

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

PRESENT: MELVIN L. SCHWEITZER

PART 45

MELVIN L. SCHWEITZER Justice J.S.C.

China Development Industrial Bank

INDEX NO. 650957/2010

Morgan Stanley & Co. Incorporated et al

MOTION DATE 001,002
MOTION SEQ. NO. 003
MOTION CAL. NO.

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

Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...

Answering Affidavits — Exhibits

Replying Affidavits

PAPERS NUMBERED

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that this motion by defendants Morgan Stanley & Co Incorporated and Morgan Stanley & Co International PLC to

Dismiss each of the causes of action of the complaint is DENIED,

Motion by defendant TCW Asset Management Company, Jeffrey Gundlach and Louis Lucido to dismiss each of the causes of action against them is GRANTED

Motion by Morgan Stanley & Co to strike Plaintiff demand for jury trial with respect to fraudulent inducement claim is DENIED, and with respect to all other causes is GRANTED

Dated: February 25, 2011

Melvin L. Schweitzer J.S.C.

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DO NOT POST

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

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

-----X  
CHINA DEVELOPMENT INDUSTRIAL BANK,

Plaintiff,

-against-

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

Defendants.  
-----X

Index No. 650957/2010

DECISION AND ORDER

Sequence Nos. 001, 002, 003

**MELVIN L. SCHWEITZER, J.:**

This matter involves the sale of an investment product by a diversified financial services firm to a sophisticated, institutional investor. The investor asserts it was, *inter alia*, defrauded in the transaction, as the financial services firm made numerous materially false statements in connection with the marketing of the investment product.

**Background**

Defendant Morgan Stanley & Co. Incorporated and its affiliate Morgan Stanley & Co. International PLC (together, Morgan Stanley) designed and, through an affiliate, held an investment product (Supersenior Swap) which was the senior security in the capital structure of a hybrid collateralized debt obligation (CDO). Plaintiff, China Development Industrial Bank (CDIB), brought this action alleging that its purchase from Morgan Stanley of a mirror credit default swap tied to the Supersenior Swap was induced by fraud, that Morgan Stanley also engaged in common law fraud in connection with the sale, that a co-defendant, TCW Asset

Management Company (TCW), which was the collateral manager of the CDO, aided and abetted Morgan Stanley's fraudulent conduct, and that Morgan Stanley, TCW and two individuals engaged in fraudulent concealment in connection with the sale. Morgan Stanley, TCW and the two individuals move to dismiss the complaint. Morgan Stanley also moves to strike CDIB's demand for a jury trial based on an express provision in the transaction document. CDIB counters that the fraudulent conduct of defendants has resulted in its suffering damages in an amount which may be proved at jury trial in this instance.

The CDO in this structure was an issuer of debt and equity to investors which used the sale proceeds to buy financial assets. In this case, the CDO held financial assets tied almost entirely to the residential real estate sector. These assets carried ratings issued by Nationally Recognized Statistical Rating Organizations (Rating Agencies). Its capital structure was comprised of equity, tiers of rated notes and the Supersenior Swap. The value of each of the securities in the CDO's capital structure was inextricably linked to the economic performance of the CDO's assets. The Supersenior Swap was the most senior security in the CDO's capital structure, senior, in fact, to notes which were rated AAA.

Plaintiff introduces the allegations of its complaint in summary fashion:

"At its core, this case is very simple. One of the largest banks on Wall Street, and one of the largest producers of rated subprime bonds in the world, made an investment tied to U.S. subprime mortgage bonds in mid-2006. During the following months, Morgan Stanley learned about serious problems with this investment. But it did not want to lose money on its bad investment, so it dumped those losses on plaintiff in April 2007.

"Defendant Morgan Stanley transferred the risks associated with its bad investment to plaintiff by calling it a 'Supersenior Swap' that was even 'higher than AAA' in safety, meaning it was similar in safety to a U.S. Treasury Bill. The 'Supersenior Swap' was in truth a credit ratings trap that was destined to fail. Too

much information supports this conclusion to permit Morgan Stanley's conduct to stand unchallenged."

CDIB proceeds to allege in detail that Morgan Stanley designed and arranged the CDO, marketed the securities in its capital structure and, subsequently, sold the mirror credit default swap tied to the Supersenior Swap to CDIB. CDIB also alleges in detail that Morgan Stanley engaged in the following fraudulent scheme.

Morgan Stanley represented to CDIB that the Supersenior Swap was an almost risk-free asset, more stable than a "AAA" rated bond and that the CDO's assets had better, more stable credit ratings than similarly rated corporate bonds. It represented that the assets were backed by mortgage bonds whose credit quality had improved in recent years. It represented that the CDO's asset default correlation assumption was lower than it knew a reasonable assumption to be in the circumstances.

At the time that Morgan Stanley made these representations, however, it allegedly knew, through its close contact with, and influence over, the Rating Agencies, that, based on the models and assumptions used to generate the ratings of the CDO's securities, its representations were false and that the Supersenior Swap was a highly risky, if not troubled, investment. The complaint states in this respect that "Morgan Stanley paid for the credit ratings and worked with the rating agencies to engineer the ratings. Morgan Stanley itself manipulated the rating agencies' models to create the STACK CDO's balance sheet, and knew that [the] weak balance sheet belied the 'Supersenior' position it marketed to CDIB as being even more stable than a AAA bond." (Complaint, ¶ 13) Furthermore, "Morgan Stanley knew, based on the assumptions

and models used to generate these ratings, that the ratings were false and that the various classes of STACK CDO notes were riskier than was indicated by their ratings.” (Complaint, ¶ 49 (d))

It also allegedly knew that mortgage originators had been lowering their standards, resulting in a higher reasonable default correlation assumption than was being applied in connection with the rating of the CDO’s assets and that the credit quality of mortgage bonds was, in fact, declining. In this respect, the complaint states that “Morgan Stanley knew that these models and assumptions were unreasonable, particularly so given the fact that it was in constant contact with the Rating Agencies and knew how unstable their models were,” (Complaint, ¶ 54) that “Morgan Stanley knew that the mortgage originators were decreasing their underwriting standards during these periods and that the decrease in underwriting standards year-over-year increased the correlation of assets generated in those years” (Complaint, ¶ 81) and that “Nor was it true that the ‘average credit quality of loans underlying home equity securitizations had improved in recent years’ as Morgan Stanley represented, which was a blatant lie . . .” (Complaint, ¶ 87) Specifically, with respect to its dealings with the Rating Agencies, Morgan Stanley allegedly learned that the agencies were changing their methodologies, yet persuaded them to grandfather the transactions at issue by using the Rating Agencies’ old methodologies. CDIB asserts that Morgan Stanley did not disclose this to CDIB. The complaint states in this regard “In essence, Morgan Stanley sold a deal to CDIB that was made with models that were no longer in use, and the models for the STACK CDO’s constituent securities were no longer in use, as Morgan Stanley knew given its extensive dealings with the Ratings Agencies.” (Complaint, ¶ 100) In sum, Morgan Stanley allegedly knew that the CDO’s assets were rated with models no

longer in use, and that Morgan Stanley was fully aware the ratings of the CDO assets were far from stable and would likely be downgraded in the future.

Finally, Morgan Stanley allegedly failed to disclose to CDIB that in this instance it had paid the Rating Agencies performance fees of up to three times the amount it ordinarily would pay to obtain a rating for a corporate obligation in return for the agencies assistance in structuring the product, including the obtaining of “grandfathered” treatment for the CDO’s assets. This arrangement allegedly corrupted the rating process by producing ratings that did not reflect the risky character of the Supersenior Swap. In this respect, the complaint states that “Defendants failed to disclose all of the compensation arrangements with the Rating Agencies – including ‘repeat player’ compensation paid by banks such as Morgan Stanley” (Complaint, ¶ 115), that “the Rating Agencies were paid nearly three times the amount to rate the [CDO] as they would have received to rate a traditional corporate debt obligation” (Complaint, ¶ 116), that “. . . they were paid substantially more to rate the [CDO] . . . because they helped Morgan Stanley structure – that is, create the product” (Complaint, ¶ 116), that “the models for the [CDO’s] constituent securities were no longer in use” (Complaint, ¶ 100) and that “the Rating Agencies structuring and attendant ‘pay for performance’ compensation undermined the credibility of their ratings to such a degree as to make those ratings false and misleading.” (Complaint, ¶ 116)

## **Discussion**

### Motion to Dismiss and Pleading Fraud Standards

To succeed on a motion to dismiss under CPLR 3211 (a) (1), a defendant must show that the relied-upon documentary evidence “resolves all factual issues as a matter of law, and conclusively disposes of the plaintiff’s claim.” *Fortis Fin. Servs., LLC v Fimat Futures USA*,

*Inc.*, 290 AD2d 383 (1<sup>st</sup> Dept 1998). To determine whether there is a basis for dismissal under CPLR 3211 (a) (7), the court's role is to determine only whether the facts as alleged fit within any cognizable legal theory. *Leon v Martinez*, 84 NY2d 83, 84 (1994). On such a motion to dismiss, the court is to accept facts as alleged in the complaint as true and to accord plaintiffs every possible favorable inference. *Guggenheimer v Ginzburg*, 43 NY2d 268 (1977). When evidentiary material has been considered on such a motion to dismiss, the criterion is whether the pleader *has* a cause of action and dismissal is not appropriate unless an alleged material fact is not a fact at all and no significant dispute exists concerning it. *Id.*

While the facts alleged in the complaint are presumed to be true, the court, however, need not accept as true “[v]ague and conclusory allegations.” *Marino v Vunk*, 39 AD3d 339, 340 (1<sup>st</sup> Dept 2007), and such allegations are insufficient to sustain a cause of action. “Bare legal conclusions and factual claims which are flatly contradicted by the record are not presumed to be true.” *Kopelowitz & Co., Inc. v Mann*, 23 Misc 3d 1112(A), 2009 WL 1037734, at \* 3 (Sup Ct Kings Cty Apr. 17, 2009) (citations omitted). *See also Jericho Group v Midtown Dev.*, 32 AD3d 294, 298-99 (1<sup>st</sup> Dept 2006) (citations omitted).

Pleading fraud requires allegations of “a material misrepresentation of fact, knowledge of its falsity, an intent to induce reliance, justifiable reliance by plaintiff and damages.” *Eurycleia Parkners, L.P. v Seward & Kissel, LLP*, 12 NY3d 553, 559 (2009). The allegations must be stated in detail. CPLR 3016.

#### Morgan Stanley's Material Misrepresentations

In the first instance, Morgan Stanley contends the complaint should be dismissed because there are no actionable statements alleged against it. The court disagrees. The court is of the

view that CDIB has alleged in sufficient detail that Morgan Stanley knew the Supersenior Swap was a highly risky, if not troubled, investment and also that the ratings process which made it appear to be safe, or even more secure than a “AAA” rated security, was deeply flawed. These flaws are pointedly alleged to be due in part to Morgan Stanley’s influence over the ratings process. Morgan Stanley’s alleged knowledge, and its statements recited above, constitute bare material misrepresentations of fact made to induce the purchase of an investment security. Accordingly, Morgan Stanley’s motion to dismiss the causes of action for fraud and fraudulent inducement for failure to state a cause of action is denied. The court also is of the opinion that, in the circumstances, Morgan Stanley had a duty to disclose relevant facts, including the “grandfathering” of ratings methodologies and the payment of extraordinarily high performance fees, regarding its own involvement in the ratings process because of its sole knowledge of those facts, even though, in the circumstances, Morgan Stanley was not a fiduciary. Therefore, Morgan Stanley’s motion to dismiss the cause of action for fraudulent concealment is also denied.

#### Justifiable Reliance

Morgan Stanley next defends that even had it made actionable statements to CDIB, CDIB made representations in the transaction document which it executed that it was not relying on the statements of Morgan Stanley and that CDIB would conduct and rely on its own due diligence in connection with making its investment decision. Morgan Stanley argues that this precludes CDIB from pleading justifiable reliance. In this respect, CDIB represented:

“Non-Reliance. It is acting for its own account, and it has made its own independent decisions to enter into [the] Transaction and as to whether [the] Transaction is appropriate or proper for it is based upon its own judgment and upon advice from such advisers as it has deemed necessary. It is not relying on any communication (written or oral) of the other party as investment advice or as

a recommendation to enter into [the] Transaction; it being understood that information and explanations related to the terms and conditions of a Transaction shall not be considered investment advice or a recommendation to enter into [the] Transaction. No communication (written or oral) received from the other party shall be deemed to be an assurance or guarantee as to the expected results of [the] Transaction; and

“Assessment and Understanding. It is capable of assessing the merits of and understanding (on its own behalf or through independent professional advice), and understands and accepts, the terms, conditions and risks of [the] Transaction. It is also capable of assuming, and assumes, the risks of [the] Transaction;

Morgan Stanley further asserts that marketing material used in connection with the sale of notes in the capital structure of the CDO was delivered to, and relied upon, by CDIB, and contained the following caveats:

“None of . . . the Managers [i.e., Morgan Stanley] . . . has separately verified the information contained in this Final Offering Memorandum. . . . Each person receiving this Final Offering Memorandum acknowledges that such person has not relied on . . . the Managers or any of their respective affiliates in connection with the accuracy of such information or its investment decision;

“Each person contemplating making an investment in the Notes must make its own investigation and analysis of the Co-Issuers and its own determination of the suitability of any such investment. . . .;

“Prior to entering into any proposed transaction, recipients should determine, in consultation with their own investment . . . advisors, the economic risks and merits . . . of the transaction; and

“Potential investors are urged to conduct their own investigation regarding the underlying asset classes, including reviewing any sources cited herein and obtaining additional information regarding the underlying collateral.”

Morgan Stanley, citing *Dannan Realty Corp. v Harris*, 5 NY2d 317, 320-321 (1959), *Citibank, N.A. v Plapinger*, 66 NY2d 90, 95 (1985) and *MBIA Ins. Co. v Merrill Lynch, Pierce, Fenner & Smith Inc.*, No. 601324/09, 2010 NY Misc LEXIS 1580, at \*5 (NY Cty 2010), *affd.*, 2011 WL 292252 (1st Dept 2011) contends that investors who make representations of this tenor

are bound by them when attempting to plead fraud, and are bound even when the representations to investors are less specific than those in the instant case.

Morgan Stanley also points to what it characterizes as CDIB's failure to perform adequate due diligence with respect to the investment transaction. This, Morgan Stanley says, undercuts CDIB's assertion of justifiable reliance. It emphasizes, in this regard, that CDIB represented in the transaction document that it had made its own investment decision based on its own judgment and advice from advisers as it deemed necessary. This, Morgan Stanley contends, puts this matter well within the ambit of the recent ruling in *MBIA Insurance Corp.*, where the plaintiff had represented that it was able to acquire knowledge sufficient to assess the investment and intended to do so. There the fraud claims were dismissed, in part, because plaintiff's representations rebutted its allegation of justifiable reliance.

Although the use of prophylactic legends with respect to sophistication in investment transaction documents, along with investor-representations regarding due diligence, have been held to negate justifiable reliance in some common law fraud actions (such as *MBIA Insurance Corp.*), Morgan Stanley has not cited a case which would persuade the court that the legends or representations present in this matter have such an effect. In fact, one of the core allegations of CDIB's complaint is that Morgan Stanley suborned and corrupted the rating agencies so that they would rate investment securities with a higher rating than would have been warranted under application of then prevailing protocols and assumptions. This posits 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.

Indeed, the content of Morgan Stanley's investment pitchbook compounded the disadvantageous position in which CDIB was allegedly trapped by Morgan Stanley's misbehavior. The pitch admitted that the CDO had no employees or operating history and advised that requests for additional information be made to Morgan Stanley. Allegedly, Morgan Stanley corrupted the process and then covered up its wrongdoing by fielding probes aimed at obtaining information which were intended to put CDIB on notice of the infirmities underlying the investment product. In sum, it is alleged that Morgan Stanley had a present intent to commit fraud and, in fact, skillfully covered it up. In such circumstances disclaimer clauses and cautionary language such as are present here (or, that this court can otherwise think of) may not be invoked to defeat the pleading of justifiable reliance.<sup>1</sup> In a case similar in many respects to the matter here, *King County v IKB Deutsche Industriebank 2010 v.s. Dist.*, Lexis 115351 \*20, the court said:

“The first argument simply repackages Morgan Stanley's argument that it made no material misstatement, an argument I have already rejected. The second and third arguments are unavailing for the same reasons I ruled in *Abu Dhabi*, under analogous circumstances, that plaintiffs' reliance on credit ratings was reasonable despite liability disclaimers and due diligence . . . disclaimers and due diligence 'requirements' are invalid if 'the information required to confirm or disprove the validity of the [ratings] was peculiarly within [Morgan Stanley's] knowledge.' Here, plaintiffs have alleged a great deal of such peculiarly-held knowledge on Morgan Stanley's part. The FAC alleges not only that Morgan Stanley knew (1) that the Rated Notes were neither safe nor stable, but also (2) that the ratings process was flawed and (3) that the Rating Agencies could not issue objective ratings – none of which was disclosed to investors or discoverable through reasonable diligence.”

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<sup>1</sup> This is particularly the case here where the transaction document provided that nothing therein would limit or exclude Morgan Stanley's liability for fraud.

*See also HSH Nordbank AG v UBS AG and UBS Sec LLC*, No. 600562/08; Slip Op. at 5; *MBIA Ins. Corp. v Royal Bank of Canada*, No. 12238/09, 2010 NY Misc, Lexis 3958 at \*61 (NY Sup Ct 2010); *see also MBIA* at 2011 WL 292252.

The court also is of the opinion that the reasonableness of CDIB's alleged reliance on the stability and meaning of the credit ratings that Morgan Stanley allegedly fraudulently procured and promoted is fact intensive and not best determined at the pleading stage. *P.T. Bank Cent. Bank N.V.*, 301 AD2d 373-378 (1st Dept 2003). Accordingly, Morgan Stanley's motion to dismiss the complaint on the grounds that CDIB did not plead justifiable reliance is denied.

#### Scienter

Morgan Stanley posits that a complaint must allege sufficient facts to support a reasonable inference that the defendant participated in, or knew about, the fraud. *Eurycleia Partners, L.P.*, 12 NY3d at 559; *Friedman v Anderson*, 23 AD3d 163, 166-167 (1st Dept 2005). CDIB's complaint pleads that Morgan Stanley had both the motive and opportunity to commit fraud and also that it recklessly or consciously made false representations in connection with the sale of the Supersenior Swap.

First, Morgan Stanley is alleged to have known that it was holding a troubled investment security that could cause it to lose over \$200 million. Due to Morgan Stanley's close relationship with, and alleged influence over, the Rating Agencies, it also had the opportunity to commit fraud by participating in the dissemination of false and misleading ratings in connection with the sale of the mirror credit default swap tied to the Supersenior Swap. Second, as detailed above, CDIB has alleged that Morgan Stanley knew that the Supersenior Swap was far from a safe "AAA" quality investment, that the ratings process relating to the CDO's assets was flawed and

that Morgan Stanley was directly involved in undermining the integrity of that rating process. These allegations are more than sufficient to support a reasonable inference that Morgan Stanley participated in or knew about the fraud. Morgan Stanley's motion to dismiss the complaint on the grounds CDIB did not adequately plead scienter is denied.

#### Ratification

Morgan Stanley contends that CDIB's execution of the May 12, 2009 Agreement and Amendment No. 1 (Amendment) with respect to the mirror credit default swap tied to the Supersenior Swap constitutes a ratification of the transaction and, therefore, CDIB has lost its right to seek rescission, but not damages. The court disagrees. First, CDIB explicitly reserved its remedies under the transaction document, which include rescission, and second, CDIB alleges it was not aware of the fraud at the time it executed the Amendment. In any event, this issue is replete with questions of fact which cannot be dealt with on a motion to dismiss. Accordingly, Morgan Stanley's motion to dismiss all of CDIB's causes of action against it on the basis of ratification is denied.

#### TCW and Individual Defendants

CDIB asserts claims against TCW, and two individuals employed by TCW, for fraudulent concealment and aiding and abetting fraud. In each case, the allegations with respect thereto lack detail, are highly speculative and conclusory. They do not, in either case, approach the standards established by clear judicial precedent under New York law for pleading a cause of action. Put simply, they are without merit and do not warrant the court spending limited judicial resources in an analysis of their manifest shortcomings. Accordingly, the motions of TCW and Jeffrey

Gundlach and Louis Lucido to dismiss the complaint pursuant to CPLR 3211 (a) (7) and 3016 (b) are granted.

### Jury Trial

Morgan Stanley moves to strike CDIB's demand for a jury trial based on the express provision in the transaction document that "each party waives, to the fullest extent permitted by applicable law, its right to have a jury trial in respect to any proceedings related to this Agreement."

Such waivers are generally upheld by courts in New York. However, such a waiver does not apply to a claim of fraudulent inducement challenging the validity of an agreement. *Wells Fargo Bank v Stargate Films, Inc.*, 18 AD3d 264, 265 (1st Dept 2005). Morgan Stanley's argument that the ratification referred to above undercuts this rule is not persuasive. As noted above, CDIB alleges it was not aware of the fraud at the time of the ratification and, thus, the ratification does not affect the rule enunciated in Wells Fargo.

Accordingly, here, Morgan Stanley's motion to strike the demand for a jury trial with respect to the fraudulent inducement claim is denied, but it is granted with respect to the other causes of action against Morgan Stanley.

Accordingly, it is

ORDERED that Morgan Stanley's motion to dismiss each of the causes of action against it is denied; and it is further

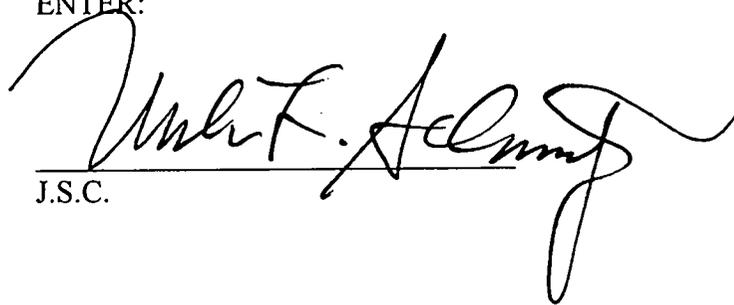
ORDERED that TCW, Jeffrey Gundlach and Louis Lucido's motion to dismiss each of the causes of action against them is granted; and it is further

ORDERED that Morgan Stanley's motion to strike CDIB's demand for a jury trial with respect to the fraudulent inducement claim is denied and, with respect to the other causes of action, is granted; and it is further

ORDERED that the parties are to appear at a Preliminary Conference at 60 Centre Street, Rm. 218, New York, New York 10007 on Wednesday, March 23, 2011 at 10 a.m.

Dated: February 25, 2011

ENTER:

  
A handwritten signature in black ink, appearing to read "Michael F. Acland", is written over a horizontal line. The signature is fluid and cursive.

J.S.C.