SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART 49M

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PROSPECT CAPITAL CORPORATION,

Plaintiff,

- v -

MORGAN LEWIS & BOCKIUS LLP, MATTHEW SCHERNECKE

Defendant.

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INDEX NO. 653941/2022

MOTION DATE 04/22/2023

MOTION SEQ. NO. 002

DECISION + ORDER ON MOTION

HON. MARGARET A. CHAN:

The following e-filed documents, listed by NYSCEF document number (Motion 002) 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31, 32, 33, 34, 35, 36, 37, 38, 43, 44, 45, 54
were read on this motion to/for DISMISS.

In this action arising from defendants' alleged legal malpractice in rendering legal services concerning plaintiff's turnover right in a debt subordination agreement, defendants move pursuant to CPLR 3211(a)(1) and (a)(7) for an order dismissing plaintiff's complaint. Plaintiff opposes the motion.

Background

Plaintiff Prospect Capital Corporation (Prospect or plaintiff) is a business development company that provides loans to middle-market companies (NYSCEF # 2 – complaint, ¶ 6). Prospect retained defendant Morgan Lewis & Bockius LLP (Morgan Lewis) for transactional legal services from January 2013 through July 2022 (*id.*). Defendant Matthew Schernecke was an attorney at Morgan Lewis during the relevant time and provided the legal services at issue (*id.*, ¶ 5).

On February 19, 2014, Prospect provided a $17 million senior secured term loan to non-party Venio LLC (Venio), a company engaged in the service of recovering unclaimed property (the Prospect Loan) (*id.*, ¶ 7). In December 2014, Venio's parent company Keane Holdings, Inc. (Keane Holdings) obtained a $12 million loan from non-party Silicon Valley Bank (SVB) (the SVB Loan) (*id.*, ¶ 8). The complaint alleges that the SVB Loan was a junior loan for purposes of providing credit support to senior lenders (*id.*, ¶ 9). In the same month, Prospect, SVB, another senior lender Bank of Montreal, and other creditors of Venio began negotiating a debt subordination agreement (the subordination agreement), under which the SVB Loan would be subordinate to the Prospect Loan so that the latter

would have to be paid in full before the SVB Loan could be paid (*id.*). Defendants were engaged in negotiating the subordination agreement on Prospect's behalf (*id.*).

Section 1 of the subordination agreement provides that if Venio defaults on the Prospect Loan, SVB will be prohibited from receiving payments on the SVB Loan before Prospect is paid in full (subordination provision) (NYSCEF # 23, at 31). Section 5 of the subordination agreement contains a turnover provision, which requires a junior lender such as SVB to disgorge and pay over to a senior lender any payments such junior lender has received from a "Keane Entity" in violation of the payment priority (turnover provision) (*id.*; complaint, ¶ 12). This action centers around the change to the scope of the turnover provision.

On December 15, 2014, defendants advised Prospect that the draft turnover provision in section 5 provided Prospect a turnover right against SVB for any payment SVB wrongfully received from Keane Holdings (*id.*, ¶ 11). Four days later, Keane Holdings and SVB sent a revised draft back to Morgan Lewis, excluding Keane Holdings from the definition of "Keane Entity," the group of entities subject to the turnover provision (*id.*, ¶ 15). Practically, this change would deprive Prospect of the right to seek turnover of any payment SVB wrongfully received on the SVB Loan because the turnover provision no longer included Keane Holdings (*id.*, ¶ 16). Defendants forwarded Prospect the redline version of the revised draft and, without pointing out the change in definition or the consequence of it, advised Prospect that "the document still works for us, substantively" (*id.*, ¶ 18). Relying on that advice, Prospect agreed to the revised version and executed the subordination agreement with other parties on December 23, 2014 (*id.*, ¶ 19). Upon closing, defendants inadvertently included a wrong version of the subordination agreement in a closing binder sent to Prospect, which version was the earlier draft that defined "Keane Entity" to include Keane Holdings (*id.*, ¶¶ 20-22).

In the following years, defendants had been erroneously advising Prospect that it had a turnover right against SVB for payments on the SVB Loan (¶ 24). For instance, in April 2015, when Venio allegedly breached its covenants under the subordination agreement, defendants confirmed that Prospect had turnover rights against SVB for such breach (*id.*, ¶¶ 25-27). In December 2017, when Keane Holdings refinanced the SVB Loan with a $12 million loan from Citizens Bank N.A. (the Citizens Loan), defendants again advised that Prospect had a turnover remedy against SVB since Keane Holdings is a "Keane Entity" (*id.*, ¶¶ 28-33).

Rather than immediately enforcing the rights, Prospect and other senior lenders sought to restructure Venio consensually (*id.*, ¶ 34). Venio explored various options, including (1) investment of new cash into Venio, (2) converting some debt into equity and other credit restructuring, or (3) a sale of Venio at a price expected to fully repay Prospect and other lenders (*id.*). Prospect alleges that it strategically consented to the third option of selling Venio's asset based on defendants' advice

that it could seek a turnover remedy even if the sale proceeds of Venio fell short of repaying the Prospect Loan in full (*id.*, ¶¶ 35-37).

By the end of 2020, Venio had liquidated and transferred operations to its buyers, leaving Prospect as the only unpaid remaining senior secured lender (*id.*, ¶ 38). As such, Prospect filed a lawsuit against SVB in January 2021 for breaching the subordination provision (section 1) and the turnover provision (section 5) of the subordination agreement (the SVB Litigation) (*id.*, ¶ 40). Notified by SVB's litigation counsel in March 2021, Prospect, for the first time, discovered that it had no turnover right on the SVB Loan and had been relying on the wrong version of the subordination agreement provided by Morgan Lewis (*id.*). Realizing the mistake, Prospect withdrew the turnover claim. Ultimately, Prospect resolved the SVB Litigation by settlement (*id.*). [1]

On October 21, 2022, Prospect commenced this instant action alleging professional negligence against defendants. The complaint alleges that defendants failed to detect and inform Prospect of the revision in the turnover provision and negligently provided advice based on the wrong version of the agreement. Prospect claims that, but for defendants' negligence, it would have had a turnover remedy against SVB, which would have avoided $12 million in damages (*id.*, ¶¶ 51-56).

Defendants move to dismiss the complaint, arguing that the subordination agreement is documentary evidence that precludes the malpractice claim since plaintiff and its in-house counsel had the opportunity and were required to read and know what was in the revised agreement when signing it. Defendants also argue that plaintiff's proximate cause allegations are speculative and its voluntary settlement of the SVB Litigation further precludes a finding of proximate cause.

In opposition, plaintiff argues that defendants cannot shift to the client the legal responsibilities Morgan Lewis was hired to undertake, including assessing the proposed revisions to the draft agreement and advising plaintiff of a significant change. As to causation, plaintiff maintains that it has sufficiently alleged that, but for defendants' negligence, it would have had the turnover right. In this connection, plaintiff highlights that a turnover provision is customarily included in a debt subordination agreement in the secured lending industry, thus SVB would have easily agreed to it. Plaintiff next argues that, since the incurrence of the Citizens Loan gave rise to a breach of the subordination agreement, it necessarily follows that plaintiff would have collected $12 million from SVB under the turnover provision. In addition, plaintiff alternatively argues that, but for defendants' erroneous advice based on the wrong version of the subordination agreement, it would not have declined other proposed options that would have put it in a more favorable financial position. Finally, plaintiff contends that its settlement of the

[1] The settlement agreement in the SVB Litigation is not disclosed in this case.

SVB Litigation is irrelevant and does not absolve defendants' liability for legal malpractice.

Discussion

On a CPLR 3211(a)(7) motion to dismiss, the court must afford the pleadings a liberal construction, accept the allegations of the complaint as true and provide the plaintiff with "the benefit of every possible favorable inference" (*Leon v Martinez*, 84 NY2d 83, 87 [1994]). "[W]hether a plaintiff ... can ultimately establish its allegations is not taken into consideration in determining a motion to dismiss" (*African Diaspora Mar. Corp. v Golden Gate Yacht Club*, 109 AD3d 204, 211 [1st Dept 2013]).

"However, factual allegations presumed to be true on a motion pursuant to CPLR 3211 may properly be negated by affidavits and documentary evidence" (*Facebook, Inc. v DLA Piper LLP (US)*, 134 AD3d 610, 613 [1st Dept 2015]). A motion to dismiss pursuant to CPLR 3211(a)(1) may be granted "only if the documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law" (*Morgenthow & Latham v Bank of N.Y. Co., Inc.*, 305 AD2d 74, 78 [1st Dept 2003]). And where "legal conclusions and factual allegations [in the complaint] are flatly contradicted by documentary evidence, they are not presumed to be true or accorded every favorable inference" (*id.* [internal citations and quotations omitted]).

To prevail a legal malpractice action, plaintiff must plead "factual allegations which, if proven at trial, would demonstrate that counsel had breached a duty owed to the client, that the breach was a proximate cause of the injuries, and that actual damages were sustained" (*Dweck Law Firm, LLP v Mann*, 283 AD2d 292, 293 [1st Dept 2001]).

Negligence

Here, plaintiff's allegations are sufficient to raise a reasonable inference that defendants "failed to exercise the ordinary reasonable skill and knowledge commonly possessed by a member of the legal profession" (*Rudolf v Shayne, Dachs, Stanisci, Corker & Sauer*, 8 NY3d 438, 442 [2007]). Plaintiff alleges that while the turnover provision is one of the key remedies to a senior lender and is customarily included in a debt subordination agreement, defendants failed to inform it of the narrowing of the turnover provision, which effectively deprived plaintiff's turnover right against SVB on the SVB Loan. Further, plaintiff alleges—and defendants do not dispute—that defendants negligently relied on a wrong version of the agreement and erroneously advised plaintiff that it had a valid turnover right on the SVB Loan when plaintiff in fact did not. This undisputed allegation further raises a reasonable inference that defendants themselves failed to detect the proposed change to the turnover provision in the first place.

The court is also not persuaded by defendants' argument that they cannot be held liable since plaintiff was supposed to read and know the content of the subordination agreement. As defendants contend, a party who signs a document is conclusively bound by its terms absent a valid excuse for having failed to read it (*Bishop v Maurer*, 33 AD3d 497, 499 [1st Dept 2006]). However, plaintiff has not tried to challenge the binding effect of the subordination agreement but instead alleges the negligence of its attorneys in providing advice on the agreement. As the Court of Appeal has held, "the binding nature of that agreement ... is not a complete defense to the professional malpractice of the law firm that generated the agreement to its client's detriment" (*Arnav Indus., Inc. Retirement Trust v Brown, Raysman, Millstein, Felder & Steiner, LLP*, 96 NY2d 300, 305 [2001]; *see also Garten v Shearman & Sterling LLP*, 52 AD3d 207, 207 [1st Dept 2008] [holding that plaintiff was not "responsible for his own loss simply because he executed the documents that defendant prepared for him"]).

Here, although plaintiff had an in-house counsel who received the draft subordination agreement, plaintiff was not fully advised of the precise issue concerning its turnover right on the SVB Loan (*cf. Cicorelli v Capobianco*, 89 AD2d 842, 842 [2d Dept 1982] ["courts have found a client to be contributorily negligent ... when the client is himself a skilled attorney who is fully advised of the issues involved and himself decides what course of action to take"]). Also, it did not seem readily apparent to plaintiff that narrowing the definition of "Keane Entity" would strip its turnover right against SVB, as defendants themselves were unaware of that legal consequence for years until the SVB Litigation. As such, defendants cannot shift their negligence to plaintiff merely because plaintiff signed the subordination agreement.

Causation and Damages

However, negligence alone is not enough to build a case of legal malpractice. For the reasons stated below, the malpractice claim is dismissed for failure to adequately allege causation and damages.

To satisfy the pleading requirement for causation, it must be alleged that " 'but for' the attorney's conduct the client would have prevailed in the underlying action or would not have sustained any ascertainable damages" (*Weil, Gotshal & Manges, LLP v Fashion Boutique of Short Hills, Inc.*, 10 AD3d 267, 272 [1st Dept 2004]; *Cosmetics Plus Group, Ltd. v Traub*, 105 AD3d 134, 140 [1st Dept 2013]). As to damages, "to survive a ... pre-answer dismissal motion, a pleading need only state allegations from which damages attributable to the defendant's conduct [or nonfeasance] may be reasonably inferred" (*Lappin v Greenberg*, 34 AD3d 277, 279 [1st Dept 2006] [internal citations omitted]). But, conclusory allegations of damages predicated on speculation cannot suffice for a legal malpractice action (*Volpe v*

Munoz and Associates, LLC, 190 AD3d 661, 661 [1st Dept 2021] citing *Bua v Purcell & Ingrao, P.C.*, 99 AD3d 843, 848 [2d Dept 2012] *lv denied* 20 NY3d 857 [2013]).

Under these standards, the court finds that the complaint, which is composed of two alternative and separate theories of causation and damages, fails to adequately plead causation under either theory.

Under the first theory, plaintiff alleges that if defendants had detected and informed it of the narrowing of the turnover provision, it would have pushed back in the negotiation to ensure that the subordination agreement include the turnover right at issue. Plaintiff alleges that the turnover remedy is customary in debt subordination agreements so its request would have been an "easy give" for SVB (complaint, ¶ 54). However, as it was SVB that made the revision to exclude Keane Holdings from "Keane Entity," the group of entities subject to the turnover provision, plaintiff's theory has to rely on the presumption that SVB and other deal parties would have been willing to take the change back (*Bua*, 99 AD3d at 848 [dismissal is warranted when "[t]he plaintiff's contention rests on speculation as to how the buyer would have responded to these requests"]).

Even affording plaintiff every favorable inference and assuming that SVB would have agreed to plaintiff's request to add back the turnover remedy, plaintiff has not sufficiently alleged that, with the turnover remedy, it would necessarily have collected $12 million from SVB upon obtaining the Citizens Loan. To be sure, in this hypothetical, since plaintiff would have the turnover right—as it so believed in reality—plaintiff would necessarily have agreed to the same option of selling Venio's assets and ended up the same with the SVB Litigation.

To prevail in the SVB Litigation, Prospect would first need to survive SVB's motion to dismiss by establishing that Keane Holdings' incurrence of the Citizens Loan triggered a default under the Prospect Loan and thus constituted a breach of the subordination agreement. That issue was never decided as the parties reached a settlement. However, even if plaintiff could prove SVB's breach at trial and prevail in the SVB Litigation, there still are gaps in the causal link. In the SVB Litigation, Prospect took the position that "whether there is a turnover remedy has no bearing on SVB's breach of its contractual obligations [under section 1] and does not obviate contract damages" (NYSCEF # 36 – Cutaia aff, exhibit 2, Prospect's MOL in the SVB Litigation at 3). In this regard, plaintiff fails to explain how an addition of the turnover remedy would have yielded a more favorable economic result since section 1's subordination provision alone provided a basis for full recovery.

In addition, the settlement of the SVB Litigation further severed the causal link. Plaintiff fails to allege that, but for defendants' negligence, it would not have opted to settle the SVB Litigation but obtained a more favorable result through litigation (*Katebi v Fink*, 51 AD3d 424, 425 [1st Dept 2008] [finding the malpractice

not viable since the settlement of the underlying action was the client's own choice and not compelled by the mistakes of counsel]), or alternatively, but for defendant's negligence, it would still have settled but obtained a better settlement outcome (*Perkins v Norwick*, 257 AD2d 48, 51-52 [1st Dept 1999] [finding that plaintiff's allegations that he might have negotiated different terms but for defendant's negligence is "entirely speculative"]).

Plaintiff's alternative theory also fails as it is based on mere speculation of unspecified future events. Plaintiff alleges that its strategy with respect to the winddown of Venio was based on defendants' erroneous advice that it had a turnover remedy against SVB. The essence of this theory is that if plaintiff had been made aware of its lack of a turnover remedy, it would have proceeded with other proposed options instead of consenting to the sale of Venio's assets. However, while the complaint vaguely refers to other proposed deals, such as (1) investment of new cash by Venio's indirect equity owner and (2) converting some debt into equity and other credit restructuring, the complaint does not specify what those proposed deals would entail and how they would have yielded a more favorable outcome (*Lisi v Lowenstein Sandler LLP*, 170 AD3d 461, 462 [1st Dept 2019] [rejecting plaintiff's theory of proximate cause as speculative]; *Sherwood Group v Dornbush, Mensch, Mandelstam & Silverman*, 191 AD2d 292, 294 [1st Dept 1993] [hypothetical course of events on which any determination of damages would have to be based on constitutes "gross speculations on future events"]). Therefore, viewed in the light most favorable to plaintiff, the allegations still do not give rise to an inference that "but for" defendants' negligence, plaintiff would not have sustained damages, which are speculative and unascertainable here.

Conclusion

In view of the above, it is

ORDERED that the motion of defendants to dismiss the complaint is granted; and the complaint is dismissed in its entirety, with costs and disbursements to defendants as taxed by the Clerk of the Court; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

5/2/2023
DATE

MARGARET A. CHAN, J.S.C.

CHECK ONE:	X	CASE DISPOSED			NON-FINAL DISPOSITION		
	X	GRANTED		DENIED	GRANTED IN PART		OTHER
APPLICATION:		SETTLE ORDER			SUBMIT ORDER		
CHECK IF APPROPRIATE:		INCLUDES TRANSFER/REASSIGN			FIDUCIARY APPOINTMENT		REFERENCE