorted CDOs based on the view it developed in 2006 that the market for RMBS and CDOs would soon deteriorate. Magnetar's *modus operandi* was to sponsor the CDO, i.e. purchase the equity tranche to gain the confidence of other investors in the CDO, while also secretly buying credit protection (by way of credit default swaps) on the CDO's more senior tranches. In this way, Magnetar was actually shorting the CDO, because the gains it stood to make from payments on its credit protection when the CDO failed far surpassed any losses it would sustain on its equity position. While the collateral for a Magnetar CDO ostensibly was selected by an independent collateral manager, Magnetar's sponsorship allowed it secretly to control collateral selection to ensure the CDO would consist of assets favoring Magnetar's short interests, at the expense of long investors.

SGCIB developed a relationship with Magnetar to collaborate in this short strategy. The latter agreed to purchase the equity tranche of a CDO that SGCIB would structure and underwrite on the condition that Magnetar would then be allowed to short the CDO via a credit default swap. The two would thus create the appearance that a willing investor had purchased the equity tranche, giving other investors comfort in investing, and SGCIB would sell the remaining tranches to those investors. The CDO deal, which was to be named Hydrus, fell apart when the proposed collateral manager, Ischus Capital Management, balked at the poor quality of the assets Magnetar and SGCIB planned to use as collateral.

Another financial institution that, like SGCIB and the Cohen defendants, owned and/or traded in a large number of securities backed by subprime mortgages was Bear Stearns Asset Management (BSAM), which managed two funds that invested in high grade subprime

mortgage-backed securities. BSAM had a pricing policy that regularly produced valuation data in a way that was roughly equivalent to the mark-to-market practices applied by the defendants in early to mid-2007. Pursuant to BSAM's pricing policy, the BSAM funds obtained multiple "marks" (i.e. price quotations) for the securities in its funds on a monthly basis, either from the dealers that had sold them the securities or from other dealers who had become familiar with the funds' holdings. The BSAM funds sent their positions to dealers on the street at the end of each month and typically averaged the marks that they received to determine a month-end valuation for each security.

Defendants, as participants in this same market – and, in the case of the Cohen defendants, colleagues with BSAM on specific CDO deals – were aware during the month of June 2007 that sales of subprime assets were being made at distressed prices. The defendants regularly monitored and/or developed mark-to-market data and knew, just as BSAM knew, that the assets that comprised or would comprise the collateral of Kleros VIII were dropping dramatically in value.

Defendants approached Northern Rock in the Spring of 2007 to solicit its investment in Kleros VIII. In their marketing materials they described Kleros VIII as a high grade CDO with 100% of its collateral rated A3 or better, and at least 70% of its collateral rated higher than A. The marketing materials indicated that the Notes would benefit from subordination protection to a varying degree for each class of Notes. Cira was held out as an experienced collateral manager, with significant resources at its disposal, that would select and manage the CDO's collateral using exhaustive research and according to rigorous criteria for the benefit of investors. In other words, defendants held out Kleros VIII as an expertly, diligently, and independently managed high grade CDO with highly-rated collateral that would be a suitable

long investment by Northern Rock. The rigorous collateral selection methodology held out to Northern Rock and other investors was a charade. Kleros VIII collateral was actually chosen with the expectation that it would not perform. It, in fact, included CDOs structured and sponsored by Magnetar. Cira instead served the short interests of SGCIB and Cohen, which each had a large exposure to toxic RMBS and CDO assets that they were desperate to offload or hedge.

Defendants also knew, but did not disclose, that the Kleros VIII ratings were undeserved, and had only been assigned because defendants provided the ratings agencies, Moody's and Standard & Poor's, with misleading and incomplete information. SGCIB knew the ratings agencies would not look through the RMBS and CDO collateral to the performance of the underlying mortgage loans when rating the Notes. SGCIB did not disclose to the rating agencies its knowledge of the loan-level performance of Kleros VIII's collateral pool, which was deteriorating before the closing. Both the Pitchbook and the OC represented that the minimum rating of collateral to be acquired by Kleros VIII would be A3/A- as rated by Moody's and Standard & Poor's, respectively. SGCIB knew that it would not deliver to Northern Rock at closing, and did not deliver, Notes that deserved the inflated ratings assigned to them, or that were of the credit quality the ratings implied.

Defendants also misled Northern Rock regarding the subordination levels that were structured to protect each of the classes of Notes being offered to investors. SGCIB's representations in the Pitchbook and OC indicated that Class A-2 and Class B Notes marketed to Northern Rock would benefit from substantial subordination protection – $290,500,000 and $74,500,000 respectively. This was false. The Kleros VIII collateral incurred substantial losses in value even before the transaction closed. The subordination protection was illusory.

Discussion

On a motion to dismiss for failure to state a claim, the court accepts all factual allegations pleaded in plaintiff's complaint as true and gives plaintiff the benefit of every favorable inference. CPLR 3211 (a) (7); *Sheila C. v Povich,* 11 AD3d 120 (1st Dept 2004). The court must determine whether "from the [complaint's] four corners[,] 'factual allegations are discerned, which taken together, manifest any cognizable cause of action at law.'" *Gorelik v Mount Sinai Hosp. Ctr.,* 19 AD3d 319, 319 (1st Dept 2005) (quoting *Guggenheimer v Ginzburg,* 43 NY2d 268, 275 (1977)). Aside from the allegations themselves, the court must also "accept as true . . . whatever can be reasonably inferred therefrom in favor of the pleader." *P.T. Bank C. Asia v ABN AMRO Bank N.V.*, 301 AD2d 373, 375-76 [1st Dept. 2003]. Vague and conclusory allegations, however, are not sufficient to sustain a cause of action. *Fowler v American Lawyer Media, Inc.*, 306 AD2d 113 (1st Dept 2003).

Dismissal pursuant to CPLR 3211 (a) (1) is allowed if "a defense is founded upon documentary evidence." Such evidence must be "unambiguous, authentic, and undeniable." *HSH Nordbank v Goldman Sachs Group, Inc.*, 2013 NY Slip Op 33015(U), at *4 [Sup Ct, NY County 2013]. "To succeed on a [CPLR 3211 (a) (1)] motion . . . a defendant must show that the documentary evidence upon which the motion is predicated resolves all factual issues as a matter of law and definitively disposes of the plaintiff's claim." *Ozdemir v Caithness Corp.,* 285 AD2d 961, 963 (2d Dept 2001). Furthermore, it is appropriate to grant such a motion to dismiss "where [such evidence] utterly refutes plaintiff's factual allegations, conclusively establishing a defense as a matter of law." *Goshen v Mut. Life Ins. Co.,* 98 NY2d 314, 326 [2002].

Fraud

To state a claim for fraud, a plaintiff must allege "[1] a material misrepresentation of a fact, [2] knowledge of its falsity, [3] an intent to induce reliance, [4] justifiable reliance by the plaintiff, and [5] damages." *Eurycleia Partners, LP v Seward & Kissel, LLP,* 12 NY3d 553, 559 [2009]. CPLR 3016 (b) requires that "the circumstances constituting the wrong shall be stated in detail." Under this heightened pleading standard, the plaintiff must state each element "in sufficient detail to give a defendant a fair opportunity to prepare a defense." *People v Charles Schwab & Co., Inc.,* 2011 NY Misc. LEXIS 5387, at *15 [Sup. Ct. 2011] *affd in part*, 109 AD3d 445 [1st Dept 2013]. If sufficient factual allegations with regards to even a single element are lacking, "then the cause of action must be dismissed." *Loreley Fin. (Jersey) No. 7, Ltd. v Credit Agricole Corp. and Inv. Bank*, No. 650673/2010, Slip Op. at 8 [Sup Ct NY County June 16, 2011].

Misrepresentations and Omissions

SGCIB contends that Northern Rock has not adequately meet the heightened standards for pleading fraud as the alleged facts are not detailed in quality. It contends that Northern Rock resorts to fraud-by-hindsight after seeing that its investment has deteriorated in value. New York courts have reflected this thrust. *See Cuomo v Charles Schwab & Co., Inc.,* No. 453388/2009, 2011 WL 5515434, at *8 (Sup Ct NY Cnty Oct. 24, 2011) ("Fraud by hindsight [] will not sustain the complaint . . . if it fails to allege facts demonstrating [] a statement was [] misleading when made."). This approach of the New York courts raises specific questions with respect to Northern Rock's allegations referencing the Notes' ratings and subordination protection.

SGCIB argues that even if Northern Rock has adequately alleged detailed misrepresentations, it cannot be held liable. Northern Rock's allegations, it says, rely on

actionable misrepresentations in the Pitchbook, even though there is language in that document, as well as in the OC, that states Pitchbook material may be "superseded, amended and supplemented. . . ." Pitchbook at 2-3; *see Banco Espirito Santo de Investimento, S.A. v Citibank N.A.,* No. 03 Civ. 1537, 2003 WL 23018888, *5, 14 (SDNY Dec. 22, 2003) (dismissing fraud claim where offering materials indicated the defendant would not be bound by statements outside the final offering document). Additionally, the OC states that it is a statement of the Co-Issuers – Kleros Preferred Funding VIII, Ltd. and Kleros Preferred Funding VIII, LLC – and expressly not SGCIB. SGCIB contends that, as in *Emps.' Ret. Sys. v Morgan Stanley & Co.,* 814 F Supp 2d 344, 353 (SDNY 2011), the fact that the offering material was not a statement by the defendant is fatal to the plaintiff's claim.

SGCIB's arguments are unpersuasive. The court addresses them seriatim.

Pludeman v Northern Leasing Sys., Inc., 10 NY3d 486, 491-92 is a reminder that the requirement to plead sufficient detail under CPLR 3016 (b) should not be "so strictly interpreted," nor should it be confused with "unassailable proof of fraud." This is especially true in instances where it may be impossible to state with any further particularity the circumstances constituting fraud, such as when the concrete facts are peculiarly within the knowledge of the committing party. "Necessarily, then, section 3016 (b) may be met when the facts are sufficient to permit a reasonable inference of the alleged conduct." *Id.; see also Polonetsky v Better Homes Depot,* 2001 Slip Op. 09256 (Court of Appeals NY 2001).

The complaint has alleged in granular detail, and with particularity, facts that form the foundations of reasonable inferences that SGCIB committed fraud in marketing Kleros VIII to Northern Rock. Northern Rock provides ample factual support for the allegation that SGCIB knew the RMBS and housing markets were drying up and the mortgages they pooled were

rapidly deteriorating in value, yet still marketed Kleros VIII as filled with high grade collateral. This is hardly a case of fraud by hindsight.

Recently, this court rejected a defense attacking supposedly conclusory and speculative allegations in another CDO action that provided less detail than Northern Rock provides here. *See CIMB Thai Bank PLC, v Morgan Stanley*, 2013 NY Slip Op 32264(U) (Sup Ct NY County 2013). In that action, the plaintiff sought to hold the defendants liable for fraud by contesting the accuracy of the defendant's representations of the CDO collateral manager's independence and alleged the misrepresentations of the quality of investments they marketed. Unlike the case at hand, Thai Bank's alleged facts only referenced the biases of their portfolios, the structures of such portfolios, and the defendants' shorting strategy that led to a strong inference that the purported independent third-party managers were not in fact independent. *Id.* at 7. The court denied Morgan Stanley's motion to dismiss.

Houbigant, Inc. v Deloitte & Touche, LLP, 303 AD2d 92, 97 (1st Dept 2003) holds that "[t]he language of CPLR 3016 (b) merely requires that a claim of fraud be pleaded in sufficient detail to give adequate notice." *Id.* at 97; *see also Foley v D'Agostino,* 21 AD2d 60, 64 (Sup Ct AD, 1st Dept 1964). Northern Rock's allegations are specific to the marketing and sale of the Notes and quality of the collateral, which gives clear notice to defendants.

SGCIB's attempts to shield itself from allegations of misrepresenting the Notes' credit ratings fall short for several reasons. Defendant's assertion that credit ratings are non-actionable statements of rating agencies' opinions varies from New York law. New York courts have said that "alleged misrepresentations concerning credit ratings were not statements of predictions or opinions and instead were 'facts constituting the actual evaluation by reputable independent entities concerning the creditworthiness of the Notes.'" *MBIA Ins. Corp. v Royal Bank of Can.*,

28 Misc 3d 1225(A), 2010 Slip Op 51490(U), at *34 (citing *M&T Bank Co v Gemstone CDO VII, Ltd.*, 23 Misc 3d 1105(A), 2009 NY Slip Op 50590(U) (Sup Ct, Erie County 2009), *affd as modified*, 68 AD3d 1747 (4th Dept 2009)). The credit ratings are representations of "present analysis of current valuation" and form the basis of actionable misstatements. *M&T Bank*, 23 Misc 3d 1105(A), 2009 Slip Op 50590(U), at *12.

This is not a case in which plaintiff takes issue with the ratings agency, but rather the allegation that defendant possessed knowledge as to the lack of support for the ratings. *See Allstate Ins. Co. v Credit Suisse Sec. (USA) LLC*, 2014 NY Slip Op 50106(U), at *14 ("[a]llegations based on credit ratings have been upheld, . . . where the complaint focused not on the subjective belief of the ratings agency but on the knowledge of the defendants as to the support of the ratings"). Northern Rock alleges that SGCIB withheld material information in order to procure unjustified ratings that eventually induced Northern Rock to invest.

The court has sustained fraud claims where the defendants allegedly marketed highly rated securities when they knew the ratings were false. In *China Dev. Indus. Bank v Morgan Stanley*, Index No 650913/2010, 2011 NY Misc LEXIS 1808, Morgan Stanley allegedly marketed a CDO it arranged as "more stable than a 'AAA' rated bond" and possessing "more stable credit ratings than similarly rated corporate bonds." *Id.* at *4. Upon the plaintiff's allegations that the ratings process was deeply flawed, Morgan Stanley's influence over the process, and consequently its knowledge of the ratings' falsity, the court held that plaintiff adequately plead misrepresentation. In *Abu Dhabi Commercial Bank v Morgan Stanley & Co. Inc.*, 651 F Supp 2d 155 (SDNY 2009), the court stated that the defendant's marketing of highly rated notes in spite of its knowledge of the ratings' inaccuracy sufficiently constituted misrepresentation.

The facts Northern Rock alleges mirror these cases. CDIB and Abu Dhabi Commercial Bank's allegations closely track Northern Rock's – the credit quality of collateral would be high grade, the marketed ratings from Standard & Poors and Moody's from both the Pitchbook and the OC reflected the true credit quality of the Notes, and SGCIB's knowledge of the falsity of the ratings and these statements.

There is a similar information asymmetry between SGCIB's alleged knowledge of the true state of the Kleros VIII collateral's subordination levels and how it marketed them to Northern Rock. The court disagrees with SGCIB's assertion that Northern Rock misunderstood the meaning of subordination. The subordination marketed in the Pitchbook and confirmed in the OC was allegedly not accurate, since the value of the collateral was collapsing and SGCIB knew this. Northern Rock alleges all of this. The court in *MBIA Ins. Corp. v Royal Bank of Canada,* 28 Misc 3d 1225(A) 2010 NY Slip Op 51490(U) (Sup Ct, Westchester County 2010) recognized that allegations of the defendant's "actual knowledge . . . of the losses that were occurring in the collateral and the consequent deterioration in the subordination protection" were sufficient to state a claim for fraud. *Id.* at *33.

SGCIB contends that Northern Rock is pointing to alleged misrepresentations in the Pitchbook, and that both the Pitchbook and OC say the offering is being made only through the OC, and that material not contained in the OC may not be relied upon. It is certainly the case in complex financings that there are frequently preliminary and final offering documents that contain such language of limitation. Customarily, large portions of the preliminary document are not excised from the final. Fine tuning and completion is the purpose of the exercise. Not so here, where significant portions of the Pitchbook do not appear in the OC. Much of this material is said to contain misrepresentations made as part of a fraudulent marketing scheme.

The court knows of no precedent for allowing an offeror of securities to use such a mechanic to amble away from liability for key misrepresentations used to induce investors to purchase securities. Disclaimers are recognized in New York in limited situations, if specifically tailored to alert investors to known risks. Abandonment in plain view of essential pieces of a fraudulent marketing plan is a different animal. If tolerated, malefactors would rush to own one. Markets would be negatively impacted, and the cost of capital inefficiently increased. SGCIB's position is unavailing.

SGCIB contends that the language of the OC shields it from liability because the OC attributes its contents to the Co-Issuers, legal entities just formed to hold the collateral and issue the Notes. Liability for misrepresentations is said to be quarantined to these corporate entities. Regarding a similar provision, the court in *Allstate Ins. Co. v Morgan Stanley & Co.*, 2013 NY Slip Op 31130(U), said that "[d]efendants may be liable for drafting and distributing statements they knew to be false, regardless of who they credit as the source of the information." *Id.* at *35. *See also Metropolitan Life Ins. Co. v Morgan Stanley*, 2013 Slip Op 31544(U) (Sup Ct, NY County 2013), at *28.

The group pleading doctrine supports Northern Rock's position of SGCIB's liability. The doctrine allows plaintiffs to "rely on a presumption that statements in prospectuses, registration statements . . . or other group-published information are the collective work of those individuals with direct involvement in the everyday business of the company." *Dodona I, LLC v Goldman, Sachs & Co.*, 847 F Supp 2d at 647 n. 13 (quoting *In re Oxford Health Plans, Inc.*, 187 FRD 133, 142 (SDNY 1999)). Under the doctrine, defendants are responsible for the documents they prepare and distribute because "no specific connection between fraudulent representations in [an] [o]ffering [m]emorandum and particular defendants is necessary where ...

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defendants are insiders or affiliates participating in the offer of the securities in question." *Abu Dhabi,* 651 F Supp 2d at 177 (quoting *Luce v Edelstein*, 802 F2d 49, 55 (2d Cir. 1986)).

Scienter

To satisfy this element, plaintiff must allege that defendant knowingly made false statements with the intent to deceive. The pleading need only "contain[] some rational basis for inferring that the alleged misrepresentation was knowingly made." *Houbigant,* 303 AD2d at 98. This requirement "should not be confused with an unassailable proof of fraud." *Pludeman,* 10 NY3d at 492.

SGCIB posits its interests were firmly in line with those of Northern Rock, and references Société Générale's investment of over $2.5 billion in the Notes. Northern Rock introduces several factors that potentially undermine the strength of this argument, such as the size and price of the position and the amount of fees SGCIB expected to earn.

This is a factual issue which will not be resolved at this stage. *See Allstate Ins. Co. v Morgan Stanley & Co.*, 2013 NY Slip Op 31130(U), at *22 (Sup Ct NY County 2013) (rejecting defendant's contention that its retention of equity in an RMBS negated an inference of scienter, because this "motive-related argument[] regarding the rationality of plaintiffs' allegations" merely raises a fact issue inappropriate to resolve on a motion to dismiss). Perhaps SGCIB was an all in long investor, but, then, it may have retained an unmarketable position taken to facilitate the transaction.

SGCIB contends that nothing in Northern Rock's kitchen-sink approach alleging general knowledge of the failing market actually referenced the Kleros VIII offering specifically. It cites *Landesbank Baden Wurttemberg v Goldman, Sachs & Co.*, 821 F Supp 2d 616, 622 (SDNY 2011) where the court said "reference to raw data is not sufficient to plead that defendant[]

knowingly made false statements." The applicable New York standard only requires a "reasonable inference," of scienter, while Rule 9(b) of the Federal Rules of Civil Procedure and its interpreting case law is far more demanding. *See Novak v Kasaks,* 216 F3d 300, 309 (2d Cir 2000) ("[w]here plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information"). *Landesbank* is not helpful to SGCIB.

SGCIB's reliance on *Woori Bank v RBS Securities, Inc.*, 910 F Supp 2d 697 (SDNY 2012) is similarly questionable and the court looks to *CIMB Thai Bank* as more analogous and instructive.

> Defendants' reliance on *Woori Bank* is unavailing, as in that case, the court found no additional allegations which would have satisfied the pleading with particularity requirement for scienter. For example, the court found no allegation that the defendants were simultaneously marketing these CDOs to Woori while at the same time going short on the very assets that comprised them. Here, Thai Bank has clearly pleaded that defendants engaged in self-dealing, marketing the CDO's long position while taking the short position themselves. More significantly, Thai Bank has alleged that defendants misrepresented their role as portfolio manager to Thai Bank, an assertion not necessarily confined to documentary proof.

CIMB Thai Bank, 2013 NY Slip Op 32264(U), at *18.

In *Stichting Pensioenfonds ABP v Credit Suisse Group AG,* 2012 NY Slip Op 5243(U) (Sup Ct NY County 2012), the court concluded that the scienter element can be satisfied where the complaint alleges that:

> [D]efendants were involved in every step of the complex process that eventually resulted in the Certificates including making the mortgage loans, selecting the loans for securitization, commissioning diligence reviews of the loans, servicing the loans, monitoring loan performance, bundling the loans into RMBS, and selling the RMBS Certificates to investors.

As in *Stichting,* the court finds it "rational to infer that [the defendant] knew that many of the representations in its Offering Documents were false." *Id.* at *10.

Reliance

When assessing whether a plaintiff has alleged reasonable reliance on a motion to dismiss, a court may "consider the entire context of the transaction, including ... the sophistication of the parties, and the context of any agreements between them." *CIMB Thai Bank PLC,* 2013 NY Slip Op 32264(U) at 1. A court must be mindful that "[t]he pleading requirements for reliance are minimal on a motion to dismiss, and it is generally premature to decide the question at the pleading stage." *Allstate Ins. Co. v Stanley*, 2013 WL 2369953 (N.Y.Sup.), 15.

Northern Rock alleges that it relied on SGCIB's misrepresentations in the Pitchbook, OC, and other communications concerning the high ratings of the collateral and the Notes, the subordination protection afforded to various tranches of the Notes, the safety of supposedly comparable assets historically, and the experience and skill of the ostensibly independent collateral manager. It contends this reliance was reasonable because it was not industry practice for an investor in Northern Rock's position to perform a complete loan-level, forensic revaluation of a complex CDO by assessing the hundreds of underlying securities and tens of thousands of loans that made up the collateral of a CDO (including CDOs within the collateral) in order to verify representations regarding the investment quality of the securities it purchased. As a result, Northern Rock did not know and could not have reasonably discovered that SGCIB and its collaborators were allegedly offloading substandard RMBS assets into Kleros VIII, marketing the Notes through exaggerated ratings and subordination cushions, and then shorting the investments.

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SGCIB's arguments that Northern Rock has failed to allege reasonable reliance are twofold. First, SGCIB maintains that the complaint shows that if Northern Rock had done routine diligence and analyzed the loan-level data of the underlying collateral, it could have learned of the alleged misrepresentations. Second, the disclaimers and disclosures in the OC as well as Northern Rock's awareness of the risks in the U.S. market at the time of the transaction preclude Northern Rock from alleging reasonable reliance, particularly when it did not conduct its own due diligence. Third, Northern Rock disclaimed any reliance on SGCIB as a condition of purchasing the notes and represented that it had access to the requisite financial information to make an independent decision to invest in Kleros VIII. SGCIB highlights these passages in the OC:

- [P]rospective investors must rely on their own examinations of the co-issuers and the terms of the offering, including the merits and risks involved, and must not rely upon information provided by or statements made by the initial purchaser, the co-placement agents, or any of its affiliates.

- It is expected that prospective investors are ... willing and able to conduct an independent investigation of the risks posed by an investment in the offered securities.

In light of the disclaimers and general awareness of the investment risks, SGCIB contends that Northern Rock's failure to plead its diligence requires dismissal.

New York charges sophisticated investors such as Northern Rock with an affirmative duty to protect themselves from misrepresentations made during business transactions. *Phoenix Light SF Ltd. v Goldman Sachs Group, Inc.*, 43 Misc 3d 1233(A) [Sup Ct 2014] at *5; *see also HSH Nordbank AG v UBS AG*, 95 AD3d 185, 194-195 [1st Dept 2012] ("As a matter of law, a sophisticated plaintiff cannot establish that it entered into an arm's length transaction in justifiable reliance on alleged misrepresentations if that plaintiff failed to make use of the means

of verification that were available to it"). 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." *Allstate Ins. Co. v Morgan Stanley*, 2013 WL 2369953 (N.Y.Sup.), 15 (citing *China Dev. Indus. Bank v Morgan Stanley & Co. Inc.*, 86 AD3d 435, 436 [1st Dept 2011]).

This is true even if a sophisticated plaintiff had previously disclaimed reliance on a defendant. *See e.g. Basis Yield Alpha Fund Master v Stanley*, 2013 WL 942359 (N.Y.Sup.), 2 (holding that "detailed and extensive disclaimers of reliance in the Master Purchase Letter ... w[ould] not bar a claim for fraud if the plaintiff has made specific allegations regarding facts known to the defendant and which could not have been discovered by the plaintiff in the course of due diligence"). Northern Rock must sufficiently allege that SGCIB "possessed peculiar knowledge about the misrepresentations and omissions, and that plaintiffs could not have uncovered the misrepresentations and omissions even with reasonable due diligence." *Phoenix Light SF Ltd. v Goldman Sachs Group, Inc.*, 43 Misc 3d 1233(A) [Sup Ct 2014] at *5. The court finds that Northern Rock has done precisely that.

SGCIB's arguments are not compelling. First, it mischaracterizes the complaint by arguing that Northern Rock admits it could have learned of the alleged misrepresentations if it had done routine diligence. In fact, Northern Rock has specifically alleged both that it was not industry practice for a potential investor to assess each and every loan in the thousands comprising the Kleros VIII collateral, and that its lack of access to granular information about the CDO collateral pools did not permit it to do so. This case bears significant differences from cases that SGCIB uses for support. In *HSH Nordbank AG*, 95 AD3d 185, 194-195 (1st Dept

2012), the facts regarding the fraud were available publically and through market data. *UST Private Equity Invs Fund* is also distinguishable because one of the plaintiffs' officers possessed the very documents containing the telltale information that later alerted the plaintiffs to the alleged fraud. Here, Northern Rock specifically alleges that "even with the most extensive inquiry" it could not have discovered the information misrepresented and concealed by SGCIB.

SGCIB also relies on *Phoenix Light SF Ltd. v Goldman Sachs Group, Inc.*, 43 Misc 3d 1233(A) [Sup Ct 2014]. In that case, while Phoenix Light pled that the defendants possessed peculiar knowledge regarding the investment, the complaint acknowledged that the plaintiffs could have discovered the defendants' alleged fraud if they had asked for the loan files that were in the defendants' possession at the time of the transaction. *Phoenix Light SF,* 43 Misc 3d 1233(A) [Sup Ct 2014] at *7. The court concluded that "[i]t does not matter if the failure to seek this information was because of blind faith in the process of origination and/or securitization, or if it was attributable to the desire to quickly get on board of what the investors thought was a profitable bandwagon; the obligation of a sophisticated investor to inquire cannot merely be excused." *Id.*

Phoenix Light is markedly different from this case. Northern Rock maintains throughout its complaint that SGCIB had peculiar knowledge that Kleros VIII had junk collateral instead of the high quality collateral it had promised, that the monthly mark-to-market valuations showed Kleros VIII was grossly overvalued, that SGCIB and its collaborators withheld critical information from the rating agencies to inflate the securities' ratings, and that they intended to short the Kleros VIII investment. Northern Rock has very clearly alleged that it did not have access to granular information with respect to the mortgage pools and that no amount of investigative diligence could have alerted it to these underlying problems.

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This case is analogous to *China Dev. Indus. Bank v Morgan Stanley*, where the plaintiff alleged that the defendant had suborned and corrupted the ratings agencies so that they would assign higher ratings to their securities. *China Dev. Indus. Bank,* 2011 NY Misc. LEXIS 1808, at 14 (NY Sup Ct Feb 25, 2011) *affd in part*, 86 AD3d 435, 436 [1st Dept 2011]). The court upheld the plaintiff's fraud claim because the complaint "posit[ed] a set of circumstances constituting fraud, with respect to the investment here, that could not have been discovered by any degree of due diligence or analysis performed by the most sophisticated of investors." *Id.* at 14-15; *see also CIMB Thai Bank PCL v Morgan Stanley*, 2013 WL 5314330 (NY Sup Ct), 1 ("even a sophisticated investor armed with a bevy of accountants, financial advisors, and lawyers could not have known that [defendant] would select inherently risky underlying assets and short them"). Because Northern Rock has alleged, among other things, that SGCIB submitted outdated information to the ratings agencies to produce the inflated ratings, the court does not believe that any amount of due diligence would have uncovered the alleged fraud.

With regard to SGCIB's second line of argument, SGCIB does not cite any cases in which disclaimers, general disclosures with respect to risk, or general awareness of the U.S. market's risks precluded fraud where the plaintiff had also specifically alleged that the defendant possessed peculiar information regarding the underlying investment and that the plaintiff could not have uncovered the fraud. As the First Department said in *China Dev. Indus. Bank*, the general rule that contractual disclaimers can preclude a sophisticated plaintiff from pursuing a fraud claim is not determinative where the plaintiff has "sufficiently alleged that [the defendant] had peculiar knowledge of the facts underlying the fraud and that the circumstances present would preclude any investigation ... conducted with due diligence." *China Dev. Indus. Bank,* 86

AD3d 435, 436 [1st Dept 2011]). The general disclosures and awareness of the riskiness of the investment are unavailing to bar Northern Rock from alleging reasonable reliance.

Northern Rock has pled with particularity that SGCIB possessed peculiar information regarding the underlying problems with the Kleros VIII collateral, that SGCIB misled the rating agencies with respect to the value of the Kleros VIII collateral, and that no amount of due diligence could have discovered the alleged misrepresentations and concealments.

Northern Rock has pled reasonable reliance.

Loss Causation

Closely related to proximate cause, loss causation requires that "the misrepresentations directly caused the loss about which plaintiff complains." *Laub v Faessel*, 297 AD2d 28, 31 (1st Dept 2002). Without "some reasonable connection between the act or omission of the defendant and the damage which the plaintiff has suffered," a fraud claim will fail. *Id.* A plaintiff may satisfy the requirements of loss causation if "it was foreseeable that [the plaintiff] would suffer losses as a result of relying on [the defendant's] alleged misrepresentations." *MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, 87 AD3d 287, 295 [1st Dept 2011]; *see also Silver Oak Capital L.L.C. v UBS AG*, 82 AD3d 666, 667 (1st Dept 2011) (finding that the plaintiffs have sufficiently alleged loss causation "since it was foreseeable that [plaintiffs] would sustain a pecuniary loss as a result of relying on [defendant's] alleged misrepresentations"); *AUSA Life Ins. Co. v Ernst and Young*, 206 F3d 202, 217 [2d Cir 2000] ("we will continue to treat loss causation…as a concept which embodies notions of foreseeability"). Loss causation prevents plaintiffs from casting the nets of liability too broadly. *See Loreley Fin. (Jersey) No. 4 Ltd. v UBS Ltd.*, 42 Misc 3d 858, 865 [Sup Ct 2013] ("Misconduct may have occurred, but if the misconduct was not the basis for the loss, a viable claim is not pleaded").

SGCIB argues that Northern Rock does not provide particular facts that illustrate how its alleged misrepresentations caused its losses as opposed to the collapse of the housing market in general, and the subsequent financial crisis. It relies on *Fin. Guar. Ins. Co. v Putnam Advisory Co.*, No. 12 Civ 7372, 2013 WL 5230818 (SDNY Sep 10, 2013), where the plaintiff maintained it had pled loss causation by alleging "that the very wrong of which it complains – that the collateral was selected by a net short investor with interests adverse to long investors – caused the collateral to be far more likely to default than that of a typical CDO, even in the event of market-wide losses." *Id.* at *3. The court there held that plaintiff did not satisfy the loss causation prong of fraud because it failed to plead "facts sufficient to demonstrate that there was *any* pool of collateral that could have avoided default while still conforming to [the CDO's] detailed eligibility criteria." *Id.* (emphasis in original).

SGCIB's attempt to escape liability by suggesting that the general market downturn was an intervening cause has already been consistently rejected on numerous occasions. *See e.g. Allstate Ins. Co. v Morgan Stanley & Co.*, 2013 WL 2369953 (NY Sup Ct), at *11 (observing that the defendants' claim that the market downturn was an intervening cause is premature); *MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, 87 AD3d 287, 296 [1st Dept 2011]; (holding that "[i]t cannot be said, on this pre-answer motion to dismiss, that [plaintiff's] losses were caused, as a matter of law, by the 2007 housing and credit crisis"); *Allstate Ins. Co. v Credit Suisse Sec. (USA) LLC*, 42 Misc 3d 1220(A) [Sup Ct 2014] at *15.

In the wake of a market downturn or crisis of the type that occurred in 2007-2008, a plaintiff must plead "facts which, if proven, would show its loss was caused by the alleged misstatements as opposed to intervening events." *Lentell v Merrill Lynch & Co., Inc.*, 396 F3d 161, 174 [2d Cir 2005]. As explained in *Loreley Fin. (Jersey) No. 4 Ltd. v UBS Ltd.*, part of the

rationale behind this precedent is to fend off opportunistic investors attempting to take advantage of market-wide downturns to recoup lost investments when their losses had nothing to do with any alleged representations made by the defendant. 42 Misc 3d 858, 864 [Sup Ct 2013]. However, "[i]t is not...necessary to allege that the entirety of the loss was caused by the alleged misstatements and none was caused by the more general market decline." *Allstate Ins. Co. v Stanley*, 2013 WL 2369953 (NY Sup Ct), 12. Where the plaintiff has sufficiently pled some causation between the defendant's alleged misstatements and its resulting loss, even if the defendant claims that an intervening cause (such as the 2007-2008 financial crisis) was to blame, causation "is a matter of proof at trial and not to be decided on a ... motion to dismiss." *HSH Nordbank AG v Goldman Sachs Group, Inc.*, 43 Misc 3d 1225(A) [Sup Ct 2013] (citing *Emergent Capital Inv. Mgt., LLC v Stonepath Group, Inc.*, 343 F3d 189, 197 [2d Cir 2003]).

Northern Rock has alleged a chain of causation where the misrepresentations regarding the underlying collateral and the inflated ratings caused the Notes to be grossly overvalued not just after the market crash – but at the very moment when Northern Rock purchased them. *See e.g. Stichting Pensioenfonds ABP*, 38 Misc 3d 1214(A) at *12-13 (describing a chain of causation involving an abandonment of underwriting standards in an investment vehicle). Northern Rock contends the Notes were grossly overvalued at the time of the transaction because, foreseeing future problems with the mortgage market, SGCIB and its affiliates offloaded its defective mortgage-backed securities into the collateral. As mentioned above, the ratings were falsely inflated to make the collateral more attractive to investors. Northern Rock has sufficiently alleged a chain of causation leading from the alleged offloading of toxic collateral and securing false ratings by deception to a decline in the value of its Notes.

Northern Rock has pled loss causation.

Damages

Due to SCGIB's misrepresentations as alleged, Northern Rock justifiably relied on the Pitchbook and OC. Northern Rock agreed to invest a total of $34,000,000 in two classes of Notes on June 8, 2007. The Notes became worthless. Northern Rock's damages equal the amount it invested.

SGCIB's motion to dismiss Northern Rock's cause of action of common law fraud is denied.

Breach of Contract

Northern Rock alleges a breach of contract claim against SGCIB. A cause of action for breach of contract requires plaintiff to allege the existence of a contract, that plaintiff performed under the contract, that defendant breached the contract, and that plaintiff sustained damages. *JP Morgan Chase v J.H. Electric of New York, Inc.*, 69 AD3d 802 (2d Dept 2010); *Furia v Furia,* 116 AD2d 694 (2d Dept 1986).

Northern Rock's allegations that SGCIB's behavior amounted to a breach of contract are reminiscent of its allegations of misrepresentation. Northern Rock alleges that a material term of the purchase agreement for the Notes was that SGCIB would deliver securities that had legitimately earned and had been assigned high grade ratings. Thus, SGCIB's failure to deliver Notes that were actually of such quality constituted a material breach by defendant of its contract with plaintiff. SGCIB, on the other hand, rebuts that it never gave assurances of credit quality in the first place.

Northern Rock relies on *MBIA Ins. Corp. v Royal Bank of Canada,* 28 Misc 3d 1225(A), 2010 NY Slip Op 51490 (Sup Ct, Westchester County 2010) (borrowing the holding from *MBIA Ins. Corp. v Merrill Lynch,* 27 Misc 3d 1233(A), 911 NYS2d 694 (NY Sup Ct 2010) that despite

abiding by the nominal ratings, the defendants would still be considered in breach of contract by not delivering the quality of notes as the ratings indicate). Northern Rock's support collapses because the Appellate Division overturned the lower court's breach of contract ruling finding "[n]owhere in the plain language of the documents [did] there appear a promise of credit quality." *MBIA Ins. Corp. v Merrill Lynch,* 81 AD3d 419, 420 (1st Dept 2011).

Also, fatal to Northern Rock's claim is that it is duplicative of the common law fraud claim.

SGCIB's motion to dismiss Northern Rock's cause of action of breach of contract is granted.

Unjust Enrichment

Because Northern Rock's investments are governed by a written contract, in this case, the Notes, its unjust enrichment claim must be dismissed. *See Goldman v Metro. Life Ins. Co.*, 5 NY3d 561, 572 (2005) (existence of contract "ordinarily precludes recovery in quasi contract for events arising out of the same subject matter").

SGCIB's motion to dismiss Northern Rock's cause of action of unjust enrichment is granted.

Rescission

Rescission returns an investor to his original position by unwinding the transaction. It is the forced reacquisition of an asset at the price for which it was sold. To assert such a claim, Northern Rock was required to state in its complaint that it restored, or offered to restore, to the defendants the notes it bought. *Goldsmith v Nat'l Container Corp.*, 287 NY 438, 442-43 (1942); *Vail v Reynolds*, 118 NY 297, 303 (1890). Northern Rock did neither. Also, rescission is unavailable where, as here, money damages will fully compensate claimant.

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SGCIB's motion to dismiss Northern Rock's claim for rescission is granted.

ORDERED that SGCIB's motion to dismiss plaintiff's fraud cause of action is denied; and it is further

ORDERED that SGCIB's motion to dismiss plaintiff's unjust enrichment and contract causes of action and claim for rescission is granted.

Dated: August 5, 2014

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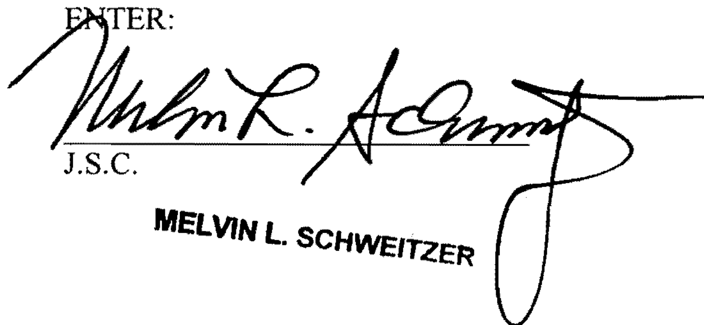

J.S.C.

MELVIN L. SCHWEITZER