SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

P BARBARA R. KAPNICK

E-FILE PART 39

Index Number : 650259/2009
AMBAC ASSURANCE UK LTD.
vs.
J.P. MORGAN INVESTMENT
SEQUENCE NUMBER : 001
DISMISS ACTION

INDEX NO. ______

MOTION DATE ______

MOTION SEQ. NO. ______

MOTION CAL. NO. ______

his motion to/for ______

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION

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

Dated: 3/24/10

HON. BARBARA R. KAPNICK J.S.C.

Check one: ☒ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

E-FILE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK : IA PART 39

---------------------------------------x

AMBAC ASSURANCE UK LIMITED, in the name of Ballantyne Re plc,

Plaintiff,

-against-

J.P. MORGAN INVESTMENT MANAGEMENT, INC.,

Defendant.

---------------------------------------x

DECISION/ORDER
Index No. 650259/09
Motion Seq. No. 001

BARBARA R. KAPNICK, J.:

Plaintiff Ambac Assurance UK Limited ("Ambac"), brings this action in the name of Ballantyne Re plc ("Ballantyne") against J.P. Morgan Investment Management, Inc. ("JPMIM"), which was allegedly charged with investing and serving as the discretionary investment manager for a $1.65 billion investment portfolio (the "Portfolio") pursuant to an Investment Management Agreement (the "IMA") it entered into with Ballantyne on May 2, 2006.[1]

Background

The Complaint alleges that the Portfolio's assets were dedicated to funding Ballantyne's obligations under certain notes (the "Notes") relating to securities that Ballantyne issued to capitalize itself and finance certain statutory reserve

[1] Ambac is prosecuting claims in Ballantyne's name pursuant to the IMA and a certain Guarantee and Reimbursement Agreement discussed below.

requirements which apply to reinsurers of term life insurance policies.[2]

On May 2, 2006, Ambac also entered into a Guarantee and Reimbursement Agreement (the "G&R Agreement") with Ballantyne and another guarantor named Assured Guaranty (UK) Ltd. ("Assured Guaranty"). Pursuant to the G&R Agreement, Ambac agreed to guarantee $900 million of the Notes.[3]

The proceeds from the Notes offering were transferred into two accounts at JPMIM, namely: the "Pre-Funded Account" and the "Excess Reserves Account." Plaintiff alleges that the IMA was structured to require JPMIM to maintain a safe and diversified portfolio.

---

[2] According to the Complaint, in October 2004 non-party Scottish Re (U.S.), Inc. ("Scottish Re") agreed to reinsure certain pools of term life insurance policies (the "Reinsured Policies"). The Reinsured Policies are governed by Regulation XXX, which requires term life reinsurers to maintain substantially higher reserves than actuarial projections indicate will be needed to pay the death benefits associated with the Reinsured Policies.

Scottish Re created Ballantyne to serve as a special purpose vehicle to raise the substantial funds needed to satisfy Regulation XXX's additional reserves requirements.

[3] Assured Guaranty guaranteed a further $500 million of those Notes. The G&R Agreement designates Ambac as the Directing Guarantor for as long as any of the Ambac-guaranteed Notes are outstanding or Ambac is owed any money under the documents executed in connection with the Notes Offering on May 2, 2006 (the "Transaction Documents"). The G&R Agreement further provides that, if no Ambac-guaranteed Notes are outstanding and all amounts owed to Ambac pursuant to any of the Transaction Documents are paid in full, Assured Guaranty becomes the Directing Guarantor.

Specifically, the Investment Guidelines annexed to the IMA required JPMIM to seek "reasonable income while providing a high level of safety of capital," and contained "limitations for investments in the [Portfolio] on the basis of sector and ratings."

In addition, JPMIM was required to adhere to New York and Delaware laws limiting the investments reinsurers can make, including Chapter 13 of the Delaware Insurance Law, which prohibits insurers and reinsurers from investing more than 50% of their assets in securities "secured by first or second mortgages or deeds of trusts representing first or second liens upon real estate..." (*see* sections 1305[4] and 1323).

Plaintiff alleges that instead of creating, managing, and diversifying the Portfolio in a conservative and prudent manner pursuant to the IMA and its fiduciary duties as an investment advisor, JPMIM invested almost exclusively in risky subprime and Alt-A residential mortgage-backed and home-equity backed securities (the "Subprime Securities").

Plaintiff further alleges that JPMIM continued purchasing and holding Subprime Securities for the Portfolio even after its corporate parent, JPMorgan Chase Bank N.A. ("JPMorgan Chase"), had enough evidence about the growing risk of collapse of the Subprime Securities market from its various business units that its Chief Executive Officer, Jamie Dimon, was able to conclude that "this stuff could go up in smoke."

Specifically, plaintiff relies on certain statements made by Mr. Dimon, which were quoted in a magazine article dated September 2, 2008 (the "Fortune article"), discussing JPMorgan Chase's strategic response to the credit crises. According to the article, Mr. Dimon concluded by the second week of October 2006 not only that the market for Subprime Securities "could go up in smoke," but had also instructed his subordinates, including the head of the division that runs JPMIM, to "watch out for subprime," and directed the head of securitized products that "[w]e need to sell a lot of our positions."[4]

Plaintiff also cites to an article dated January 30, 2007 (the "MarketWatch article"), which states, "[Mr. Dimon] also said defaults are rising at JPMorgan [Chase] 'a little bit,' adding, 'home equity is subject to deterioration' from a recession, but that the bank is well positioned to sustain a downturn in the economy. The bank has largely exited the subprime lending area."[5]

Plaintiff alleges that despite recognizing the increasing risks of holding Subprime Securities through its parent JPMorgan Chase, JPMIM "[did not] inform Ballantyne, Ambac or Assured Guaranty that the Ballantyne Portfolio failed to comply with the Investment Guidelines, including [the stated investment

---

[4] *See Jamie Dimon's Swat Team: How J.P. Morgan's CEO and his crew are helping the big bank beat the credit crunch*, Fortune Magazine, Sept. 2, 2008.

[5] The article is entitled: *Dimon Sees a Sign of Recession*, MarketWatch, Jan. 30, 2007.

objective]," and it "continued purchasing and holding Subprime Securities for the Portfolio after it had determined to reduce its own exposure to such securities and that of other clients."

The Complaint goes on to allege that during JPMIM's tenure as investment manager, the Portfolio lost approximately $1 billion. As a result of the losses suffered, Ballantyne failed to make scheduled payments under its Notes, thereby causing Ambac's and Assured Guaranty's guarantees to be called upon. Plaintiff alleges that during January and February 2009, Ambac made approximately $2.5 million in payments to Noteholders that Ballantyne was unable to make.

The Complaint sets forth claims for breach of contract (first cause of action), breach of fiduciary duty (second cause of action), and gross negligence (third cause of action).

JPMIM now moves for an Order, pursuant to CPLR §§ 3211(a)(1) and (a)(7), dismissing the Complaint in its entirety.

<u>Discussion</u>

I. Breach of Contract Claim

JPMIM contends that the breach of contract claim should be dismissed because JPMIM complied fully with the Investment Guidelines, it did not act with gross negligence or willful misconduct in managing the Accounts, and it did not violate the Delaware Insurance Code.[6]

At the outset, JPMIM contends that plaintiff has failed to allege that defendant violated the IMA or the Investment Guidelines, which specifically provide that JPMIM can invest the funds in the Accounts in up to 60% of "Home Equity Loan Asset Backed Securities" and in up to 50% of "Mortgage Backed Securities," including up to 30% of Alt-A mortgage-backed securities.

While plaintiff concedes that defendant did not exceed the percentage limitations, it nevertheless contends that JPMIM breached the IMA by failing to even pursue the investment objective of "obtain[ing] reasonable income while providing a high level of safety of capital" stated in the Guidelines.

---

[6] In addition, JPMIM contends that all of plaintiff's claims are barred because neither Ballantyne nor plaintiff objected in writing to any transactions "within a period of ninety (90) days from the date of receipt of any statement from [JPMIM],..." as required by section 7(d) of the IMA. However, this argument is of no moment as plaintiff's claims are based upon JPMIM's failure to manage the Portfolio in accordance with the investment objective rather than predicated upon a specific "act or transaction."

Plaintiff cites to the case of *Sergeants Benevolent Association Annuity Fund v. Renck*, 2004 WL 5278824 at *4-5 (Sup. Ct., NY Co. 2004), *rev'd on other grounds*, 19 AD3d 107 (2005), in which the Court upheld a breach of contract claim based on defendant's alleged failure to comply with the fund's investment strategy of "conservative capital appreciation." However, there the plaintiff had alleged that the defendant breached that requirement "by investing ... the assets ... in highly volatile technology, communication and Internet Stocks." *Id.* Conversely, here it is undisputed that defendant invested the assets precisely in the type of securities provided for, and agreed upon by the parties, in the Investment Guidelines.

Merely alleging failure to pursue an investment objective, where defendant actually followed the specific diversification requirements contained in the Guidelines that were intended to implement that objective, is not sufficient to set forth a claim for breach of contract. *See Guerrand-Hermès v. J.P. Morgan & Co. Inc., 2 AD3d 235, 238 (1st Dep't 2003)*, in which the Court dismissed a breach of contract claim alleging that the investment advisor declined to follow its client's direction to sell certain securities, based on the rationale that the investment advisor had discretionary authority over the account and "was in compliance with the investment guidelines' diversification requirements;" *see* *also Vladimir v. Cowperthwait*, 42 AD3d 413, 415 (1st Dep't 2007), in which the Court found that an investment manager with discretionary authority was not liable to an investor for failure to achieve an investment objective where the securities purchased complied with the contractual diversification requirements.[7]

Moreover, at oral argument held on the record on December 16, 2009, defendant's counsel pointed out that the parties, at plaintiff's insistence, entered into a revised set of Guidelines on December 28, 2007, when the Portfolio had already started suffering losses. The new Guidelines stated the same investment goal, *i.e.*, "to obtain reasonable income while providing a high level of safety of capital," and listed every security purchased as of that date as a permitted security in the Portfolio.

JPMIM next contends that plaintiff failed to sufficiently

---

[7] After this motion was fully submitted, but prior to oral argument, the parties, pursuant to Commercial Division Rule 18, submitted a copy of a decision rendered by the Hon. Melvin L. Schweitzer in the case of *CMMF, LLC v. J.P. Morgan Investment Management, Inc., et al.*, Index No. 601924/09, dated December 10, 2009, in which the Court, *inter alia*, dismissed those portions of the breach of contract claim predicated on the allegations that, "defendants had too much appetite for risk, and did not disclose that risk in its statements, even if their investment decisions did result in a portfolio which comported with the sector diversification guidelines." *Id.* at 6. In *CMMF*, Judge Schweitzer ultimately declined to dismiss the claim for breach of contract because there, unlike this case, plaintiff had actually alleged that JPMIM violated the percentage limitations provided for in the "sector" guidelines.

allege that defendant managed the Accounts in a grossly negligent manner.[8] Plaintiff argues that JPMIM knew, through its parent or affiliate JPMorgan Chase, that Subprime Securities were too risky and did not warn plaintiff or take appropriate action. However, as defendant points out, Mr. Dimon's statements in the Fortune article did not concern the type of securities at issue here. Rather, the securities discussed by Mr. Dimon were "CDOs" (*i.e.*, Collateralized Debt Obligations) and "SIVs" (*i.e.*, Structured Investment Vehicles), which were never purchased for these Accounts. Further, the quotes from the MarketWatch article relate to mortgage lending and not to mortgage-backed securities.[9]

Plaintiff has not otherwise alleged facts which adequately support the allegation that JPMIM acted with gross negligence or

---

[8] Section 14(b) of the IMA provides that JPMIM shall not be liable for any losses "arising from any depreciation in the value of the Accounts ... except to the extent such Losses are judicially determined to be proximately caused by the gross negligence or willful misconduct of [JPMIM]."

[9] Defendant also points out that in a class action involving securities fraud claims against Ambac Financial Group, Inc. ("Ambac Financial"), which is Ambac's holding company, filed in the United States District Court for the Southern District of New York and captioned *In Re Ambac Financial Group, Inc. Securities Litigation*, Case No. 08-CV-411, Ambac Financial argued in its motion to dismiss that, like its competitors and numerous other financial institutions, it failed to predict the unprecedented impact of adverse market trends. JPMIM thus contends that Ambac's argument imputing knowledge of the then-looming credit crisis to JPMIM is inconsistent with Ambac's parent's position in the federal case.

willful misconduct in managing the Accounts. *See Retty Financing, Inc. v. Morgan Stanley Dean Witter & Co.*, 293 AD2d 341 (1st Dep't 2002) (affirming dismissal of breach of contract claim for gross negligence or willful misconduct where the Complaint failed to set forth actions by the defendant evincing "a reckless disregard for the rights of [plaintiff] or 'smack[ing]' of intentional wrongdoing...[citation omitted]").

JPMIM further contends that it did not violate Chapter 13 of the Delaware Insurance Code (the "Code") which prescribes the types of securities that are eligible investments for insurers. JPMIM points out that the Investment Guidelines expressly provide that "[o]ne hundred percent (100%) of invested assets ... must have at least two ratings from [National Recognized Statistical Rating Organizations]." Thus, JPMIM argues that the securities challenged by plaintiff in this case are not covered, as alleged by plaintiff, by §1323 of the Code, which does not mention ratings and applies to single commercial residential mortgages, or participations in such mortgages. Rather, defendant contends they fall under §1308, which covers "obligations rated 1 or 2 by the SVO [[10]] if they are

[10] "SVO" refers to the "Securities Valuation Office of the National Association of Insurance Commissioners." JPMIM contends that all the securities at issue here were rated "A" or higher by Standard & Poor's, or "A2" or higher by Moody's at the time of purchase, and that an "A" rating is the equivalent of a "1" rating by the SVO.

issued, assumed or guaranteed by any solvent institution created or existing under the laws of the United States..." (§1308[a]).

Section 1309(a)(1) defines "obligations" to include "bonds, debentures, notes and other evidences of indebtedness ... as well as participation interests in any of the foregoing." Defendant contends that all the securities at issue here are "notes" or "participation interests" covered by section 1308 and satisfy the ratings requirement of that section. Thus, JPMIM argues that it did not violate §1308 as that section does not impose any limitation on the amount of such securities that may be owned.

In opposition, plaintiff contends that the vast majority of securities purchased by JPMIM were "bonds and notes ... secured by first or second mortgages or deeds of trust," of the kind covered by §1323 and subject to the 50% limitation.

However, defendant contends that an investment is not required to comply with both sections of the Code. In fact, §1308(c) provides that, "[a]n insurer may also invest any of its funds in obligations other than those permitted in subsections (a) or (b) of [§1308] *or* those eligible for investment under 1323 (real estate mortgages) of this title if they [meet the requirements of §1308(c)] (emphasis added)." Moreover, §1302(c) provides in relevant part that an investment "may be qualified or requalified at the time of acquisition or at a later date,... under <u>any section of this chapter</u> (emphasis supplied), if the relevant conditions contained in the section are satisfied at the time of qualification or requalification." Thus, this Court finds that JPMIM did not breach the IMA as it complied with §1308 of the Code which is applicable to the securities at issue.

Accordingly, this Court finds that plaintiff's breach of contract cause of action must be dismissed.

II. Breach of Fiduciary Duty and Gross Negligence Claims

JPMIM contends that the breach of fiduciary duty and gross negligence claims should be dismissed for failure to state a claim because they are preempted by New York General Business Law ("GBL"), Art. 23-A, §352, *et seq.* ("the Martin Act" or "the Act").[11]

Section 352-c(1) of the GBL (the Martin Act) provides that:

> 1. It shall be illegal and prohibited for any person, partnership, corporation, company...to use or employ any of the following acts or practices:
> (a) Any fraud, deception, concealment, suppression, false pretense...;

---

[11] As additional grounds for dismissal of the tort claims, JPMIM contends that defendant owed no duty to plaintiff, the claims are duplicative of plaintiff's breach of contract claim and the economic loss doctrine bars tort claims based only on economic harm.

> (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;
>
> (c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made;
>
> where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities..., regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

The Court of Appeals has held that there is no implied private right of action under the Martin Act as the purpose of the statute was:

> to create a statutory mechanism in which the Attorney-General would have broad regulatory and remedial powers to prevent fraudulent securities practices by investigating and intervening at the first indication of possible securities fraud on the public and, thereafter, if appropriate, to commence civil or criminal prosecution;..."

CPC Intl. v. McKesson Corp., 70 NY2d 268, 277 (1987).

JPMIM relies on the case of *Nanopierce Techs., Inc. v. Southridge Cap. Mgmt.*, 2003 WL 22052894, at *3-4 (SDNY 2003), in which the Court (Sand, J.) in a comprehensive decision reviewing New York case law from both the Federal and State Courts, held that claims such as breach of fiduciary duty and negligent misrepresentation which, unlike common law fraud, do not require proof of deceitful intent, are covered by the Martin Act and cannot be asserted by private litigants. *See also* Horn v. 440 E. 57th Co., 151 AD2d 112 (1st Dep't 1989).

Plaintiff contends that the tort claims are not preempted by the Martin Act because they are not predicated upon allegations of fraud or deceptive conduct, but only involve mismanagement of the Portfolio. *See Louros v. Kreicas*, 367 F Supp 2d 572, 595-96 (SDNY 2005), in which the Court held that "[a] claim of breach of duty that involves securities but does not allege any kind of dishonesty or deception implicates neither the plain language of the statute nor its policies."

However, plaintiff's claims do not involve mere mismanagement as the claims discussed in *Louros v. Kreicas*.[12] Rather, the claims here are premised on the allegations in the Complaint that JPMIM was aware of the risks related to the Subprime Securities and

---

[12] In *Louros v. Kreicas, supra*, 367 F Supp 2d at 596, the Court held plaintiff "simply alleged that [defendant] breached a fiduciary duty owed to [plaintiff] to manage his accounts in a way that comported with his needs and to keep him informed about the market and the trades in his account. This [claim] does not allege deception, deliberate or otherwise. Accordingly, [the claim] does not come within the Martin Act, and will not be dismissed."

Similarly, in *CMMF, LLC v. J.P. Morgan Investment Management, Inc., supra*, Judge Schweitzer declined to dismiss the tort claims as preempted by the Martin Act after making a finding that the plaintiff there was seeking damages only for mismanagement of its portfolio.

failed to disclose them to plaintiff or Ballantyne, while, at the same time, it was reducing its own exposure, and that of other clients, to such securities. *See In Re Bayou Hedge Fund Litigation*, 534 F Supp 2d 405, 422 (SDNY 2007), in which the Court, distinguishing *Louros v. Kreicas*, observed that a host of state and federal decisions have found breach of fiduciary claims arising in the securities context to be preempted by the Martin Act, and that that analysis was "consistent with the statute's broad reach and purpose;" *see also Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.*, 651 F Supp 2d 155, 172 (SDNY 2009), which held that "[t]he Martin Act preempts, at least, the following common law claims when they are predicated on the purchase or sale of securities within or from New York: negligence; breach of fiduciary duty; negligent misrepresentation;..."

Accordingly, this Court finds that plaintiff's claims do fall within the purview of the Martin Act and thus must be dismissed as preempted.[13]

---

[13] Since the tort claims are dismissed as preempted, this Court need not discuss defendant's additional grounds for dismissal of these claims.

The motion is thus granted in its entirety and the action is dismissed, with prejudice and without costs or disbursements.

This constitutes the decision and order of this Court.

Dated: March 24, 2010

Barbara R. Kapnick
J.S.C.

BARBARA R. KAPNICK
J.S.C.