

China Dev. Indus. Bank v Morgan Stanley & Co. Inc.
2018 NY Slip Op 33385(U)
December 21, 2018
Supreme Court, New York County
Docket Number: 650957/10
Judge: Charles E. Ramos
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

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CHINA DEVELOPMENT INDUSTRIAL BANK,

Plaintiff,

Index No. 650957/10

-against-

MORGAN STANLEY & CO. INCORPORATED (n/k/a
MORGAN STANLEY & CO. LLC), MORGAN STANLEY &
CO. INTERNATIONAL PLC (f/k/a MORGAN STANLEY
& CO. LIMITED), TCW ASSET MANAGEMENT COMPANY,
JEFFREY GUNDLACH, LOUIS LUCIDO, and DOES 1-50,

Defendants.

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Hon. C. E. Ramos, J.S.C.:

The Morgan Stanley defendants move for summary judgment, dismissal and/or sanctions for spoliation of evidence, and an award of fees and costs.

Plaintiff China Development Industrial Bank (CDIB) commenced this action against the Morgan Stanley defendants for fraud arising out of a financial instrument called the STACK 2006-1 (Stack). Stack involved a derivative that issued notes backed by an asset portfolio containing mostly credit default swaps linked to non-prime residential mortgage backed securities. CDIB's investment in Stack ultimately resulted in a total loss.

According to CDIB, Morgan Stanley was the underwriter for Stack and designed and marketed it as an "almost risk free" product that was nearly impossible to fail. Purportedly, Morgan Stanley secretly constructed Stack to be a "hitman" that was designed to blow up in CDIB's hands. The Morgan Stanley

defendants are alleged to have altered Stack's investment rules to force Stack to buy a particularly problematic slice of sub-prime securities from an already risky and toxic class of securities that Morgan Stanley was hoping to get off its own books, while simultaneously permitting it to profit by shorting the transactions, fueling an \$8 billion short. Shortly after Morgan Stanley closed the trade, the credit default obligation at the heart of Stack began to collapse.

CDIB commenced this action against Morgan Stanley in 2010 alleging common law fraud, premised on the contention that Morgan Stanley had a duty to disclose the unstable collateral which was sold into its Stack CDO and Stack's true risks, given Morgan Stanley's misstatements regarding the investment risks involved.

The parties engaged in extensive discovery. In support of its motion, the Morgan Stanley defendants argue that they did not misrepresent or omit material information. In addition, they assert that the record reveals that CDIB cannot prove that it justifiably relied on any alleged misrepresentations or omissions, or that it suffered losses. Finally, the Morgan Stanley defendants maintain that dismissal of the complaint is warranted as a spoliation sanction because CDIB has destroyed evidence.

Discussion

Under the common law doctrine of spoliation, dismissal is

appropriate where key evidence is destroyed prior to examination by the opposing party (*Sage Realty Corp. v Proskauer Rose*, 275 AD2d 11, 16-17 [1st Dept 2000]). Willfulness or bad faith are not necessary predicates (*Id.*).

It is not disputed that CDIB failed to impose a litigation hold until 2010, despite reasonably anticipating litigation in August 2007. In addition, it is not disputed that CDIB began collecting some, but not all, evidence relating to Stack as early as 2007. CDIB failed to preserve and actually destroyed two hard drives, including one used by its employee who monitored Stack. In addition CDIB failed to preserve the metadata for 59 audio recordings, and internal and external email communications predating 2010. The selective destruction by CDIB of some of this evidence is extremely troubling.

CDIB has not offered a reasonable excuse for its grossly negligent and/or willful conduct. Moreover, CDIB has refused to produce key witnesses for deposition, preventing the Morgan Stanley defendants from deposing the custodians whose files were destroyed.

The destroyed evidence is clearly relevant and may even be critical to the issues in this action. Nonetheless, the destroyed evidence does not constitute the sole source of relevant information by which the Morgan Stanley defendants can establish their defense, and thus, the extreme sanction of

striking the complaint at this point is not appropriate (see *Alleva v United Parcel Servc., Inc.*, 112 AD3d 543 [1st Dept 2013]).

Exercising its broad discretion under CPLR 3126, this Court determines that the appropriate sanction for CDIB's conduct is to precluding CDIB from presenting and relying upon any audio recordings and email communications to establish its claims. This will ensure a level playing field between the parties.

This Court also determines that the Morgan Stanley defendants have failed to demonstrate, as a matter of law, that they owed no duty to disclose to CDIB the truth about Stack's ratings, unstable collateral and investment risks. CDIB has successfully raised a triable issue that a duty to disclose existed in light of the Morgan Stanley defendants' peculiar knowledge of its own expert analysis that the bonds contained within Stack would fail spectacularly, and that its portfolio management team actually designed Stack to fail, in part due to its own \$6 billion short position, which CDIB could not have uncovered despite its sophistication and due diligence. In addition, issues also remain as to whether and to what extent the Morgan Stanley defendants actually underwrote the securities contained within Stack that would give it peculiar knowledge about Stack's true risks (see *ACA Fin. Guaranty Corp. v Goldman Sachs & Co.*, 25 NY3d 1043 [2015]; *China Dev. Indus. Bank v Morgan*

Stanley & Co. Inc., 86 AD3d 435 [1st Dept 2011]).

This Court also finds triable issues with respect to whether the Morgan Stanley defendants actually caused CDIB's losses.

Finally, fact issues surrounding when CDIB discovered the fraud preclude summary judgment as to CDIB's purported ratification of the swap in May 2009 which would result in a waiver of its right to rescission and a jury trial.

Therefore, it is

ORDERED that defendants' motion is denied with respect to summary judgment, and granted to the limited extent provided herein with respect to the spoliation of evidence.

The parties shall contact the Part Clerk in order to place this matter on the trial calendar.

Dated: December 21, 2018

ENTER:



J.S.C.

CHARLES E. RAMOS