Financial Structures Ltd. v UBS AG
2014 NY Slip Op 30919(U)
April 7, 2014
Supreme Court, New York County
Docket Number: 601159/08
Judge: Saliann Scarpulla
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 39

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FINANCIAL STRUCTURES LIMITED and
ARROWOOD INDEMNITY COMPANY,

Plaintiffs,

-against-

UBS AG and UBS SECURITIES LLC,

Defendants.

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Index No. 601159/08
Motion Seq. No. 005

DECISION AND ORDER

HON. SALIANN SCARPULLA, J.:

This is an action to recover damages for breach of an alleged oral contract made to induce plaintiffs Financial Structures Limited and Arrowood Indemnity Company ("Financial/Arrowood") to issue certain insurance policies guaranteeing the payment of principal and interest on approximately $94,000,000 worth of notes issued in a collateralized debt obligation ("CDO") securitization. Defendants UBS AG and UBS Securities LLC (collectively "UBS") move for summary judgment dismissing the complaint. Financial and Arrowood cross-move for summary judgment on their breach of contract claim.

Defendant UBS AG is a Swiss bank engaged in banking, financial, advisory, trading and service activities in Switzerland and abroad, and defendant UBS Securities LLC is an indirect wholly-owned subsidiary of UBS AG, and is part of its investment bank, serving as UBS AG's broker-dealer in the United States.

This action arises in connection with a CDO known as NS Repack, which was structured by UBS. According to the allegations of the complaint, defendants formed a special-purpose entity NS Repack Ltd. A special purpose entity is formed to issue interest-bearing notes, and the proceeds of the notes are used to purchase collateral such as bonds and mortgages, which generate cash flow. The cash flow is received by a trustee, which then uses the money to make interest and principal payments to the holders of the notes issued by the special purpose entity. In certain CDOs, the collateral may also involve derivative contracts, which relate to a "Reference Pool" of assets, and the cash flow is generated from payments arising from such contracts. There are classes of notes, and the notes are paid in order of seniority, with the most junior class notes bearing the most risk. If there is not enough cash flow generated by the collateral in a given period, then certain levels of notes will not be paid.

Plaintiffs allege that NS Repack Ltd. issued approximately $94,000,000 in fixed rate secured notes which were sold to institutional investors. The structure of the NS Repack CDO permits substitution of assets in the Reference Pool of collateral. The NS Repack notes were collateralized by certain junior level notes of two other CDOs known as North Street Referenced Linked Notes 2000-1 ("NS1") and North Street Referenced Linked Notes 2000-2 ("NS2"). The NS1 and NS2 notes were linked, via credit default swaps with UBS, to Reference Pools of corporate bonds and asset-backed securities, each in the amount of $1.2 billion.

In October 2000, Arrowood's predecessor Royal Indemnity Company ("Royal") issued insurance policies and Financial issued reinsurance agreements, guaranteeing payment of interest and principal on the $94,000,000 worth of notes which had been issued in connection with NS Repack. Royal bore the risk that payments received on the NS-1 and NS-2 Notes, based on the cash flow from the Reference Pools, would fall short of the amounts needed to pay sums due on the NS Repack Notes.

According to UBS, to the extent that there were defaults in the Reference Pools, the principal amount of the NS1 and NS2 notes would be written down in reverse order of seniority, which would fund credit protection payments to UBS for the amount of any default losses. As such, the extent of Financial/Arrowood's liability on the NS Repack notes correlated to the number and amount of the defaults in the Reference Pools.

The Reference Pools were governed by "Reference Pool Guidelines" which permitted UBS to substitute assets in and out of the pools. Financial/Arrowood alleged that it was concerned that UBS would engage in "ratings arbitrage." Specifically, according to the allegations of the complaint, because the market price of assets reflects a deterioration in the quality of those assets more quickly than the ratings of those assets, there will, at any time, be a range of prices for assets all bearing the same rating. Under the Reference Pool Guidelines, if an asset with a particular rating was removed from the Reference Pool, any asset substituted into the Reference Pool would be required to have the same or higher rating.

The risk, according to Financial/Arrowood, was that the collateral manager, UBS, would remove an asset that deserved its rating, and replace it with a lower-priced asset that had the same rating, but was not deserving of that rating, and, thus, was likely to be downgraded to a lower rating in the future. By pulling a higher-priced asset out of the Reference Pool and replacing it with a lower priced asset, UBS would benefit from the difference in price for its own account.

Financial/Arrowood alleged that, in order to induce it to issue the insurance policies, UBS orally agreed that it would not engage in "ratings arbitrage," and would manage the Reference Pools to at least maintain the quality of those pools, or to increase such quality, and to avoid defaults. Financial/Arrowood maintained that UBS represented that because it had retained ownership of 10% of the notes in the NS2 transaction, it was in UBS's interest to avoid defaults in the Reference Pools. Further, UBS allegedly represented to Financial/Arrowood that UBS's reputation depended upon its proper management of the credits in the Reference Pools, and it allegedly urged Financial/Arrowood to rely upon UBS's expertise in this area.

In its complaint, Financial/Arrowood asserted claims for fraud, breach of contract, promissory estoppel and unjust enrichment.[1] The breach of contract claim was based on Financial/Arrowood's allegation that UBS orally agreed to manage the Reference Pools to

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[1] The claims for fraud, promissory estoppel and unjust enrichment have been dismissed.

increase or at least maintain their quality, and to minimize the possibility of default. It alleged that UBS breached the oral agreement by withdrawing credits from the Reference Pools that were stable and deserved the ratings that they had, and that were likely to maintain or increase ratings, and replaced them with ones that had the same ratings, but were likely to be downgraded in ratings.

In its interrogatory responses, Financial/Arrowood stated that: (1) the oral agreement was created during numerous meetings and telephone calls between July 2000 and October 27, 2000; (2) at least five different representatives of Financial/Arrowood participated in the meetings and calls and that at least six representatives of UBS participated; and (3) representatives of Donaldson, Lufkin and Jenrette ("DLJ"), the investment firm that managed the NS Repack transaction, participated on behalf of UBS.

According to Financial/Arrowood, at some point, Wayne King ("King"), who was the UBS manager of NS Repack and the underlying NS1 and NS2 notes, stated to Ray Gee ("Gee"), the Financial/Arrowood employee responsible for issuing the policies, that UBS would remove deteriorating credits to avoid defaults. Gee testified that "King made a commitment to me that first meeting that, if Royal did the transaction with them, the purpose of the active pool management would be to have the ability to remove deteriorating credits to avoid defaults...the purpose of the actively-managed pool is they would remove the deteriorating credits to avoid defaults." Gee regarded it as UBS' obligation to prevent any credit events and to avoid defaults, no matter what the market

conditions were. At that meeting, Gee committed to UBS that he would present the transaction to Royal. He later testified that he had the authority to bind Royal to contractual obligations in connection with the transaction, with approval from his superiors, however at the time of that meeting he did not have authority from his superiors to contractually commit Royal to issue the policies. Rather, at that meeting, he committed to present the transaction to Royal.

In May 2000, King drafted, and UBS ratified, a Credit Process, which, according to Financial/Arrowood, confirmed the terms of the alleged oral agreement and was intended to ensure that the Reference Pools were managed in a manner consistent with the way in which the transaction had been presented to investors. Financial/Arrowood contended that the Credit Process existed solely to implement the oral agreement by managing the Reference Pools to avoid defaults. The mission statement of the Credit Process was:

> (1) To create and authorize an NS-RLN 2001-1 Commitments Committee to make decisions regarding the Reference Pool;
> (2) To propose and ratify rules and procedures for decision making and monitoring of the Reference Pool so that the Reference Pool is managed in a manner consistent with the way the transaction was originally represented to investors.

According to Peter Harnik ("Harnik"), who Financial/Arrowood stated was in charge of implementing the credit process, a gatekeeper was to be appointed -- King -- whose job was to see that assets that were likely to default would be removed so that defaults would be avoided to the extent possible. Harnik testified that the mission

statement accurately represented the commitments that UBS made to investors. According to King, the credit process was created, and the commitments committee was formed "in response to the standard question we would get from all noteholders, who want to simply know how are you guys set up here internally, who manages the process, who looks at defaults, how do you make sure that good assets get in and bad assets stay out." When asked if UBS entered into any binding agreement with FSL or Royal that was not documented in a signed writing, he responded "No, we did not."

A Royal representative, David King, testified that it was his understanding, based on an initial meeting in August 2000 describing the NS Repack structure at the Financial/Arrowood offices with representatives from DLJ, subsequent discussions with Financial/Arrowood employees after the deal had closed, and ongoing communications with UBS, that there was a commitment between UBS and Financial/Arrowood that UBS would manage the Reference Pool to avoid defaults. When asked at his deposition "was it ever your understanding that [Financial/Arrowood] and UBS had entered into some kind of a binding oral contract?" he responded, "my understanding is there was – there was a commitment between the two parties – a deal that UBS would – would manage the reference pools to avoid defaults." David King further testified that in his subsequent conversations with King, King continued to ensure Financial/Arrowood that he was meeting UBS' obligation to minimize defaults. David King testified that his

understanding was that UBS was contractually obligated to minimize defaults and that King regarded it as an obligation as well.

UBS now moves for summary judgment dismissing the breach of contract cause of action. It claims that no oral agreement was formed, Financial/Arrowood failed to allege any specific contract terms, and that any representations made to Financial/Arrowood fall short of establishing a contract. It further contends that any such contract would conflict with the terms set forth in the Reference Pool Guidelines, which govern the manner in which the assets in the Reference Pools are managed.

In support of its motion, UBS notes, among other things, that Royal's Underwriting Memorandum for the policies issued for NS Repack, states only that UBS would be "motivated" by its own economic interests to replace deteriorating credits. It does not mention anything about an oral agreement to remove such credits. UBS also notes that Financial/Arrowood executed an agreement in August of 2000 with DLJ pursuant to which Financial/Arrowood agreed to issue the policies insuring the NS Repack securities. That agreement did not mention an oral side agreement or set forth that the Reference Pools had to be governed in a way so as to avoid defaults. Although UBS was not a party to that agreement, Financial/Arrowood conceded, as set forth above, that DLJ represented UBS in negotiations with it.

In opposition to the motion, and in support of its cross motion, Financial/Arrowood contends that the parties executed a valid oral contract with clear

terms and UBS breached that contract. Specifically, King made the offer on behalf of UBS, Financial/Arrowood accepted and provided consideration by issuing the policies.

Discussion

A party moving for summary judgment is required to make a prima facie showing that it is entitled to judgment as a matter of law, by providing sufficient evidence to eliminate any material issues of fact from the case. *Winegrad v. New York Univ. Med. Ctr.*, 64 N.Y.2d 851 (1985). The party opposing must then demonstrate the existence of a factual issue requiring a trial of the action. *Zuckerman v. City of New York*, 49 N.Y.2d 557, 562 (1980).

It is axiomatic that a party seeking to recover under a breach of contract theory must prove that a binding agreement was made as to all essential terms. *Silber v. New York Life Ins. Co.*, 92 A.D.3d 436, 439 (1st Dept. 2012). "An agreement must have sufficiently definite terms and the parties must express their assent to those terms." *Id.* In order to establish the existence of a valid and binding oral contract, the terms must be clear and definite, and the conduct of the parties must evince mutual assent sufficiently definite to assure that the parties were truly in agreement with respect to all material terms. *See Carlsen v Rockefeller Ctr. N., Inc.*, 74 A.D.3d 608 (1st Dept. 2010).

The court finds that UBS has made a *prima facie* showing that the parties did not form an oral contract, and Financial/Arrowood has not put forth sufficient evidence to demonstrate that any factual issue exists which would preclude granting of summary

judgment to UBS. For the same reasons, Financial/Arrowood is not entitled to summary judgment on its claim for breach of contract.

The evidence presented does not establish when the agreement was allegedly reached or the extent of its terms. Financial/Arrowood provides in its interrogatory responses that the agreement was the result of numerous meetings between July and October of 2000, although it does not articulate any specific terms which were agreed to at any specific meeting. In its memorandum of law, however, Financial/Arrowood contends that the agreement was made when Wayne King promised that UBS would manage the Reference Pools to avoid defaults and, in order to effectuate that promise, UBS created the credit process.

While the credit process ratified by UBS demonstrates UBS's intent to manage the Reference Pool in a manner consistent with the way the transaction was originally presented to investors, to maintain quality control, and to monitor the Reference Pools, there is no mention of or reference to the alleged oral agreement between UBS and Financial/Arrowood. The evidence presented establishes that the credit process was not enacted to give effect to the alleged oral agreement, as Financial/Arrowood argues, it was created to help UBS fulfill the obligations that it made to its investors. Notably, the credit process could not have been enacted to give effect to the alleged oral contract, because the credit process was ratified in May 2000, and Financial/Arrowood claims that the alleged oral contract was created sometime between July and October 2000.

While Financial/Arrowood relies on Gee's testimony that King promised that UBS would manage the Reference Pools to avoid defaults in any market conditions, it also relies on Harnik's deposition testimony that UBS would remove assets that were likely to default to the extent possible. Thus, it is not clear whether Financial/Arrowood is asserting that under the alleged oral agreement UBS was strictly bound to avoid defaults in the Reference Pools, or if it agreed to avoid them to the extent possible. It is also unclear, and Financial/Arrowood offers no evidence, as to what the term "to the extent possible" would mean if that were the criteria.

Although Gee and David King testified that it was their understanding that there was a commitment between UBS and Financial/Arrowood that UBS would manage the Reference Pool to avoid defaults, no Financial/Arrowood representative testified as to the exact timing and terms of a specific oral contract setting forth this commitment, and, conversely, Wayne King clearly testified that UBS did not enter into any binding agreement with FSL or Royal that was not documented in a signed writing.

To be sure, Financial/Arrowood was concerned, in issuing the policies, about the possibility that UBS would engage in ratings arbitrage and it expressed its concerns to UBS. The evidence submitted also shows that UBS was aware that Financial/Arrowood, as well as the investors in the notes, were concerned about the management of the assets in the Reference Pools and that UBS represented, in some manner, that they would attempt to avoid defaults. However, the evidence presented fails to demonstrate that

Financial/Arrowood and UBS entered into a binding oral agreement as to the management of the Reference Pools.

In accordance with the foregoing, it is hereby

ORDERED that the motion for summary judgment by defendants UBS AG and UBS Securities, LLC is granted and the complaint is dismissed; and it is further

ORDERED that the cross motion for summary judgment by plaintiffs Financial Structures Limited and Arrowood Indemnity Company is denied; and it is further

ORDERED that the Clerk is directed to enter judgment accordingly.

This constitutes the decision and order of the court.

Dated: New York, New York
April 7, 2014

ENTER:

J.S.C.
HON. SALIANN SCARPULLA