

Aozora Bank, Ltd. v Morgan Stanley & Co. Inc.

2014 NY Slip Op 32135(U)

August 5, 2014

Sup Ct, New York County

Docket Number: 652118/13

Judge: Melvin L. Schweitzer

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doctrine of forum non conveniens requires the case be brought in Japan, and (3) the Amended Complaint fails to state a cause of action.

Background

The facts are as alleged in the Amended Complaint.

Structured investment vehicles (SIVs) are special purpose entities, which, in the context of the mortgage securitization market referenced here, borrowed money by issuing short- and medium-term debt, in the form of commercial paper, medium term notes, and other medium-term debt, collectively known as the SIV's liabilities. The SIV then used that money to buy longer-term, supposedly high grade and highly rated assets such as asset-backed securities (ABS), residential mortgage-backed securities (RMBSs), and collateralized debt obligations (CDOs). Rating agencies generally gave these SIV's liabilities top rated or investment grade ratings, which reflected the high quality of the SIV's assets and thus, the stability of the investment. In exchange for investing in such a low-risk product, investors received only a modest rate of return.

MS structured the Cheyne SIV with S&P, and also served as the arranger and placement agent of the Capital Notes. In these roles, MS was responsible for, *inter alia* (1) engaging S&P to rate the SIV and the Capital Notes, (2) structuring the SIV, which included approving the SIV's assets, (3) soliciting investments, and (4) distributing ratings and other information regarding the Capital Notes to plaintiff and other investors. Aozora's purchase of the Capital Notes occurred on November 28, 2006.

S&P, a nationally recognized statistical rating organization, was responsible for issuing unbiased and independent credit ratings for the Cheyne SIV and the Capital Notes, which

investors relied upon in making their investment decisions. Aozora alleges S&P colluded with MS to assign the SIV and the Capital Notes fraudulently inflated ratings that did not accurately reflect their true credit risks.

Aozora alleges defendants represented to Aozora and other investors that the Capital Notes warranted A and A3 investment grade ratings by S&P and Moody's, respectively, and that the entire SIV structure warranted a AAA rating. Such ratings allegedly conveyed to Aozora that the Capital Notes and the Cheyne SIV were as safe, secure, and reliable as high quality corporate or government bonds, had a very low probability of default, and had been rated on the basis of current, accurate, and complete data and analysis, and reliable models and assumptions.

Defendants also represented that the amount of RMBS supporting the Cheyne SIV would not exceed 55%.

Aozora alleges these ratings and representations were false, and defendants knew them to be false. It alleges that S&P (1) knew the correlation assumptions had not been tested and were not based on actual default experience, data, or studies, but were instead based on mere speculation, (2) knew its ratings models were based on stale historical data that did not reflect the current state of the market, and (3) knew that a large number (far above 55%) of the Cheyne SIV's assets were nonprime RMBS. MS, which had access to S&P's ratings models, similarly knew that they were based on irrelevant historical data and inaccurate correlation assumptions. Aozora also alleges MS knew that the assets it placed in Cheyne SIV's portfolio were toxic and not deserving of AAA or investment grade ratings. Aozora alleges that such information was not available to it at the time of its investment.

Aozora alleges the defendants were highly motivated to issue artificially inflated ratings because (1) MS's fees were entirely dependent on the successful launch of the Cheyne SIV and the successful placement of the Capital Notes, neither of which could have occurred without the false ratings, and (2) S&P's fees for the Cheyne SIV transaction, which were in excess of three times the amount of its normal fee, and its repeat player compensation in connection with other transactions, were predicated on S&P's issuance of the false ratings.

Based on S&P's allegedly false ratings and the false information they conveyed, Aozora, on November 28, 2006, invested \$30 million in the Capital Notes. In late 2007, when the Cheyne SIV collapsed, Aozora lost its entire investment.

Discussion

On a motion to dismiss for failure to state a cause of action, the court accepts all factual allegations pleaded in plaintiff's complaint as true, and gives plaintiff the benefit of every favorable inference. CPLR 3211 (a) (7); *Sheila C. v Povich*, 11 AD3d 120 (1st Dept 2004). The court must determine whether "from the [complaint's] four corners[,] 'factual allegations are discerned which taken together manifest any cause of action cognizable at law.'" *Gorelik v Mount Sinai Hosp. Ctr.*, 19 AD3d 319 (1st Dept 2005) (quoting *Guggenheimer v Ginzburg*, 43 NY2d 268, 275 (1977)). Vague and conclusory allegations are not sufficient to sustain a cause of action. *Fowler v American Lawyer Media, Inc.*, 306 AD2d 113 (1st Dept 2003).

Statute of Limitations

Pursuant to New York's statute of limitations borrowing provision, Aozora's claims must be timely under Japanese law. When a nonresident sues in New York on a cause of action that accrued outside of New York, CPLR 202 requires the claim be timely under the shorter of either

New York's statute of limitations or that of the jurisdiction of accrual. *Global Fin. Corp. v Triarc Corp.*, 93 NY2d 525, 528 (1999). Economic injuries accrue where the plaintiff resides and sustains economic impact. *Id.* at 529. As the losses Aozora sustained, due to its investments in the Cheyne SIV, occurred in Japan, the applicable Japanese statute of limitations, which is three years as contrasted to six years under the New York statute of limitations (CPLR 213), applies.

Defendants have the burden of proof under both Japanese and New York law to demonstrate the Japanese statute of limitations bars Aozora from pressing its suit. *A.F. Rockland Plumbing Supply Corp. v Hudson Shore Associated Ltd. P'ship*, 96 AD3d 885, 886 (2d Dept 2012) ("In moving to dismiss a cause of action pursuant to CPLR 3211 (a) (5) as barred by the applicable statute of limitations, a defendant bears the initial burden of demonstrating, prima facie, that the time within which to commence the action has expired."). As Japan's statute of limitations is three years for tort claims, which encompass claims for fraud, negligent misrepresentation, and aiding and abetting fraud, the defendants must establish the statute of limitations was triggered at or before the threshold date of June 2010.

The parties' experts on Japanese law agree that proving the statute of limitations has run under Japanese law requires defendants show evidence of Aozora's actual knowledge of (1) its damages, (2) identity of the perpetrators, and (3) facts sufficient for an ordinary person to determine the act causing the damage constituted a tort. The court finds the first and second elements are met. Defendants have sufficiently alleged Aozora's (1) knowledge of its financial losses subsequent to the Capital Notes' downgrading and liquidation in 2007, and (2) familiarity

with the identities of all named defendants at the time it purchased the Capital Notes, via the offering memorandum detailing the roles of the various parties involved in the Cheyne SIV.

In the context of the third element, the parties disagree on what constitutes actual knowledge. The experts present conflicting affidavits on this subject revolving around the ordinary person standard.

Defendants' expert argues an ordinary person possesses the same attributes, such as status, occupation, skill, and ability, as the claimant. Thus, the third element would be met at the point in time that a sophisticated financial institution with Aozora's attributes and resources would judge that a tort has occurred. Defendants argue such an institution would have, in this case, possessed sufficient facts in August 2008 to make such a judgment.

Defendants' expert contends that Japanese law permits use of circumstantial evidence to demonstrate a claimant did indeed have actual knowledge of facts sufficient to make that judgment. The expert asserts circumstantial evidence encompasses publicly available information, reasonable opportunity to access such information, and the claimant's level of sophistication. The defendants cite the following facts, taken collectively, as sufficiently establishing actual knowledge such that a sophisticated investor with extensive experience in structured finance products would have made the necessary connection to defendants' allegedly inflated ratings in time to file its claims by August 2008: (1) similarly situated investors filed claims with nearly identical allegations in the federal *Abu Dhabi Commercial Bank v Morgan Stanley & Co.* case, (2) Aozora was aware of downgrades to the Capital Notes, followed by the SIV's insolvency and subsequent liquidation, (3) extensive press coverage, in both the English and Japanese media, of the subprime crisis, and the systematic inflation of credit ratings,

downgrades and default, beginning in August 2007, (4) Aozora's ties to the United States, including its maintenance of a New York office from 2005 to the present, for the specific purpose of gathering information, American private equity firm Cerberus's 61.84% ownership of Aozora on September 3, 2003, and Aozora's chief executive officer's personal connections to the United States.

Plaintiff's expert counters that no Japanese court has adopted such an individualized "ordinary person" standard, and courts instead adhere to a broader standard of an average person, without regard to sophistication, profession, or status. He notes that the defendants' expert's sources are limited to a single Japanese professor and an uncited medical malpractice case. He further maintains that, under Japanese law, the plaintiff's nature is irrelevant to whether it possessed actual awareness of each of the three elements. The expert insists on a strict requirement of actual knowledge of tortious conduct, distinguishable from New York's inquiry notice standard under CPLR 213. The expert argues it is insufficient to demonstrate whether the plaintiff should or *could* have been aware of facts suggesting its losses resulted from the defendants' tortious actions. The defendants must instead demonstrate Aozora actually was aware of those facts. He cites to a case holding that the statute of limitations barred a claim, where plaintiff was aware of facts sufficient to know defendant illegally concealed its insolvency. The case detailed widely circulated reports of the insolvency, multiple prior lawsuits holding in favor of investors, criminal prosecutions against management, a trustee's admission of excessive liabilities, and a government investigation.

Aozora's contention that defendants do not demonstrate that Aozora had actual knowledge prior to June 2011 is based on defendants' failure to establish that Aozora received

notice either that the *Abu Dhabi* case was filed in 2008 or its class certification denied in June 2010, or was aware of related media coverage, which originated, and was primarily disseminated, outside of Japan. Aozora's expert cites precedent establishing there is no duty under Japanese law to monitor foreign litigation, as it would be an unjustifiable burden. He notes (1) Japanese investors were not plaintiffs in *Abu Dhabi*, (2) no Japanese investor was engaged in a lawsuit concerning subprime loan-related SIVs and CDOs naming an investment bank or credit-rating agency as defendant, (3) Aozora mainly provides services for Japanese clients, and (4) the news articles defendants reference provide only generalized reports about ratings downgrades, rating agencies' mistaken assumptions, and the agencies potential for conflicts of interest. The articles do not implicate defendants in any wrongdoing concerning the Cheyne SIV. He asserts Aozora genuinely believed its losses resulted from deteriorating market conditions.

Where parties disagree on foreign law, the court has the power to determine foreign law "after any presentation of evidence which furnishes the court sufficient information to decide." *Stichting Pensioenfonds ABP v Credit Suisse Group AG*, 38 Misc 3d 1214(A), 2012 Slip Op 52433(U), *4 (Sup Ct, NY County 2012). CPLR 4511 (b) requires a court to take judicial notice of the laws of foreign countries when requested, and that the judge determines questions of foreign law.

Pursuant to CPLR 4511 (b), the court holds that the expert affidavits and translations of Japanese statutes and cases provide sufficient evidence to determine the statute of limitations standard. The court declines to use defendants' subjective ordinary person standard to determine when the statute of limitations was triggered. The court holds that Japanese law requires evidence of actual knowledge to trigger the statute of limitations.

The court has held that a similar statute of limitations issue presented a question of fact for the jury. *See Stichting Pensioenfonds ABP v Credit Suisse Group AG*, 38 Misc 3d 1214(A), 2012 Slip Op 52433(U), *5 (Sup Ct, NY County 2012) (holding that whether plaintiff gave prompt notice of its claim under the applicable Dutch statute of limitations was not suitable for resolution on a motion to dismiss). The determination here is for the trier of fact. A record must be fully developed to determine whether Aozora possessed actual knowledge of its claims in June 2010.

Defendants' motion to dismiss based on the statute of limitations is denied.

Contractual Limitations Provision

Alternatively, defendants argue Aozora's claims are barred under a contractual provision. Aozora licensed S&P's RatingsDirect and Japanese-translated Research Online subscription-based services to receive credit ratings and other research publications from S&P prior to and throughout its investment in the Cheyne SIV. The licenses were governed by a Master Subscription Agreement (MSA), entered into on August 2, 2004, which provided: "No action, regardless of form, arising from or pertaining to the services may be brought by subscriber more than one (1) year after such action has accrued" (emphasis added).

Contractual limitations periods are recognized as valid under New York law. *See Krohn v Felix Indus.*, 226 AD2d 506, 506 (2d Dept 1996). Aozora's claims must arise from, or pertain to, the MSA to be barred by the provision. *Coriale v Xerox Corp.*, 775 F Supp 2d 583, 590-91 (WDNY 2011). A limitations provision is inapplicable when it fails to embrace the subject matter of the claim asserted.

S&P argues the MSA provision is sufficiently broad to apply to Aozora's tort claims. It asserts Aozora's claims were stale by August 2009, a year after Abu Dhabi Commercial Bank filed its suit, which provided Aozora knowledge sufficient to make a claim. S&P's logic presumes its alleged misrepresentations, in the form of the artificially inflated credit ratings, were accessible to Aozora only through its licensed information products. As evidence, S&P cites to an allegation in Aozora's complaint: "S&P undertook to sell and communicate its rating services to Plaintiff through private information services."

Aozora counters that the MSA provision applies only to the services provided through the licenses and not to its tort claims. Aozora is correct. The contractual language is not sufficiently broad to encompass S&P's alleged malfeasance in assigning fraudulent credit ratings simply because those credit ratings were available through the subscription service. Access to the credit ratings was not limited to S&P's subscription services. The credit ratings also appeared on S&P's public website and newswires, and were contained in the Information Memoranda soliciting investments in the Capital Notes. Aozora, in the Amended Complaint, makes explicit mention of these additional sources ("MS [with S&P's knowledge and approval] also communicated the false ratings to investors via private information services such as Bloomberg;" "Defendants disseminated the foregoing information to Plaintiff and other investors, in the form of artificially inflated ratings, through various private information services;" "S&P made the false and misleading statements to Plaintiff through various documents and private information services"). S&P's cited cases are inapplicable because they address claims that clearly arose out of a contract. Aozora's tort claims, in contrast, do not depend on a contractual relationship.

The one-year limitations period in the MSA does not apply and does not bar Aozora's claims.

Forum Non Conveniens

CPLR 327 (a) provides that “[w]hen the court finds that in the interest of substantial justice the action should be heard in another forum, the court, on the motion of any party, may stay or dismiss the action in whole or in part on any conditions that may be just.” The burden is squarely on the defendants, and it is a “heavy burden [to] demonstrat[e] that the forum chosen by [the plaintiff] is an inappropriate one.” *Banco Ambrosiano, S.P.A. v Artoc Bank & Trust Ltd.*, 62 NY2d 65, 74 (1984). At the same time, New York courts should not be “required to add to their financial and administrative burdens by entertaining litigation which does not have any connection with this state.” *Islamic Republic of Iran v Pahlavi*, 62 NY2d 474, 478-479 (1984).

The decision to dismiss on *forum non conveniens* grounds is left to the sound discretion of the court, and New York courts consistently dismiss cases lacking a “substantial nexus” to New York. *See e.g. Pahlavi*, 62 NY2d at 479 (dismissing case lacking substantial nexus to New York that “would be better adjudicated elsewhere”); *Silver v Great Am. Ins. Co.*, 29 NY2d 356, 361 (1972) (same); *Shin-Etsu Chem. Co. v 3033 ICICI Bank Ltd.*, 9 AD3d 171 (1st Dept 2004) (same). To determine whether a “substantial nexus” exists, New York courts balance the following factors, no one of which is dispositive: (1) the residency of the parties, (2) whether “the transaction out of which the cause of action arose occurred primarily in a foreign jurisdiction”, (3) the location of relevant witnesses and documents, (4) the applicability of foreign law, and (5) the availability of an alternative forum. *See Pahlavi*, 62 NY2d at 479.

Here, the factors laid out in *Pahlavi* weigh heavily against dismissal, as a substantial factual nexus exists between New York and the allegations in the Amended Complaint.

Defendants argue that the core elements of Aozora's allegations occurred in the United Kingdom and Japan, rather than in New York, and contend either of those locations is the "primary situs" of the transactions out of which Aozora's claims arise. *See Tegra S.A. v Bombardier, Inc.*, 80 AD3d 443, 444 (1st Dept 2011). The defendants point to the fact that the Cheyne SIV, the placement agent, and the arranger were based in the United Kingdom, and that communications between the involved parties occurred primarily in the United Kingdom and Japan, where the majority of the evidence, documents, and witnesses are located.

Aozora argues that core elements of the allegations are located in New York. Aozora alleges that MSIL is properly considered a subsidiary of Morgan Stanley, headquartered in New York, and that relevant conduct occurred in New York – specifically, that MS & Co., a New York entity, played a significant role in structuring and arranging the Cheyne SIV and conspired, in New York, with S&P to obtain false ratings. S&P is headquartered in New York and its assignment of the allegedly inflated ratings to the Capital Notes occurred in New York. Key evidence, documents, and witnesses are located in New York. Additionally, defendants extensively litigated similar claims in New York in the *Abu Dhabi* case.

Defendants argue the court would be burdened with questions of foreign law, noting, for example, that Japanese law does not recognize separate causes of action for fraud, negligent misrepresentation, and aiding and abetting fraud. In resolving choice of law questions in New York, the court must first determine whether there is, in fact, a conflict between the laws of the two jurisdictions. *See Haywin Textile Products, Inc. v Int'l Fin. Inv. & Commerce Bank Ltd.*,

152 F Supp 2d 409, 411 (SDNY 2001). Defendants fail to establish whether foreign law does in fact apply, or that it materially deviates from New York law – the law they assume in their briefs. *See Yoshida Printing Co., Ltd. v Aiba*, 213 AD2d 275, 275 (1st Dept 1995) (“Neither the fact that plaintiff is a Japanese corporation, whose witnesses may speak Japanese, nor the potential necessity of applying Japanese law, renders New York an inconvenient forum”).

The parties’ residency strongly favors New York, as S&P and both MS & Co. and its parent, Morgan Stanley, are headquartered in New York. Despite being a foreign entity, a significant level of deference remains due to Aozora as plaintiff. *See Manela v Garantia Banking Ltd.*, 940 F Supp 584, 592 (SDNY 1996) (holding “the fact that plaintiff is not himself a resident of the United States, while reducing the weight given to his choice of forum, ‘is not an invitation to accord [his] selection of an American forum no deference since dismissal for *forum non conveniens* is the exception rather than the rule.”) (quoting *In re Air Crash Disaster Near New Orleans, La. on July 9, 1982*, 821 F2d 1147, 1164 n. 26 (5th Cir 1987), *vacated on other grounds*, 490 US 1032 (1989)).

S&P and MS are unlikely to face greater hardship in litigating this dispute in New York than in either Japan or the United Kingdom. First, defendants, other than MSIL, are New York residents. They are headquartered and conduct business in the forum district. *See Ancile Inv. Co. Ltd. v Archer Daniels Midland Co.*, 08 CIV. 9492 (PAC), 2009 WL 3049604 (SDNY Sept. 23, 2009) (stating that the defendant, a multinational corporation, could not plausibly argue it is not amenable to suit in the forum district in which it is headquartered); *see also Manela v Garantia Banking Ltd.*, 940 F Supp 584, 592 (SDNY 1996) (noting that a defendant’s residency in the forum district weighs heavily against dismissal)).

Defendants' argument for alternative fora in either the United Kingdom or Japan is unavailing. Defendants' forum non conveniens motion is denied.

Fraud

The elements of a cause of action of common law fraud in New York are (1) material misrepresentation of a fact, (2) knowledge of its falsity, (3) an intent to induce reliance, (4) justifiable reliance by the plaintiff, and (5) damages. *Eurycleia Partners, LP v Seward & Kissel, LLP*, 12 NY3d 553, 559 (2009). New York law requires allegations with respect to fraud to "be stated in detail." CPLR 3016 (b).

Material misrepresentations

The initial question is whether credit ratings constitute facts or nonactionable opinions. S&P cites precedent in Second Circuit courts, which have held that ratings are merely forward-looking statements of opinion, actionable only when the defendant is alleged not to have believed that opinion at the time it was made. *See Tolin v Standard & Poor's Fin. Servs., LLC*, 950 F Supp 2d 714, 722 (SDNY 2013); *In re Bear Stearns Mortg. Pass-Through Certificates Litig.*, 851 F Supp 2d 746, 771 (SDNY 2012). S&P maintains Aozora does not allege that S&P's employees did not honestly believe in the accuracy of the credit ratings it assigned to the Capital Notes and the Cheyne SIV. S&P contends Aozora makes only "generalized allegations about the purported deficiencies in the ratings process," and cites cases in which courts found insufficient those allegations that inferred only that some employees believed the rating agencies could have used better methods, such as modernized models or an alternative set of assumptions. *See In re Lehman Bros. and Erisa Litigation*, 684 F Supp 2d, 485, 494-95 (SDNY 2010); *Tsereteli v Residential Asset Securitization Tr. 2006-A8*, 692 F Supp 2d 387, 395 (SDNY 2010).

Recent New York court holdings have held credit ratings to constitute actionable statements of present fact. In *M&T Bank Corp. v Gemstone CDO VII, Ltd.*, the court held that ratings are not mere opinions or predictions, but are rather “facts constituting the actual evaluations by reputable independent entities concerning ... creditworthiness ... [they are] not just predictions of future valuation but a present analysis of current valuation.” *M&T Bank Corp. v Gemstone CDO VII, Ltd.*, 23 Misc 3d 1105(A), 2009 Slip Op 50590(U), *11 (Sup Ct, Erie County 2009) (also noting the financial market’s widespread dependence on credit ratings due to their reputation for reliability).

The court holds Aozora has pled with specificity that (i) S&P issued inflated A and AAA investment-grade ratings for the Capital Notes and Cheyne SIV, respectively, (ii) the ratings conveyed, inaccurately, to Aozora and other investors that the Capital Notes offered a safe and secure investment, with a low probability of default, (iii) defendants knew these representations were false, based on their awareness that the ratings were founded on correlation assumptions grounded in speculation and on ratings models that utilized obsolete housing market data, (iv) defendants were aware RMBS comprised more than 55% of the portfolio, and (v) MS colluded with S&P in misrepresentations by marketing the Capital Notes.

Aozora has adequately met the first element under either characterization of credit ratings by alleging that S&P, as expressed by specific S&P management and employees, both at the time of assigning the credit ratings to the Cheyne SIV and the Capital Notes and subsequently, did not believe in the validity of those ratings.

Scienter

Aozora alleges S&P issued misleading credit ratings with knowledge of their falsity. Aozora provides examples indicating S&P possessed knowledge that the inflated credit ratings did not reflect the actual risks associated with the toxic, low quality securities comprising the Cheyne SIV portfolio. Aozora states that S&P made unreasonably low correlation assumptions, based on speculation and outdated historical data, knew that mortgage quality was rapidly deteriorating, based on performance reports, deliberately did not update its models to reflect more current and accurate information, as a cost-saving measure, knew the Cheyne SIV portfolio consisted of more than 55% RMBS, and was aware it could not issue objective ratings because its direct involvement with the portfolio created a conflict of interest. Aozora alleges S&P obtained its knowledge of the Capital Notes' true creditworthiness through direct involvement in the SIV structuring, receipt and analysis of non-public mortgage loan performance statistics, information from non-prime lending companies, weekly reports from the Bank of New York (BoNY) regarding the SIV portfolio's precise composition and its assets' market value, as well as non-public information provided by various mortgage lenders, and the particular insight and experience possessed by individual S&P management and employees involved in rating the SIV.

Aozora has plead scienter.

Justifiable reliance

The primary inquiry as to justifiable reliance is whether Aozora had reasonable access to resources that would have enabled it to perform due diligence that would have exposed the credit ratings as false. New York imposes an affirmative duty on sophisticated investors, such as Aozora, to investigate the details of business transactions. In *UST Private Equity Investors*

Fund, Inc. v Salomon Smith Barney, the court stated: “[A] sophisticated institutional investor cannot establish it entered into an arm’s length transaction in justifiable reliance on alleged misrepresentations if it failed to make use of the means of verification that *were available to it.*” *UST Private Equity Investors Fund, Inc. v Salomon Smith Barney*, 288 AD2d 87, 88 (1st Dept 2001) (emphasis added).

The peculiar knowledge exception impacts a sophisticated institutional investor’s investigative duty when it could not, through exercising reasonable due diligence, have discovered the true quality of the subject of the representation. As corollary to this exception, the plaintiff, to conduct such investigation, must “have the means available to him, of knowing, by the exercise of ordinary intelligence.” *HSH Nordbank AG v UBS AG*, 95 AD3d 185, 193 (1st Dept 2012); *see also King Cnty., Wash. v IKB Deutsche Industriebank AG*, 751 F Supp 2d 652, 661 (SDNY 2010) (in claiming credit ratings were false and misleading, plaintiffs sufficiently alleged information required to confirm or disprove the ratings’ validity was peculiarly within Morgan Stanley’s knowledge, none of which was disclosed to investors or discoverable through reasonable diligence.).

Aozora has sufficiently alleged the information needed to confirm the accuracy or falsity of the credit ratings was, indeed, peculiarly within defendants’ knowledge. Aozora alleges in its complaint: “No amount of diligence or independent valuation could have revealed to plaintiff that the ratings were false.” Aozora alleges it properly conducted due diligence, and only facts peculiarly within defendants’ knowledge would have alerted a sophisticated investor that S&P’s models were based on irrelevant data and flawed correlation assumptions, and that the Cheyne SIV contained a substantial quantity of low quality assets. Aozora was precluded from accessing

such detailed portfolio-level information or the existing SIV performance history when it made its post-launch purchase. Aozora alleges S&P was in a unique position to obtain this information, due to its ongoing monitoring of the collateral assets, receipt of material and non-public information regarding nonprime lending companies, receipt of mortgage loan performance statistical information on RMBS, weekly reports from BoNY regarding portfolio composition, and review of additional, material non-public information provided by mortgage lenders.

Defendants contend that disclaimers contained in the Offering Memorandum preclude a claim of common law fraud when they address “the subject matter of the alleged misrepresentation with sufficient specificity.” *HSH Nordbank AG v UBS AG*, 95 AD3d 185, 201 (1st Dept 2012). Disclaimers equating to generalized boilerplate not “track[ing] the substance of the alleged misrepresentation” do not negate the reliance element. *See Caiola v Citibank, N.A., N.Y.*, 295 F3d 312, 330 (2d Cir 2002).

Applying the peculiar knowledge exception to disclaimers, in *China Dev. Indus. Bank v Morgan Stanley & Co., Inc.*, the court recognized that a sophisticated business entity’s allegations of fraudulent inducement may be precluded by such disclaimers, unless the plaintiff sufficiently alleged that the defendant “possessed peculiar knowledge of the facts underlying the fraud, and the circumstances present would preclude any investigation by [plaintiff] conducted with due diligence.” *China Dev. Indus. Bank v Morgan Stanley & Co., Inc.*, 86 AD3d 435, 436 (1st Dept, 2011).

Precedent does not establish a bright line rule for determining whether defendants’ disclaimers are sufficiently specific. The disclaimers warn investors should not consider the Information Memorandum a recommendation, state investors acknowledge making their own

independent investigations, and list various risk factors. This is similar to *UST Private Equity Investors Fund, Inc. v Salomon Smith Barney*, in which the offering memorandum advised plaintiffs that defendant investment bankers could not guarantee the accuracy or completeness of the information set forth therein, and specifically directed plaintiffs to “rely upon their own examination” and to request “whatever additional information or documents they deemed necessary to make an informed investment decision.” *UST Private Equity Investors Fund, Inc. v Salomon Smith Barney*, 288 AD2d 87, 88 (1st Dept 2001). The *UST Private Equity Investors* court held the disclaimers were sufficiently specific. This case, however, bears greater similarity to the recent *Loreley Financing (Jersey) No. 3 Ltd. v Citigroup Global* decision. Although the disclaimers of reliance did include “very strongly-worded disclaimers and disclosures about the inherently risky nature ... and that the purchaser would conduct its own due diligence,” the court found them to be merely “boilerplate statements regarding the speculative and risky nature of investing in mortgage-backed CDOs and the possibility of market turns.” *Loreley Financing (Jersey) No. 3 Ltd. v Citigroup Global*, 987 NYS2d 299 (1st Dept 2014) (quoting *Basis Yield Alpha Fund (Master) v Goldman Sachs Group, Inc.*, 115 AD3d 128, 138 (1st Dept 2014)). The Cheyne SIV disclaimers do address the general speculative and risky nature of investing in mortgage-backed CDOs and the possibility of market turns, as well as the reliability of the credit ratings, but do not specifically draw attention to ratings methodology, such as correlation assumptions, outdated models, or percentage composition of RMBS securities. Additionally, the disclaimers are ineffective in the face of allegations that defendants had peculiar knowledge of the facts which were not discoverable by reasonable due diligence.

In any event, whether the totality of Aozora's investigative efforts was reasonable is a question of fact, and viewing the allegations in the light most favorable to Aozora, it has sufficiently pled justifiable reliance, not defeated by the disclaimers.

Loss causation

A satisfactory allegation of loss causation demonstrates the loss was foreseeable by providing a causal link between the misrepresentation and the decreased returns to the plaintiff over the course of the securitization. *See MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, 87 AD3d 287, 295-96 (1st Dept 2011) (it was foreseeable the plaintiff would suffer losses as a result of relying on the defendant's alleged misrepresentations about the mortgage loans); *Silver Oak Capital L.L.C. v UBS AG*, 82 AD3d 666, 667 (1st Dept 2011) (“[P]laintiffs sufficiently allege loss causation since it was foreseeable that they would sustain a pecuniary loss as a result of relying on Financial's alleged misrepresentations”).

The parties disagree about the cause of Aozora's alleged \$30 million loss. Aozora claims a direct relationship between S&P's misstatements and its loss, whereas S&P cites market forces. Aozora argues the Capital Notes would have been unmarketable and would not have been issued but for S&P's misrepresentations of the quality of the securities comprising the Cheyne SIV portfolio. The toxic assets contained in the SIV eventually led to its collapse, allegedly causing Aozora to lose its entire investment.

The misrepresentation must be not only foreseeable, but also the *direct* cause of alleged damages. Aozora's losses must not be attributable to the more general market decline alone. *See Laub v Faessel*, 297 AD2d 28, 31 (1st Dept 2002) (defendant failed to allege facts indicating any portion of its supposed losses was attributable to the defendants' actions, as distinct from market

forces). Aozora is not required to allege the *entirety* of its losses was caused by its reliance on the credit ratings assigned to the Cheyne SIV. In *Stichting Pensioenfonds ABP*, the court said:

When a market-wide phenomenon (such as the financial crisis of 2007–2008) may have caused the loss, the plaintiff must plead “facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events ... [i]t is not, however, necessary to allege that the entirety of the loss was caused by the alleged misstatements and none was caused by the more general market decline.

Stichting Pensioenfonds ABP, 2012 WL 6929336, at *11.

It is the fact finder’s duty to determine whether and which losses were proximately caused by the defendant’s misrepresentations and which were due to extrinsic forces, and not properly to be considered on a motion to dismiss. See *Emergent Capital Inv. Mgmt., LLC v Stonepath Group, Inc.*, 343 F3d 189, 197 (2d Cir 2003).

Aozora has plead all five elements of a cause of action of common law fraud.

Defendants’ motion to dismiss for failure to state a cause of action is denied.

Negligent Misrepresentation

Aozora alleges MS negligently omitted material facts concerning the credit quality of the Capital Notes.

“A claim for negligent misrepresentation requires the plaintiff to demonstrate (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) (emphasis added); see also *Stichting Pensioenfonds ABP v Credit Suisse Group AG*, 38 Misc 3d 1214(A), 2012 Slip Op 52433(U), *13 (Sup Ct, NY County 2012). Liability for negligence

requires a tortfeasor breach the duty running between it and the injured party. *See Kimmell v Schaefer*, 89 NY2d 257, 263 (1996).

Aozora fails to plead a special relationship between it and MS that would impose a duty of care on MS. Both Aozora and MS were sophisticated financial institutions in an arms-length business transaction. New York cases clearly establishes that a special relationship cannot be founded upon such everyday transactions. *See M&T Bank Corp. v Gemstone CDO VII, Ltd.*, 23 Misc 3d 1105(A), 2009 Slip Op 50590(U), *12 (Sup Ct, Erie County 2009) (“The special relationship requires a closer degree of trust than that in an ordinary business relationship.”); *MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, 87 AD3d 287, 296 (1st Dept 2011) (“Generally, a special relationship does not arise out of an ordinary arm's length business transaction between two parties.”); *HSH Nordbank AG v UBS AG*, 95 AD3d 185, 208 (1st Dept 2012).

An exception to this general rule exists when the party allegedly liable for negligent misrepresentation possesses “unique or specialized expertise,” or is the repository of such a degree of confidence and trust as to justify the injured party’s reliance on the tortfeasor’s negligent misrepresentation. *See Kimmell v Schaefer*, 89 NY2d 257, 263 (1996). Aozora alleges MS’s expertise and skill in the area of complex structured investments, its control over the flow of information to investors regarding the Rated Notes, and possession of highly material non-public information regarding the SIV’s performance qualifies as “unique or specialized expertise.” MS’s expertise is no more than what is to be expected of a financial institution soliciting investment in a structured investment vehicle, and a claim of an entity’s “knowledge of the particulars of its own business practices is insufficient to sustain the cause of action.” *See*

MBIA Ins. Corp. v Countrywide Home Loans, Inc., 87 AD3d 287, 297 (1st Dept 2011). The court, in *Stichting*, dismissed a negligent misrepresentation claim relying upon the plaintiff's allegations that the defendant had superior knowledge of its own underwriting procedures and unique capacity to investigate the loans underlying the Certificates it issued. *Stichting Pensioenfonds ABP v Credit Suisse Group AG*, 38 Misc 3d 1214(A), 2012 Slip Op 52433(U), *13 (Sup Ct, NY County 2012).

Aozora bases its negligent misrepresentation claim on MS's allegedly superior knowledge of the loans comprising the Cheyne SIV and the models used to rate it. This capability is only to be expected of a financial institution in the business of structuring investment vehicles, and does not create a special relationship between Aozora and MS. MS did not have a duty toward Aozora that could serve as a basis of a negligent misrepresentation claim.

MS' motion to dismiss the negligent misrepresentation claim is granted.

Aiding and abetting

To properly plead its claim that MS aided and abetted S&P, Aozora must allege "(1) the existence of an underlying fraud, (2) knowledge of this fraud on the part of the aider and abettor, and (3) substantial assistance by the aider and abettor in achievement of the fraud." *Stanfield Offshore Leveraged Assets, Ltd. v Metropolitan Life Ins. Co.*, 64 AD3d 472, 476 (1st Dept 2009) (quoting *UniCredito Italiano Spa v JPMorgan Chase Bank*, 288 F Supp 2d 485, 502 (SDNY 2003)).

Aozora has alleged the existence of an underlying fraud committed by S&P.

Aozora must demonstrate MS's knowledge of the underlying fraud S&P allegedly committed was actual, rather than constructive knowledge. *See CRT Investments, Ltd. v BDO*

Seidman, LLP, 85 AD3d 470, 472 (1st Dept 2011); *Oster v Kirschner*, 77 AD3d 51, 56 (1st Dept 2010). Knowledge need only be plead generally at the pre-discovery stage, because “a plaintiff lacks access to the very discovery materials which would illuminate a defendant’s state of mind.” 77 AD3d 51, 55 (1st Dept 2010). Knowledge is necessarily discerned from the surrounding circumstances. *Id.* at 56. Only a “reasonable inference of knowledge” is required. *Goel v Ramachandran*, 111 AD3d 783 (2d Dept 2013).

The complaint permits a reasonable inference of actual knowledge. Among the allegations permitting such an inference is, first, MS’s strong position to know that the Cheyne SIV’s assets were risky and of a low quality not deserving investment grade ratings. MS placed itself in such a position through its determination of the types of assets the SIV would acquire, development of the SIV’s structural modifications, active participation in the mortgage credit market, access to S&P’s ratings models, and receipt of the Clayton due diligence reports. Second, the complaint alleges that MS possessed a strong motive to obtain false ratings, and thus promote the fraud, because its structuring fees depended on obtaining a credit rating sufficient to launch the Cheyne SIV, and its performance fees relied on a large spread between the yield from risky assets and the low rates paid to investors. Allegedly, these incentives caused Morgan Stanley to induce S&P to issue the AAA and investment grade ratings despite knowing that the Cheyne SIV portfolio contained low quality assets unworthy of such ratings.

The complaint pleads actual knowledge of S&P’s fraud.

Substantial assistance of a fraud requires (1) the aider and abettor affirmatively assists, helps conceal, or by virtue of failing to act when required to do so, enables the fraud to proceed, and (2) such actions proximately caused the harm on which the primary liability is predicated.

Stanfield Offshore Leveraged Assets, Ltd. v Metropolitan Life Ins. Co., 64 AD3d 472, 476 (1st Dept 2009). MS is correct it owed no fiduciary duty to Aozora, which would require it to act in certain circumstances. But contrary to MS's assertion that it performed no more than its routine role of arranger and placement agent, which cannot constitute substantial assistance, the complaint alleges MS affirmatively acted in support of the fraud by overpaying S&P to issue ratings it knew were false. MS actively enabled the fraud by distributing documents containing the false ratings.

Aozora claims MS substantially assisted in S&P's fraud through its adaption and creation of new SIV methodology, which it presented to S&P for use in the Cheyne transaction, and its efforts to pressure or encourage S&P to issue ratings it did not believe were accurate. The critical test is not whether the behavior involved in aiding and abetting was routine, but whether it made a substantial contribution to the perpetration of the fraud. *JP Morgan Chase Bank v Winnick*, 406 F Supp 2d 247, 257 (2005) (recognizing that "even ordinary course transactions, can constitute substantial assistance under some circumstances, such as where there is an extraordinary motivation to aid the fraud") (quoting *Primavera Familienstiftung v Askin*, 130 F Supp 2d 450 (SDNY 2001)). Aozora claims MS's behavior, described above, was critical in inducing its and others' investment in the SIV.

Aozora has sufficiently pled that MS's actions proximately caused its injury. Aozora claims that MS pressured S&P into issuing AAA and investment grade ratings which the Cheyne SIV and the Capital Notes did not deserve. MS solicited Aozora's investment by communicating the false ratings to Aozora, which induced Aozora to invest. Aozora's losses, suffered when the Cheyne SIV collapsed due to the failure of the risky assets, were the reasonably foreseeable result

of MS's conduct. *In re Agape Litigation*, 773 F Supp 2d 298, 322-23 (2011).

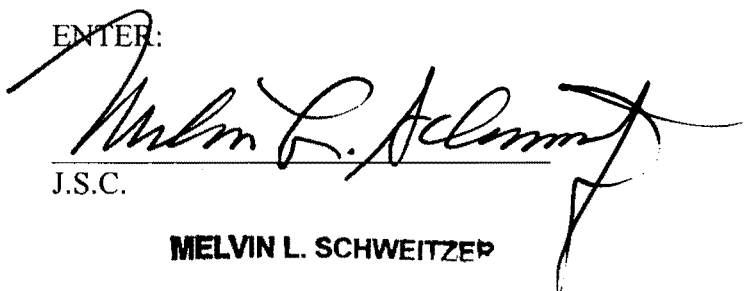
Aozora has plead a claim of aiding and abetting fraud.

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

ORDERED that defendants' motion to dismiss is denied as to all other claims.

Dated: August 5, 2014

ENTER:

A handwritten signature in black ink, appearing to read "Melvin L. Schweitzer", written over a horizontal line. The signature is stylized and extends to the right of the line.

J.S.C.

MELVIN L. SCHWEITZER