

CMMF, LLC v J.P. Morgan Inv. Mgt., Inc.

2011 NY Slip Op 33697(U)

April 8, 2011

Supreme Court, New York County

Docket Number: 601924/09

Judge: Melvin L. Schweitzer

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

PRESENT: MELVIN L. SCHWEITZER
J.S.C.

PART 45

Index Number : 601924/2009

CMMF, LLC

VS.

J.P. MORGAN INVESTMENT MANAGE

SEQUENCE NUMBER : 004

DISMISS

INDEX NO. _____

MOTION DATE _____

MOTION SEQ. NO. _____

MOTION CAL. NO. _____

Th

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 by defendant to dismiss plaintiff's claims for negligence and breach of fiduciary duty is DENIED ;

Motion by defendant to dismiss plaintiff's claims for breach of contract is DENIED in part and GRANTED in part ;

Defendant's motion to dismiss plaintiff's claim for negligent misrepresentation is DENIED , all as per the attached Decision and Order.

Dated: April 8, 2011

Melvin L. Schweitzer
 MELVIN L. SCHWEITZER
 J.S.C.

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION

Check if appropriate: DO NOT POST REFERENCE

SUBMIT ORDER/ JUDG.

SETTLE ORDER/ JUDG.

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

Plaintiff, a highly sophisticated investment feeder fund, turned to Chase for investment advisory services. Plaintiff, an active market participant, was clearly aware of the diversified nature of Chase, the services it performed for clients with competing interests and the conflicts inherent in Chase taking proprietary positions which might not necessarily correlate with the interests of some of its clients at all times. Plaintiff, in this case, had both the experience and the financial resources to negotiate to protect its interests, and vigorously did so here.

Morgan opened its negotiations with the plaintiff by proffering a draft investment management agreement (IMA) which relieved it of many of the common law duties which otherwise would inform its relationship with plaintiff. It proposed that its actions be governed by a gross negligence standard. Plaintiff counter proposed removal of the gross negligence standard and insisted on a package of protections based on the fiduciary standards of the common law. Ultimately, in May 2006, plaintiff and Morgan entered into the IMA in which Morgan agreed to provide investment management services to plaintiff under a grant of broad discretion to carry out its role. The IMA, replete with provisions granting Morgan discretionary investment authority and containing fulsome language warning its client of the volatility of market results, also was executed on plaintiff's terms insofar as the protection of plaintiff's common law rights is concerned. As such, this IMA maximized plaintiff's legal protections in a market environment where conflicts risk was of significant concern to plaintiff.

In 2009, plaintiff brought an action in this court alleging the same four causes of action it brings here. Defendants moved to dismiss that complaint pursuant to CPLR 3211 (a) (1) and CPLR 3211 (a) (7). On December 11, 2009, the court granted defendants' motion to dismiss plaintiff's claims for negligence and breach of fiduciary duty, denied in part and granted in part

defendants' motion to dismiss plaintiff's claim for breach of contract and denied defendants' motion to dismiss plaintiff's claim for negligent misrepresentation. On January 25, 2011, the Appellate Division unanimously affirmed the court's order.

On December 20, 2010, plaintiff filed the FAC and on January 31, 2011 defendants moved to dismiss it pursuant to CPLR 3211 (a) (1) and CPLR 3211 (a) (7).¹ The IMA negotiations between Morgan and the plaintiff and the IMA's resultant terms *viz.* plaintiff's common law rights are spelled out in the FAC in a manner which establishes a context within which some of the more specific allegations of the causes of action of the FAC will be evaluated herein.

Discussion

Breach of Contract

In the original complaint, plaintiff asserted, *inter alia*, that Morgan's implementation of a series of ill conceived investment strategies exposed plaintiff to risks well beyond those which were reasonable within the context of the provisions of the IMA and, accordingly, breached the IMA. Also, the original complaint alleged that defendants violated certain sector diversification limitations contained in guidelines (Guidelines) attached to the IMA, and thus breached the IMA. The court held that "Except for the complaint's allegations that defendants violated the sector diversification guidelines, the numerous other allegations of breach of contract are at odds with the clear meaning of the IMA and the Guidelines. . . . Essentially, plaintiff's position is that

¹ Defendants assert that the FAC is procedurally barred and also that plaintiff has not requested this court's permission to amend. They also contend the FAC is barred by the law of the case doctrine. The court finds defendants' procedural position to be incorrect, and, to ensure the absence of doubt, treats plaintiff's present submissions as a request for permission to amend the complaint, which it grants. The court also finds defendants' law of the case argument to be unpersuasive.

defendants had too much appetite for risk . . . even if their investment decisions did result in a portfolio which comported with sector diversification guidelines. This contention fails to state a cause of action for breach of the IMA. . . . Plaintiff's allegation that defendants violated the sector guidelines, on the other hand, does present a claim for breach of contract." Decision and Order, p. 6.

In the FAC, plaintiff has tailored its contract claims to include allegations, *inter alia*, that Morgan (i) failed to modify plaintiff's strategic and tactical asset allocation among broad sectors of the fixed income markets given changing fundamentals although it was required by the IMA to do so, (ii) failed to adhere to maximum sector caps set forth in the Guidelines and (iii) failed to adhere to specific credit quality limitations and maturity and duration requirements. Absent from its FAC contract claims is the broad allegation in its original complaint regarding Morgan's allegedly ill-conceived investment strategies.²

The plaintiff's allegation with respect to Morgan's failure to modify plaintiff's strategic and tactical asset allocation among broad sectors of the fixed income markets given changing fundamentals is similar to its prior allegation in its original complaint that Morgan failed to actively manage the duration and yield curve posture of the portfolio. As the court held with respect to the prior claim, this claim is at odds with the clear meaning of the IMA and the Guidelines which granted broad discretion to Morgan regarding investment decisions. Accordingly, defendants' motion to dismiss this claim is granted.

² Defendants contend that, in fact, plaintiff has not scrubbed the complaint of that allegation. The court, affording plaintiff every reasonable inference in interpreting the complaint, as it must do, finds defendants' assertion to be without merit. Specifically, the court interprets paragraph 132 of the FAC in its entirety to refer to the prior paragraph, which relates to Morgan's failure to "adhere to the maximum sector caps set forth in the Guidelines."

As to plaintiff's claim that Morgan violated the specific sector diversification limits set forth in the Guidelines, the court is of the opinion, as it was in its prior decision, that this allegation properly states a cause of action for breach of the IMA. Accordingly, defendants' motion to dismiss this claim is denied.

As to plaintiff's claim that Morgan breached specific credit quality limitations, there is no assertion that Morgan violated the detailed, quantitative credit ratings requirements set forth in the Guidelines. Rather, plaintiff alleges that credit ratings of individual investments had to reflect high quality, and that Morgan thus was required to look behind the nominal ratings to determine the actual risk associated with any investments. The court disagrees with plaintiff's position *viz.* the IMA. Morgan was required to invest plaintiff's assets only in securities bearing certain ratings issued by identified rating agencies. There was no contractual obligation to look behind the nominal ratings to determine the actual risk associated with particular investments. This is clearly established New York law. *See MBIA Insurance Corporation v Merrill Lynch*, 81 AD3d 419 (1st Dept 2011). Accordingly, defendants' motion to dismiss this claim is granted.

Plaintiff's contract claims also allege that certain mortgage-backed securities held in its account had extended beyond a five-year average life, thereby putting those securities out of compliance with the Guidelines, and that the duration requirements were violated. Defendants characterize these allegations as the only new ones pertaining to the IMA among plaintiff's breach of contract claims. As to these allegations, the court is of the view that there are material questions of fact, which can only be addressed at a later date in these proceedings, surrounding the interpretation and application of the provision of the Guidelines which states "Legal Final Maturity per security will be five years (from settlement date) except for amortizing assets (such

as ABS, MBS, CMO's, and MBS) for which the weighted average life will be used instead of the legal final maturity date." The court thus concludes that, giving plaintiff the benefit of every inference, this claim states a cause of action. Accordingly, defendants' motion to dismiss this claim is denied.

Negligence and Breach of Fiduciary Duty

In the court's prior Decision and Order pertaining to the original complaint, the court granted defendants' motion to dismiss these causes of action on the basis that they were duplicative of plaintiff's breach of contract claim. This holding was affirmed on the same basis by the Appellate Division.

The court relied, in part, on the reasoning *viz.* this issue set forth in *Brooks v Key Trust Co. Nat'l Ass'n*, 26 AD3d 628 (3d Dept 2006) and distinguished the reasoning set forth in *Bullmore v Ernst & Young Cayman Islands*, 45 AD3d 461 (1st Dept 2007). The court will address these decisions in its analysis here, as well.

In its original complaint, plaintiff set out both a broad claim and two specific claims regarding breach of contract. The court characterized those claims in its earlier decision:

"Plaintiff's breach of contract claims focus on defendants' management of plaintiff's portfolio as it relates to securities backed by residential real estate collateral. Plaintiff asserts that defendants saturated the portfolio with those assets, which it characterizes as the riskiest, most illiquid securities in the market. According to plaintiff, defendants thus breached the IMA's stated objective of maintaining a high level of current income consistent with low volatility of principal. Plaintiff further alleges that defendants failed to select the most attractive individual securities within each asset sector; failed to actively manage the duration and yield curve posture of the portfolio vis-a-vis the Merrill Lynch three-month LIBOR benchmark set forth in the Guidelines to enhance returns and control risks; failed to recommend a course of action to decrease exposure to residential real estate; and failed to sell securities with risk and credit quality profiles that plaintiff had not bargained for. Specifically, the complaint alleges

that defendants violated the sector limits of the Guidelines because mortgage securities comprised over 46% of plaintiff's portfolio by July 2007 although the Guidelines limited this asset class to 20%. Plaintiff also alleges that defendants failed to provide daily and monthly statements of account that accurately reported the risks associated with the securities listed on the statements." Decision and Order, pp. 5, 6.

The plaintiff's negligence and breach of fiduciary claims also were broad. The court characterized those claims in its earlier decision:

"Plaintiff alleges defendants negligently managed plaintiff's portfolio in a manner that violated their duty of care to plaintiff. It is settled law that an investment manager of an investment account owes a fiduciary duty to its customer. Plaintiff asserts defendants breached this duty by saturating the portfolio with risky residential real estate securities to an extent not necessary to achieve the Merrill Lynch three-month LIBOR benchmark set forth in the Guidelines. In particular, plaintiff repeats its allegation that by July 2007, mortgage securities far exceeded their sector limitation of 20%. Plaintiff also alleges defendants were negligent and violated their fiduciary duties to plaintiff, *inter alia*, by failing to disclose the credit standing of the collateral underlying real estate securities, failing to sell off risky real estate assets, and purchasing additional amounts of these securities as default rates on their underlying collateral began to rise." Decision and Order, pp. 10, 11.

As discussed above, plaintiff now has crafted its FAC to set forth more limited breach of contract claims, while to a large extent repeating its negligence claim as it was in its original complaint. Structured in such a fashion, the claims for breach of contract, negligence and breach of fiduciary duty do not overlap. The question, then, turns to whether these claims are duplicative as a matter of New York law.

In *Clark-Fitzpatrick, Inc. v Long Island R. Co.*, 70 NY2d 382 (1987), the Court of Appeals addressed this issue in the context of an action seeking damages for problems encountered by plaintiff in performing its contract for railroad track improvements due to

defendants' alleged unpreparedness to proceed with the project. The court affirmed dismissal of the negligence claim saying:

“It is a well-established principle that a simple breach of contract is not to be considered a tort unless a legal duty independent of the contract itself has been violated (*Meyers v Waverly Fabrics*, 65 NY2d 75, 80, n 2; *North Shore Bottling Co. v Schmidt & Sons*, 22 NY2d 171, 179; *Rich v New York Cent. & Hudson Riv. R. R. Co.*, 87 NY 382, 390). This legal duty must spring from circumstances extraneous to, and not constituting elements of, the contract, although it may be connected with and dependent upon the contract (*see Rich v New York Cent. & Hudson Riv. R. R. Co.*, 87 NY 382, 398, *supra*).

“Here, plaintiff has not alleged the violation of a legal duty independent of the contract. In its cause of action for gross negligence, plaintiff alleges that defendant failed to exercise “due care” in designing the project, locating utility lines, acquiring necessary property rights, and informing plaintiff of problems with the project before construction began. Each of these allegations, however, is merely a restatement, albeit in slightly different language, of the “implied” contractual obligations asserted in the cause of action for breach of contract (*cf. Deerfield Communications Corp. v Chesebrough-Ponds Inc.*, 68 NY2d 954 [fraud claim held to be dressed-up version of contract cause of action]).”

Id. at 390.

In *Sommer v Federal Signal Corp.*, 79 NY2d 540 (1992), the Court of Appeals again addressed this issue in the context of consolidated actions against a fire alarm company with respect to a fire resulting in extensive property damage. The court's important opinion reads in relevant part:

“In *North Shore Bottling Co. v Schmidt & Sons*, 22 NY2d 171, 179), we recognized that “a contracting party may be charged with a separate tort liability arising from a breach of a duty distinct from, or in addition to, the breach of contract.” A tort may arise from the breach of a legal duty independent of the contract, but merely alleging that the breach of a contract duty arose from a lack of due care will not transform a simple breach of contract into a tort. *Clark-Fitzpatrick, Inc. v Long Is. R. R. Co.*, 70 NY2d 382, 389; *Rich v New York Cent. & Hudson Riv. R. R. Co.*, 87 NY at 398, *supra*.

“A legal duty independent of contractual obligations may be imposed by law as an incident to the parties’ relationship. Professionals, common carriers and bailees, for example, may be subject to tort liability for failure to exercise reasonable care, irrespective of their contractual duties. *Rich v New York Cent. & Hudson Riv. R. R Co.*, 87 NY at 399, *supra*; Prosser, *552 Borderland, *op. cit.*, at 402-405). In these instances, it is policy, not the parties’ contract, that gives rise to a duty of due care (*see Prosser, Torts*, at 613 [4th ed.]”

Id. at 551, 552. The court held that plaintiff was not seeking the benefit of its contractual bargain, as in *Clark-Fitzpatrick, Inc., supra*, but instead sought recovery of damages for a fire that spread out of control.

The Appellate Division, First Department in *Rodin Properties-Shore Mall, N.V. v Ullman*, 264 AD2d 367 (1st Dept 1969), addressed claims for breach of contract, negligence and breach of fiduciary duty. The court, citing *Sommer, supra*, noted that professionals may be subject to tort liability for failure to exercise reasonable care, irrespective of their contractual duties. Also citing *Clark-Fitzpatrick, Inc., supra*, it held that although the legal duty for tort liability must spring from facts extraneous to and not constituting elements of the contract it may be connected with and dependent upon the contract. Similarly, the court in *Sergeants Benevolent Association Annuity Fund v Renek*, 19 AD3d 107 (1st Dept 2005) found that a duty beyond the scope of the agreement had been alleged and a negligence claim thus was not duplicative of a contract claim. Finally, the court in *Bullmore v Ernst & Young Cayman Islands, supra*, which involved allegations of fraudulent conduct in connection with the collapse of a hedge fund as a result of a valuation scheme, again citing *Sommer, supra*, found that professionals, such as investment advisors who owe fiduciary duties to their clients, may be subject to tort liability for failure to exercise reasonable care irrespective of their contractual duties.

Each of these cases is generally instructive with respect to the issue here, but none deals with the interplay of contract and tort claims in the context of an investment advisor functioning as such pursuant to a discretionary investment advisory contract. In particular, none of these cases deals with the issue of a discretionary investment advisory contract where a highly sophisticated, knowledgeable, wealthy investor has vigorously negotiated for, and received, full protection of rights under the common law not arising as a matter of the law of contracts. Actually, the case which most resembles the case here is the Appellate Division's affirmance of this court's prior opinion. *See also Assured Guaranty (UK) Ltd. v J.P. Morgan Investment Management Inc.*, 80 AD3d 293 (1st Dept 2010), a case decided on the same date as the affirmance. *Assured Guaranty* deals with an investment advisory arrangement, but the investment management arrangement includes a gross negligence standard. There, the court citing *Rodin Properties-Shore Mall, N.V. v Ullman*, 264 AD2d at 368-369, held that neither the breach of fiduciary duty claim nor the gross negligence claim was duplicative of the contract claim.

Plaintiff's theory at this stage of the proceedings is that "the AC takes pains to make clear that [plaintiff's] negligence and breach-of-fiduciary-duty claims seek relief for misconduct that is separate and distinct from the breaches targeted by the contract claim, and there is simply no 'duplication'." Plaintiff's Memorandum at p. 14. Plaintiff asserts its contract claim is based solely on empirical violations of non-discretionary limits such as the sector and maturity caps and that the FAC's breach of fiduciary-duty and negligence claims target Morgan's imprudent management of the account. In particular, plaintiff asserts that Morgan was emptying its own portfolio of risky residential real estate loans at the same period of time as it was "stuffing"

plaintiff's account with securities collateralized by such loans. With diversified financial institutions such as Morgan, which provide both investment advice and take proprietary positions, this obviously can be a reasonable client concern, and, as discussed above, appears to have informed plaintiff's negotiating position with regard to Morgan's common law duties when the IMA was being drafted.

Defendants argue that the fact plaintiff bifurcated its contract claims and its negligence and breach of fiduciary duty claims does not resolve the issue in plaintiff's favor and that bifurcation is of no consequence. Citing *Unclaimed Prop. Recovery Serv., Inc. v UBS Paine Weber Inc.*, 870 NYS2d 361 (1st Dept 2009), defendants posit that courts regularly dismiss tort claims as duplicative in cases where the contract claim also is dismissed. Defendants further rely on the decision in *Robin Bay Associates, LLC v Merrill Lynch & Co.*, 2008 WL 2275902 (SDNY 2008). There the court noted that in New York "a cause of action for breach of fiduciary duty which is merely duplicative of a breach of contract claim cannot stand." *Robin Bay* at *3 (relying on *Brooks v Key Trust Co.*, *supra*, for the point that in order to find a cause of action for breach of fiduciary duty independent of contractual duties, the plaintiff must allege that, apart from the terms of the contract, the parties created a relationship of higher trust than would arise from the contract alone). The court found there was almost total overlap between the claims for breach of contract and fiduciary duty and dismissed the claim for fiduciary duty even though it found that no contract claim was stated. *See also Celle v Barclays Bank P.L.C.*, 48 AD3d 301 (1st Dept 2008).

Plaintiff here, however, has submitted an FAC which alleges discrete contract claims while also alleging that Morgan was shedding assets of the same risky financial nature as those it

was contemporaneously purchasing or holding for plaintiff's account. The FAC repeatedly emphasizes that in the face of Morgan's attempt to contract away common law duties, plaintiff used its own sophistication and leverage to negotiate for and receive contractual assurances that its common law rights would be kept in place. This, in the court's view, demonstrates that the parties created a relationship of higher trust than would arise from their contract alone (particularly as Morgan would have crafted it) so as to permit a cause of action for breach of fiduciary duty and negligence independent of contractual duties. *See Brooks v Key Trust Co., supra*, at 630. The court is also of the opinion that its holding here, in light of plaintiff's recasting of the FAC and its repetitively strong allegations regarding plaintiff's successful negotiation to protect its common law rights in the face of Morgan's dilutive proposal, as well as the FAC's clear allegations regarding Morgan's investment posture, are in strict accordance with the holding regarding duplicative claims in the First Department's jurisprudence, including *Assured Guaranty Ltd., supra*.³

The court now turns to the issue of whether plaintiff's claims sounding in negligence and breach of fiduciary duty state a cause of action, as the court did not reach that question in its earlier opinion due to its resolution of the duplicativeness issue.

Plaintiff, in its FAC, has recited a litany of alleged behavior of defendants which clearly sets forth well pleaded claims of negligence and, in fact, gross negligence. The court here references but a few. Plaintiff alleges that despite the fact that Morgan's parent, Chase, recognized the unfolding mortgage crisis and substantially exited the subprime residential real

³ The court rejects defendants' position that the First Department's holding with respect to duplicativeness in *Assured Guaranty Ltd., supra*, was incorrect, and, rather is of the view that the holding there clarifies New York law regarding this principle as it applies to the narrow area of discretionary investment management arrangements.

estate market beginning in 2007, Morgan took no affirmative steps to reallocate plaintiff's portfolio in early 2007 to account for the subprime crisis. Plaintiff also alleges that its portfolio was far riskier than was needed to achieve its Merrill Lynch three-month LIBOR benchmark, that Morgan increased plaintiff's position in subprime and Alt-A securities in 2007 while favoring its other clients by reducing their exposure to those types of investments, and that Morgan increased plaintiff's exposure to the residential real estate sector at the same time that sector was imploding. Accordingly, defendants' motion to dismiss plaintiff's negligence claim is denied.

As to its breach of fiduciary duty claim, plaintiff has alleged that the parties to the IMA agreed and intended that Morgan and Ufferfilge had obligations under New York law which were separate and independent from their obligations under the IMA, and that they owed plaintiff a fiduciary duty of the highest good faith and fair dealing. Plaintiff asserts Morgan and Ufferfilge were aware that plaintiff, as a passive investor, was entirely dependent on them to act in plaintiff's best interest. Plaintiff goes on to allege numerous failures of Morgan and Ufferfilge to exercise due care in the performance of their fiduciary duties. Accordingly, defendants' motion to dismiss the claim for breach of fiduciary duty also is denied.

Negligent Misrepresentation

Plaintiff pleads an additional negligent misrepresentation claim in its FAC. It is that defendants provided plaintiff with reports falsely describing notes securitized by pools of subprime mortgage loans classified as "ABS-Home Equity Loans."

Defendants contend this claim is duplicative of the contract claim that alleges a breach of the IMA and the Guidelines, as the IMA and the Guidelines govern the classification of securities

suitable for plaintiff's account, and require that defendants provide plaintiff with regular statements reflecting the securities held in such account.

Plaintiff contends that while the allegedly "deceptive communications are an essential element of the claim of negligent misrepresentation, they are not an element [of] and indeed are not relevant to the claim for JP Morgan's breach of the Sector Caps." Plaintiff's Brief, p. 23.

The court is of the opinion that plaintiff is correct and that the negligent misrepresentation claims relate to communications about the quality of collateral. The contract claim is not based on communications, but rather that Morgan invested in amounts of securities for the plaintiff's account that were prohibited by the guidelines. Accordingly, defendants' motion to dismiss the additional negligent misrepresentation claim is denied.

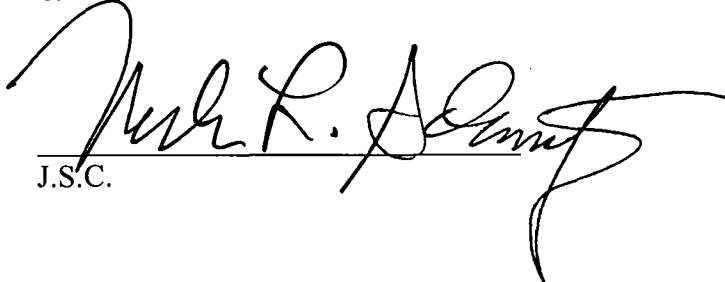
Based on the foregoing, it is hereby

ORDERED that defendants' motion to dismiss plaintiff's claims for negligence and breach of fiduciary duty is denied, defendants' motion to dismiss plaintiff's claims for breach of contract is denied in part, and granted in part, and defendants' motion to dismiss plaintiff's claim for negligent misrepresentation is denied.

A Status Conference is scheduled for May 25, 2011 at 10 a.m. at 60 Centre Street,
Rm. 218.

Dated: April 8, 2011

ENTER:


J.S.C.