

SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: MELVIN L. SCHWEITZER
Justice

PART 45

Index Number : 652129/2012
BASIS YIELD ALPHA FUND MASTER
vs.
MORGAN STANLEY
SEQUENCE NUMBER : 002
DISMISS ACTION

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 to dismiss the complaint is DENIED in part and GRANTED in part per the attached Decision and Order.

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

Dated: February 28, 2013

MELVIN L. SCHWEITZER (Signature)

- 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

-----X
BASIS YIELD ALPHA FUND MASTER,

Plaintiff,

-against-

MORGAN STANLEY, MORGAN STANLEY & CO.
LLC., (f/k/a MORGAN STANLEY & CO. INC.)
MORGAN STANLEY & CO. INTERNATIONAL PLC
(f/k/a MORGAN STANLEY & CO. INTERNATIONAL
LTD), JOHN DOES 1-50,

Defendants.
-----X

Index No. 652129/2012

DECISION AND ORDER

Motion Sequence No. 002

MELVIN L. SCHWEITZER, J.:

Defendants (collectively "Morgan Stanley") have moved to dismiss the complaint pursuant to CPLR 3211 (a) (7). For the reasons discussed below, the defendants' motion is granted in part and denied in part.

Background

The present case arises out of a \$500 million collateralized debt obligation (CDO) named "STACK 2006-1" (STACK), which issued notes which were then sold by Morgan Stanley to the plaintiff, Basis Yield Alpha Fund Master (Basis Yield).

STACK was collateralized by asset-backed securities, including residential mortgage-backed securities (RMBS), many of which were originally underwritten or securitized by Morgan Stanley or its affiliates. All of STACK's asset-backed securities were selected by Morgan Stanley. STACK then issued notes to investors in July 2006. Interest and principal payments on these notes were funded by the cash flow generated by the asset-backed securities.

STACK was structured with eight classes or tranches of notes, with credit ratings ranging from AAA for the most senior to unrated for the most junior, the latter known as the "Subordinated Notes." These credit ratings were assigned by the ratings agencies Moody's and Standard & Poor's. In the marketing materials circulated by Morgan Stanley, securing these ratings was presented as a condition of closing any sale.

Basis Yield is an investment vehicle for a highly sophisticated mutual fund based in the Cayman Islands. In July of 2006 it purchased \$17 million of unrated Subordinated Notes in the most junior tranche of STACK. In a Master Purchase Letter drafted in connection with this purchase, Basis Yield specifically disclaimed any investment reliance on Morgan Stanley, representing that it had "made its investment decision based solely upon its own judgment . . . and not upon any view, advice or representations (whether written or oral)" of Morgan Stanley. Basis Yield also represented that it had access to all the information that it deemed necessary to make an informed decision, that it had "consulted with its own legal, regulatory, tax, business, investment, financial, and accounting advisers" and that Morgan Stanley was not acting as its "fiduciary or financial or investment advisor."

Basis Yield brings claims for fraud, fraudulent concealment, and negligent misrepresentation. Its allegations include what it terms, respectively, (1) the "short bet," (2) toxic collateral, and (3) grandfathered credit ratings. First, with respect to the "short bet," Basis Yield alleges that Morgan Stanley placed a billion dollar bet against RMBS of the same kind as those which served as the collateral assets for STACK. This bet would only pay off if this type of security defaulted at a rate higher than the rate that Morgan Stanley estimated for the securities collateralizing STACK. Second, Basis Yield alleges that Morgan Stanley knew that STACK included RMBS which were "toxic," or composed of defective mortgages which did not

meet Morgan Stanley's underwriting guidelines. Finally, Basis Yield alleges that the credit ratings of the rated tranches were fraudulent, because Morgan Stanley paid the ratings agencies excessive fees to rate the CDO structure using an outdated, or "grandfathered," model which would provide inflated ratings.

Discussion

Basis Yield's Fraud Claims

To state a claim for fraud, a plaintiff must allege "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). In any claim for fraud, New York law requires that "the circumstances constituting the wrong shall be stated in detail." CPRL 3016 (b). Facts pled "on information and belief" without disclosing the source of that information are not sufficient to satisfy this pleading standard. *See Wall St. Transcript Corp. v Ziff Communications Co.*, 225 AD2d 322 (1st Dept 1996).

As a general rule, the issue of reasonable reliance should be decided by the trier of fact, not decided as a matter of law. *Swersky v Dreyer & Traub*, 219 AD2d 321, 328 (1st Dept 1996). As such, reliance is rarely a suitable matter for a motion to dismiss.

In this case, however, Basis Yield provided detailed and extensive disclaimers of reliance in the Master Purchase Letter. Although such disclaimers are generally effective under New York law, *see e.g. HSH Nordbank AG v UBS AG*, 95 AD3d 185, 194 (1st Dept 2012); *MBIA Ins. Corp. v Merrill Lynch*, 81 AD3d 419, 419 (1st Dept 2011), they will not bar a claim for fraud if the plaintiff has made specific allegations regarding facts known to the defendant and which could not have been discovered by the plaintiff in the course of due diligence. *China Dev. Indus. Bank v Morgan Stanley & Co. Inc.*, 86 AD3d 435, 436 (1st Dept 2011). The court thus

must determine whether there are any allegations in the complaint which are both pled with enough particularity to satisfy the fraud standard and reflect knowledge of facts peculiarly in the possession of Morgan Stanley at the time of the transaction. Because the court finds that in certain instances such allegations are sufficiently pled here, the disclaimers do not bar Basis Yield from pleading justifiable reliance.

1. The "Short Bet"

Morgan Stanley's alleged "short bet" against RMBS cannot support Basis Yield's claim for the simple reason that Morgan Stanley disclosed this position in the offering documents for STACK. The offering documents disclosed that Morgan Stanley was the "CDS Counterparty" in connection with STACK, and would be paid if the underlying collateral declined in quality. A position that is disclosed is not within the peculiar knowledge of Morgan Stanley, and so cannot allow Basis Yield to escape its disclaimers.

Even if Morgan Stanley's position had not been disclosed, the First Department has recently squarely confronted this question and held that such a position cannot support a claim for fraud. Simultaneously shorting and selling a security amounts simply to having a different view of the market than the buyer, and "in arm's length dealings between sophisticated parties, the seller is not obligated to disclose to the buyer its internal valuation of the item sold." *HSH Nordbank*, 95 AD3d at 202.¹ Merely taking a short position with respect to a security, absent any misrepresentation, does not create fraud liability.

¹ Basis Yield cites *ACA Fin. Guar. Corp. v Goldman, Sachs & Co.*, 35 Misc 3d 1217(A) (NY Sup Ct 2012) for the proposition that a seller may be under a duty to disclose taking a short position. However, that case rested on the allegation that the seller had permitted a third party, who intended to take a short position with respect to a CDO, "to play a major *but hidden* role in selecting its assets," while making an affirmative misrepresentation that the third party would hold a long position. *Id.* at *2, 13 (emphasis in original). It does not stand for the proposition that a seller is under a duty to disclose any short position, much less that such a position by itself can support fraud liability.

2. Toxic Collateral

Basis Yield's second allegation is that Morgan Stanley had knowledge that mortgages in the securities collateralizing STACK were defective and did not meet underwriting standards. The more general form of this allegation, based on Morgan Stanley's supposed familiarity with the market for RMBS and underwriting standards in the industry as a whole, cannot support a fraud allegation. See *HSH Nordbank*, 95 AD3d at 193, 196 (holding that general market information or industry-wide practices do not support a fraud claim). Information regarding the RMBS industry as a whole, furthermore, cannot be considered within the peculiar knowledge of Morgan Stanley, and thus does not help Basis Yield avoid its disclaimers.

The more specific form of this allegation, however, relates to Morgan Stanley's specific knowledge of particular securities in the STACK asset pool. At its most particular, the complaint names four specific securities which were underwritten by Morgan Stanley and included in the STACK asset pool. It also provides evidence that Morgan Stanley was aware of the underwriting failures of these specific securities due to investigations by the Massachusetts State Attorney General and the Federal Housing Finance Agency into Morgan Stanley's underwriting practices and due to reports produced by Morgan Stanley's third-party due diligence provider which referenced these particular securities.

The complaint includes a core of highly specific allegations with identified sources, sufficient to meet the pleading standards of CPLR 3016. Furthermore, these facts about Morgan Stanley's own underwriting and internal due diligence procedures were peculiarly within the knowledge of Morgan Stanley at the time that Basis Yield purchased the Subordinated Notes. As such, they both support Basis Yield's claim of fraud and demonstrate that, as a matter of law, its disclaimers of reliance are effective and it can plead justifiable reliance.

3. Grandfathered Credit Ratings

Basis Yield's final allegation is that Morgan Stanley used its influence over the ratings agencies (including payment of excessive undisclosed fees) to pressure them into rating the notes issued by STACK using an outdated rating model. This "grandfathered" rating model used assumptions about the underlying mortgages, such as default rates and default correlations, that Basis Yield claims Morgan Stanley knew to be less accurate than those used in a new rating model being used by the ratings agencies. The resulting ratings of the top seven tranches of notes, Basis Yield claims, fraudulently misrepresented the risks associated with STACK's assets.

The complaint contains allegations, based on information from the United States Senate's Permanent Subcommittee on Investigations, that Morgan Stanley had a collusive relationship with the ratings agencies and insisted on this grandfathering practice at exactly the time that the STACK notes were being rated. It also includes allegations that Morgan Stanley paid the ratings agencies nearly three times their normal fee to rate the STACK notes, and that using the newer and more accurate rating models would have necessitated a change in the structure of STACK. The same allegations about grandfathered credit ratings were recently held sufficient as a matter of law by the First Department both to overcome similar disclaimers and to state a claim for fraud. *See China Dev.*, 86 AD3d at 436. These allegations meet the pleading standard for fraudulent conduct related to the STACK structure as a whole. Furthermore, these facts were peculiarly in the knowledge of Morgan Stanley, and so allow Basis Yield to avoid its disclaimers of reliance; it is not barred as a matter of law from pleading justifiable reliance.

The primary difference between the present case and *China Development, supra*, is that while the plaintiff in that case bought a AAA-rated security, Basis Yield bought an unrated security. The issue then is whether an allegation of ratings fraud can support the claim of a

plaintiff who purchased an unrated security and claims that it relied on the ratings of the other notes in the CDO structure. In this complaint, Basis Yield has pled justifiable reliance on the more senior notes.

Morgan Stanley points out that Basis Yield clearly was informed that its own investment in the Subordinated Notes was unrated, highly risky, and speculative. Basis Yield does not anywhere allege that it was told that its investment was as safe as a rated, let alone a AAA-rated, note. This would be an unreasonable statement to rely on. Thus, the many disclaimers and warnings which Morgan Stanley provided about the risk of the Subordinated Notes are not relevant to Basis Yield's actual allegations.

What Basis Yield does allege is that STACK was structured as a unified CDO drawing upon a single pool of assets, and that the ratings of the senior tranches of notes were relevant and, in fact, essential to its evaluation of the much riskier most junior tranche. The complaint alleges that its purchase was conditional on the ratings agencies issuing the predicted ratings to the seven more senior tranches of STACK. It also provides an explanation as to why a failure of the higher tranches to receive the predicted ratings would have signaled problems with the structure as a whole, and thus caused it to rethink its planned investment. Finally, it describes the way that all the notes issued by a CDO are rated at the same time, based on the same model of the underlying assets, supporting the notion that the buyer of a lower tranche might evaluate its purchase as a part of a larger structure.

In light of these allegations, Basis Yield has adequately pled justifiable reliance on the ratings assigned to the notes in senior tranches. Whether it did in fact rely and whether this reliance was reasonable should be left to the trier of fact. Because it has alleged facts that were

peculiarly within the knowledge of Morgan Stanley, its disclaimers do not bar it from pleading justifiable reliance as a matter of law.

Next, Morgan Stanley claims that Basis Yield has not adequately alleged scienter. To satisfy the pleading standard of CPLR 3016, the complaint must allege facts “sufficient to permit a reasonable inference” that the defendant made the fraudulent misrepresentations knowingly and intentionally. *Pludeman v N. Leasing Sys., Inc.*, 10 NY3d 486, 492 (2008).

Basis Yield has met this standard. It alleges motives beyond mere greed, specifically Morgan Stanley’s need to move the underlying collateral off its books, protect its CDO business, and preserve its relationships with originators. In further support of scienter, it has alleged Morgan Stanley’s role in selecting and packaging collateral and its close business relationship with and influence over the ratings agencies. In light of these allegations, a finder of fact could reasonably infer that the alleged misrepresentations were knowingly made.

Negligent Misrepresentation

A claim of negligent misrepresentation requires “(1) the existence of a special or privity-like relationship imposing a duty on the defendant to impart correct information to the plaintiff; (2) that the information was incorrect; and (3) reasonable reliance on the information.” *J.A.O. Acquisition Corp. v Stavitsky*, 8 NY3d 144, 148 (2007). A duty to impart correct information is “imposed only on those persons who possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party.” *Greenberg, Trager & Herbst, LLP v HSBC Bank USA*, 17 NY3d 565, 578 (2011) (quoting *Kimmell v Schaefer*, 89 NY2d 257, 263 (1996)).

Basis Yield has alleged no special relationship in this case. It has claimed that a relationship of “trust and confidence” was formed due to its longstanding professional relationship with Morgan Stanley, including hiring Morgan Stanley as its investment advisor in

the past. However, even if Morgan Stanley's role as an investment advisor had created a special relationship, Basis Yield provided disclaimers which relieved Morgan Stanley of any duty to provide advice about its investment in STACK. These disclaimers are effective under New York law, and preclude Basis Yield, as a matter of law, from alleging the existence of a special relationship to support its claim of negligent misrepresentation. *HSH Nordbank*, 95 AD3d at 208-09.

Conclusion

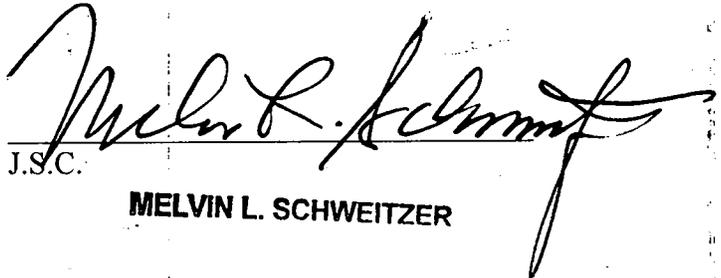
Accordingly, it is

ORDERED that Basis Yield's claim of negligent misrepresentation is dismissed; and it is further

ORDERED that Morgan Stanley's Motion to Dismiss is denied as to Basis Yield's fraud and fraudulent concealment claims.

Dated: February 28, 2013

ENTER:


J.S.C.
MELVIN L. SCHWEITZER