SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: Anil C. Singh. **PART** 45

Justice

Index Number : 651217/2012
AMBAC ASSURANCE CORPORATION
vs.
FIRST FRANKLIN FINANCIAL
SEQUENCE NUMBER : 008
COMPEL DISCLOSURE

INDEX NO. _____

MOTION DATE _____

MOTION SEQ. NO. _____

The following papers, numbered 1 to _____, **were read on this motion to/for** _____

Notice of Motion/Order to Show Cause — Affidavits — Exhibits _____ **No(s).** _____

Answering Affidavits — Exhibits _____ **No(s).** _____

Replying Affidavits _____ **No(s).** _____

Upon the foregoing papers, it is ordered that this motion is

decided in accordance with the annexed memorandum opinion.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 9/17/15

_____, J.S.C.
ANIL C. SINGH

1. **CHECK ONE:** ..... ☐ CASE DISPOSED ☑ NON-FINAL DISPOSITION
2. **CHECK AS APPROPRIATE:** .....**MOTION IS:** ☐ GRANTED ☐ DENIED ☑ GRANTED IN PART ☐ OTHER
3. **CHECK IF APPROPRIATE:** ..... ☐ SETTLE ORDER ☐ SUBMIT ORDER
☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

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

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AMBAC ASSURANCE CORPORATION and THE SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION,

Plaintiffs,

-against-

FIRST FRANKLIN FINANCIAL CORPORATION, BANK OF AMERICA, N.A., MERRILL LYNCH, PIERCE, FENNER & SMITH INC., MERRILL LYNCH MORTGAGE LENDING, INC., and MERRILL LYNCH MORTGAGE INVESTORS, INC.,

Defendants.

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DECISION AND ORDER

Index No. 651217/2012

Motion Sequence 008

HON. ANIL C. SINGH, J.:

In this case for breach of contract and fraudulent inducement in connection with a residential mortgage backed securities (RMBS) transaction, defendants move to compel plaintiffs to produce documents related to the materiality of, and its justifiable reliance on, defendant's alleged misrepresentations and documents related to defendant's affirmative defenses pursuant to CPLR § 3124. Plaintiffs oppose and cross move to dismiss defendants' affirmative defenses pursuant to CPLR § 3211 (b). Oral arguments were heard on the motions on July 27, 2015.

Facts

The Transaction at issue in this case closed on May 29, 2007, and was sponsored by Merrill Lynch Mortgage Lending, Inc. (ML Lending) and marketed by Merrill Lynch, Pierce, Fenner & Smith, Inc. (MLPF & S). The loans were originated by First Franklin Financial Corporation (First Franklin) and deposited by Merrill Lynch Mortgage Investors, Inc. (ML Investors) into First Franklin Mortgage Loan Trust, Series 2007–FFC Trust (the Trust). ML

Lending and First Franklin sold 15,812 subprime second-mortgage "balloon" loans with an aggregate principal balance of approximately $856 million to defendant ML Investors. ML Investors, as the depositor, sold the 15,812 loans to the Trust formed under a Pooling and Servicing Agreement (PSA).

To induce Ambac to issue the Policy, the Merrill Lynch Contracting Parties entered into a Insurance and Indemnity contract (I & I) and made a series of representations and warranties in addition to those in the MLPAs and the PSA. They represented to the Merrill Lynch Contracting Parties' compliance with lending and securities law, their financial condition, operations, mortgage-loan portfolios, underwriting, due diligence and quality control practices, and the aggregate characteristics of the loans included in the Transaction. Likewise, in the I & I, Ambac represented its financial soundness and ability to make payments under the policy.

Ambac's financial condition deteriorated as a result of subprime mortgage loan defaults in 2007 and 2008, and it entered statutory rehabilitation pursuant to Wisconsin Insurance Law in 2010. After a large percentage of loans defaulted, Ambac received and analyzed over 1,750 loan files. It alleges *inter alia*, that the loans were not originated or underwritten pursuant to First Franklin's ostensible originating and underwriting guidelines, nor pursuant to prudent lending practices in contradiction to the defendants' previous representations.

The Court will first address plaintiffs' cross motion for dismissal of defendants' affirmative defenses and then turn to the discovery issues.

Cross Motion to Dismiss Defendants' Affirmative Defenses

Defendants asserted two affirmative defenses, *in pari delicto* and unclean hands. Defendants primary contention is that plaintiff made significant misrepresentations of its financial condition in the I&I.

Unclean Hands

The doctrine of unclean hands is an equitable defense that is unavailable in an action exclusively for damages. Manshion Joho Ctr., Ltd. v. Manshion Joho Ctr., Inc., 24 AD3d 189, 190 (1st Dep't 2005). The action before us is one exclusively for damages. Therefore, the doctrine of unclean hands is unavailable. Accordingly, plaintiff's motion to dismiss defendants' affirmative defense of unclean hands is granted.

In pari delicto

The doctrine of *in pari delicto* bars a party that has been injured as a result of its own intentional wrongdoing from recovering for those injuries from another party whose equal or lesser fault contributed to the loss. Rosenbach v. Diversified Grp., Inc., 85 A.D.3d 569, 570 [1st Dept 2011]. See also, Kirschner v. KPMG LLP, 15 N.Y.3d 446, 464 [2011] [*in pari delicto* "mandates that the courts will not intercede to resolve a dispute between two wrongdoers"]; Chemical Bank v. Stahl, 237 A.D.2d 231, 232 [1997] [*in pari delicto* "requires immoral or unconscionable conduct that makes the wrongdoing of the party against which it is asserted at least equal to that of the party asserting it"].

Here, defendants have pled that plaintiff is *in pari delicto* as to the misrepresentations it made in the I&I. Plaintiff advances a few arguments in support of dismissal of this defense.

Plaintiffs argue that the *in pari delicto* affirmative defense fails because the law requires plaintiff's alleged misconduct to be at least as blameworthy as defendants. This is a question that must be determined at trial. J. M. Deutsch, Inc. v. Robert Paper Co., 13 A.D.2d 768 [1st Dept 1961] ["Whether or not this was actually so, and whether or not by reason thereof the parties are not to be considered in *pari delicto*, are matters which may only be determined upon the full development of the facts on a trial"].

Second, plaintiffs assert that the affirmative defense fails because it applies only where the parties "engaged in the same misconduct". In Pinter v. Dahl, 486 U.S. 622, 635-36 (1988), the Supreme Court held that the plaintiff must bear "at least substantial equal responsibility for the underlying illegality". At this stage, defendants have sufficiently pled that their *in pari delicto* affirmative defense is based on the subject of the suit. Specifically, plaintiffs' claims and defendants' affirmative defenses are premised on the same contract, involving the same loans and effectuating the same securitization.

Third, plaintiffs argue that defendants have not pleaded fraud. Notably, the affirmative defense pled by defendants is *in pari delicto*. Plaintiffs are claiming that defendants have not pled the fraud that is alleged subsumed in the affirmative defense. On a motion to dismiss affirmative defenses pursuant to CPLR 3211(b), the plaintiff bears the burden of demonstrating that the defenses are without merit as a matter of law. 534 E. 11th St. Hous. Dev. Fund Corp. v. Hendrick, 90 A.D.3d 541, 541-42, [1st Dept 2011]. In deciding a motion to dismiss a defense, the defendant is entitled to the benefit of every reasonable intendment of the pleading, which is to be liberally construed. Id. A defense should not be stricken where there are questions of fact requiring trial. Id. In this case, the defendants have sufficiently alleged the facts under which they would plead *in pari delicto*.

Next plaintiffs argue that the affirmative defenses were waived in I & I. While this motion was, *sub judice*, plaintiffs submitted a letter dated August 7, 2015 to the Court stating that pursuant to the First Department's decision in J.P. Morgan Securities Inc. v. Jason Ader et. al., 127 AD 3d 506 [1st Dept 2015], it is not pressing the position that "the waiver of defenses in the Insurance and Indemnity Agreement applies to Ambac's fraudulent-inducement claim".

Since the argument has been raised both in the papers and at oral argument, the Court will address waiver.

This court notes that fraudulent inducement is one of plaintiffs' main claims. As noted in Ader, "a contractual jury waiver provision is inapplicable to a fraudulent inducement cause of action that challenges the validity of the underlying agreement." Id. See also, Wells Fargo Bank, N.A. v Stargate Films, Inc., 18 AD3d 264 [1st Dept 2005]; *Ambac Assur. Corp. v DLJ Mtge. Capital, Inc.*, 102 AD3d 487, 488 [1st Dept 2013]; *MBIA Ins. Corp. v Credit Suisse Sec. [USA], LLC*, 102 AD3d 488 [1st Dept 2013]. Moreover, it is of no consequence that the complaint does not contain the word "rescission" or expressly state that it challenges the validity of the operative agreement. Id. As the proverb states, "One cannot have the cake and eat it too". Here, plaintiff's complaint alleges repeatedly that it was fraudulently induced into entering into the I&I. By doing so, plaintiff challenges the validity of the underlying agreement. Therefore, plaintiff cannot now argue that the defendants should be bound by the contractual waiver provisions within the I&I.

Citibank, N.A. v. Plapinger, 66 N.Y.2d 90 (1985) and its progeny is distinguishable from the case at hand. In Plapinger, an action was brought by four banks against shareholders who had executed a guarantee as individuals of the corporate obligation in return for an extension of credit by the banks. After the corporation defaulted and filed a voluntary petition in bankruptcy, the action was brought against the guarantors, who interposed defenses and counterclaims that the banks had fraudulently misrepresented that an additional line of credit would be extended in consideration for the guarantee. The Court of Appeals affirmed the grant of summary judgment in favor of plaintiff banks, holding that "the substance of defendants' guarantee forecloses their reliance on the claim that they were fraudulently induced to sign the guarantee by the banks' oral promise of an additional line of credit." Id. at 94-95. The line of cases that follow Plapinger

similarly state that parole evidence is barred when the parties expressly disclaim reliance on the particular misrepresentations. See Rosenblum v. Glogoff, 96 AD 3d 514 [1st Dept 2012] ["where the parties expressly disclaim reliance on the particular misrepresentations, contrary parole evidence is barred]; Capricorn Investors III, L.P. v. Coolbrands International Inc., 66 AD 3d 409 [1st Dept 2012] ["all the documents disclaim reliance on oral representations"]; Xi Mei Jia v. Intelli-tec Security Services, Inc., 114 AD 3d 607 [1st Dep't 2014] ["plaintiff's representation in the merger clause forecloses her reliance upon any representation not contained in the letter agreement"]. In the case at hand, defendants have claimed that the alleged misrepresentations are written representations in the I&I, specifically 2.04(e) of the I&I.

Motion to Compel

On a motion to compel, "CPLR 3101(a) provides for 'full disclosure of all matter material and necessary in the prosecution or defense of an action, regardless of the burden of proof.' The words 'material and necessary' have been interpreted broadly and cover any good faith request for information that will assist in the preparation for trial." Fortis Bank (Nederland) N.V. v Abu Dhabi Islamic Bank, 32 Misc 3d 1232(A) [Sup Ct, NY Cty 2010]. However, the purpose of discovery must be to sharpen the issues thus reducing delay and prolixity, rather than provide undue attention to any collateral matter to the detriment of the main issue Blittner v Berg and Dorf, 138 AD2d 439, 440-41 [2d Dept 1988].

Discovery Related to Plaintiffs' Fraud Claim

In the first instance, defendants argue that in order for plaintiffs to sustain their claim for fraudulent inducement, plaintiff must prove (a) their reliance was justifiable and (b) that the representations made to plaintiffs by defendants were material. On the other hand, plaintiffs

argue that defendants' requests have no basis since plaintiff does not need to establish reasonable reliance under Insurance Law §3105. Rather, plaintiffs argue as an insurer they are entitled to rely on its insured's material written representation as a matter of law. This argument is unavailing.

In support of plaintiffs' position, plaintiff points to the trial court decision in MBIA Ins. Corp. v Countrywide Home Loans, Inc., whereby Justice Bransten states "the Court finds no justifiable reliance requirement for a fraud claim under Section 3105" (39 Misc 3d 1220(A) [Sup Ct 2013]). Noticeably absent from plaintiff's complaint is a reference to a claim made pursuant to the Insurance Law. Insurance Law §3105 applies where a plaintiff seeks to "avoid any contract of insurance or defeat recovery thereunder" (Insurance Law §3105(b)(1)).

Plaintiff here does not seek a recessionary remedy under Insurance Law §3105 like plaintiff in MBIA. In fact, during oral argument, plaintiff acknowledges that it could not obtain a recessionary remedy in this type of case pursuant to First Department authority. (Tr. at 31). Rather plaintiff is seeking damages for fraud. See C.F. MBIA Ins. Corp. v Countrywide Home Loans, Inc., 105 AD3d 412, 412 [1st Dept 2013] (holding that the recovery of payments made pursuant to an insurance policy without resort to rescission would qualify as a §3105 claim).

Under a common law claim for fraud, a plaintiff must prove "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 NY3d 553, 559 [2009]. It is law of the case that plaintiff must establish justifiable reliance on its fraudulent inducement claim. AMBAC Assur. Corp. v First Franklin Fin. Corp., 40 Misc 3d 1214(A) [Sup Ct NY Cty 2013]. With respect to the justifiable reliance element of fraud in the

inducement or fraudulent concealment, the Court of Appeals has recently reaffirmed that if the facts represented are not matters peculiarly within the defendant's knowledge, and the plaintiff has the means available to it of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, the plaintiff must make use of those means, or it will not be heard to complain that it was induced to enter into the transaction by misrepresentations. ACA Fin. Guar. Corp. v Goldman, Sachs & Co., 25 NY3d 1043, 1044 [2015]. Additionally, defendants do not dispute materiality is an additional prong of fraudulent inducement. See Eurycleia Partners 12 NY3d at 559.

Plaintiff reasons that even if it must prove justifiable reliance and materiality it has been established as a matter of law due to defendants' written representations. As previously discussed, plaintiffs cannot argue the I & I is invalid and at the same time argue that it may rely upon the representations contained in the I &I as a matter of law. Those positions are incongruent. Plaintiff relies on the language in DDJ Mgt., LLC v Rhone Group L.L.C., which states that "where a plaintiff has gone to the trouble to insist on a written representation that certain facts are true, it will often be justified in accepting that representation rather than making its own inquiry" 15 NY3d 147, 154 [2010] (emphasis added). However, the Court of Appeals goes on to hold that even in cases where written warranties have been obtained, the issue of "whether [plaintiffs] were justified in relying on the warranties they received is a question to be resolved by the trier of fact." Id. at 156. Accordingly, here, plaintiff's reasonable reliance has not been established, as a matter of law and discovery must be conducted to assist the "fact-intensive" inquiry. Id. at 155.

Having determined the elements of plaintiff's fraudulent inducement claim, we now turn to the scope of plaintiff's disclosure. Defendants' reason that in order for the trier of fact to

understand what factors plaintiffs considered material in entering into the I & I then they must understand what plaintiffs knew about the risks inherent in RMBS and how plaintiffs assessed such risks. On the other hand, plaintiffs argue that a single transaction was at issue here thus documents that are concerning more than the single transaction are irrelevant. Defendants counter that plaintiffs were sophisticated players in the RMBS market and thus their extensive prior involvement with RMBS or how it conducted itself when underwriting insurance on deals similar to Transaction speak to the plaintiffs' viewpoint on the materiality of defendants' representations.

The mere fact that the requested discovery also relates to additional RMBS transactions does not preclude its discoverability. Several Commercial Division Judges have ordered the production of documents of non-transaction specific discovery. See MBIA Insurance Corp. v. Credit Suisse Securities (USA) LLC, No. 603751/2009; Ambac Assurance Corp. v. EMC Mortgage, LLC, No. 650421/2011. Plaintiff attempts to distinguish these cases by arguing that every loan in the transaction at bar was originated by one bank. However, the relevant inquiry is not who originated the loans, but what plaintiff, the monoline insurer, knew about the risks it was accepting.

The document categories relevant to (1) the transactions specifically identified in the Credit, Memorandum for the Transaction, and (2) the due diligence, risk modeling, and risk management by AMBAC related to RMBS, are material and necessary to defendants' defense to this action. See Clayton Funding Corp. v State Bank of Long Is., 220 AD2d 479 [2d Dept 1995]. These categories are relevant insofar as they inquire into the procedures plaintiffs followed in assessing the risk before it entered into the I & I. Id.

On the other hand, the document categories relevant to (3) the marketing of RMBS and its rating, by rating agencies and (4) materials utilized by Board of Directors and Securitization Committee are overly broad and burdensome. Plaintiffs have insured over a hundred RMBS deals involving numerous counter parties and billions of dollars. Accordingly, these categories must be and must be limited in scope. Ambac Assur. Corp. v Countrywide Home Loans, Inc., 118 AD3d 644 [1st Dept 2014] (affirming the limitation of disclosure of a subset of documents). Defendants are entitled to discovery related to the transaction at issue and three others at defendants' choosing.

Documents Related to Defendants' Affirmative Defenses

Likewise, defendants also seek to compel discovery related to their defenses of *in pari delicto* and unclean hands. These discovery requests relate to whether AMBAC fairly presented its financial condition and ability to pay insurance claims when it entered into the I & I. In §2.04 (e) plaintiffs represented that its consolidated financial statements "fairly present in all material respects the financial condition of the Insurer" and that [s]ince March 31, 2007, there has been no material change in such financial condition of the Insurer that would materially and adversely affect its ability to perform its obligations under the Policy".

This Court has already dismissed defendant's unclean hands defense however, discovery related to *in pari delicto* may still discoverable. See supra. In any event, defendant has not delineated which document request relates to which defense. The Court will analyze the categories of documents in turn.

The document categories relevant to (1) Ambac's risk modeling and surveillance of its insurance portfolio, and (2) Rating agency materials are material and necessary to defendants'

affirmative defense of *in pari delicto*. See Clayton Funding Corp. v State Bank of Long Is., 220 AD2d 479 [2d Dept 1995]. These document categories shine light on the veracity of AMBAC's statements in the I & I concerning its financial condition and ability to make claims payments.

Defendants have also requested documents related to (3) the preparation of financial statements for Ambac's parent company, AFG.. This request is overly broad and not material and necessary to defendants' affirmative defense. Defendants' seek these documents in order to establish that the financial statements of Ambac's parent were inaccurate. However, AFG is not a party to the I & I. Thus any document request related to AFG is not discoverable. Defendants' motion to compel on this category of documents is denied.

Lastly, defendants' move to compel disclosure of documents related to the investigations of any alleged or actual violation by Ambac of generally accepted accounting principles or federal securities laws. These documents are material and necessary to defendants' affirmative defense as it relates to Ambac knowledge of its true financial condition. However, the requests are overly broad and burdensome. Defendants' are entitled to those categories of documents that relate to the transaction at issue and the same three other transactions previously selected by defendants.

The parties shall meet and confer regarding production deadlines and any disputes shall be resolved at the next status conference.

Accordingly it is

ORDERED that plaintiffs' motion to dismiss is denied as to Defendants' second affirmative defense of *in pari delicto*; and it is further

ORDERED that plaintiffs' motion to dismiss is granted as to Defendants' eighth affirmative defense of unclean hands; and it is further

ORDERED that defendants' motion to compel is granted in part and denied in part.

Date: September 17, 2015
New York, New York

Anil C. Singh