Phoenix Light SF ltd. v Morgan Stanley
2015 NY Slip Op 30656(U)
April 16, 2015
Supreme Court, New York County
Docket Number: 652986/13
Judge: Charles E. Ramos
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

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PHOENIX LIGHT SF LIMITED, BLUE HERON FUNDING V LTD., BLUE HERON FUNDING VI LTD., BLUE HERON FUNDING VII LTD., SILVER ELMS CDO PLC, SILVER ELMS CDO II LIMITED and KLEROS PREFERRED FUNDING V PLC,

Plaintiffs,

Index No. 652986/13

-against-

MORGAN STANLEY, MORGAN STANLEY & CO. LLC, MORGAN STANLEY MORTGAGE CAPITAL HOLDINGS LLC, MORGAN STANLEY ABS CAPITAL I, INC., MORGAN STANLEY CAPITAL I INC., SAXON CAPITAL, INC., SAXON FUNDING MANAGEMENT LLC, and SAXON ASSET SECURITIES COMPANY,

Defendants.

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Hon. Charles E.Ramos, J.S.C.:

In motion sequence number 001, defendants Morgan Stanley, Morgan Stanley & Co. LLC, Morgan Stanley Mortgage Capital Holdings LLC, Morgan Stanley ABS Capital I, Inc., Morgan Stanley Capital I Inc., Saxon Capital, Inc., Saxon Funding Management LLC, and Saxon Asset Securities Company move, pursuant to CPLR 3211 (a), (3), (5), and (7), to dismiss the plaintiffs' amended complaint.

The following factual allegations are set forth in the amended complaint, and for the purposes of this motion are accepted as true.

Plaintiffs were either direct purchasers of more than $340 million worth of residential mortgage-backed securities (RMBS) or obtained their claims through assignment. The claims at issue

here arise from 37 separate certificate purchases made in 26 different offerings (the Certificates), all of which were structured, marketed, and sold by the defendants during the period of 2005 through 2007 (amended complaint, ¶ 1).

Plaintiff Phoenix Light SF Limited (Phoenix), a limited liability company incorporated in Ireland, was assigned Certificates purchased by nonparties WestLB AG (WestLB), a German corporation, Greyhawk Funding LLC (Greyhawk), a Delaware limited liability company, Harrier Finance Limited (Harrier), a Cayman Islands limited liability company, and Kestrel Funding P.L.C., an independent limited liability company incorporated in Ireland. Plaintiff Silver Elms CDO PLC (Silver Elms), a public limited liability company incorporated under the laws of Ireland, is an assignee of some of the Certificates purchased by nonparty Paradigm Funding LLC (Paradigm), a now defunct Delaware limited liability company. Plaintiff Kleros Preferred Funding V PLC (Kleros), a "public limited company" incorporated under the laws of Ireland, is also an assignee of some of the Certificates purchased by WestLB, as well as an original purchaser (amended complaint, ¶¶ 4; 9; 11).

Plaintiffs Blue Heron Funding V Ltd., Blue Heron Funding VI Ltd., and Blue Heron Funding VII Ltd., all Cayman Island companies, and plaintiff Silver Elms CDO II Limited (Silver Elms II), a "public limited company" formed under the laws of Ireland,

were original purchasers of some of the Certificates (amended complaint, ¶¶ 6-8; 10). Plaintiffs Phoenix, Silver Elms, and Kleros allege that the assignment of the Certificates included an assignment of "all associated rights, title, interest, causes of action, and claims in and related to" the Certificates (amended complaint, ¶¶ 4; 9; 11).

Morgan Stanley Offerings

The amended complaint alleges that "[d]efendants used U.S. Securities and Exchange Commission (SEC) forms, such as registration statements, prospectuses, and prospectus supplements, as well as other documents - such as pitch books, term sheets, loan tapes, offering memoranda, draft prospectus supplements, 'red,' 'pink' and 'free writing' prospectuses and electronic summaries of these materials - to market and sell the certificates to plaintiffs" (amended complaint, ¶ 2). Defendants disseminated the key information in these documents to third parties, such as rating agencies and broker-dealer and analytics firms, for the purpose of marketing and selling the Certificates to plaintiffs (collectively, the documents and information disseminated by defendants will be referred to as the Offering Documents) (*id.*). Plaintiffs make several allegations that the Offering Documents for each of the 26 offerings at issue were materially false and misleading and omitted material information.

First, plaintiffs allege that the Offering Documents'

representations concerning the loan originators' underwriting guidelines were false and misleading, because the loan originators abandoned their stated underwriting guidelines in order to originate as many loans as possible, and were not evaluating the borrowers' ability to repay the loans or assessing the actual value and adequacy of the mortgaged properties serving as collateral (*see* amended complaint, ¶¶ 54-57; 69-73; 85-89; 101-103; 115-117; 129-131; 143-146; 158-162; 174-177; 189-191; 203-205; 217-221; 233-235; 247-250; 262-267; 279-283; 296-301; 313-316; 328-330; 342-345; 357-361; 369-371; 383-385; 397-400; 412-414; 426-428; *see also* ¶¶ 435-507). Plaintiffs allege that defendants knew that the Certificates' underlying loans were not originated pursuant to underwriting guidelines and that the loans were not likely to be repaid, and, despite this knowledge, failed to disclose this information (*see id.*; ¶¶ 553-595).

Second, plaintiffs allege that the Offering Documents made material misrepresentations about the loan-to-value ratios (LTV Ratios) regarding the Certificates' underlying loans, as they misrepresented the actual percentages of the Certificates' underlying loans that had LTV Ratios in excess of 80% and 100%. It is alleged that defendants used false and inflated appraisals and valuations for the loan properties in order to generate the artificial LTV Ratios in the Offering Documents. Further, it is alleged that defendants were well aware that the appraisal

valuation process was being manipulated by the loan originators and appraisers by virtue of the due diligence defendants performed on the loans, their participation in originating the loans, and through their ownership and control of lender (*see* amended complaint, ¶¶ 58-59; 74-75; 90-91; 104-105; 118-119; 132-133; 147-148; 163-164; 178-179; 192-193; 206-207; 222-223; 236-237; 251-252; 268-269; 285-286; 302-303; 317-318; 331-332; 346-347; 372-373; 386-387; 401-402; 415-416; 429-430; 514-522).

Third, the Offering Documents allegedly misrepresented the underlying loans' owner occupancy rates (OOR), as they falsely represented that a large percentage of the loans supporting the Certificates were issued to borrowers who actually lived in the properties serving as collateral for those loans. This created the impression that it was unlikely that these borrowers would default on the loans, because higher OORs indicate safer loans, while lower OORs indicate riskier ones. It is alleged that defendants knew that the OORs were falsely inflated but did not challenge them or change them, because higher OORs result in higher credit ratings from the credit agencies (*see* amended complaint, ¶¶ 60-61; 76-77; 92-93; 106-107; 120-121; 134-135; 149-150; 165-166; 180-181; 194-195; 208-209; 224-225; 238-239; 253-254; 270-271; 287-288; 304-305; 319-320; 333-334; 348-349; 374-375; 388-389; 403-404; 417-418; 523-527).

Fourth, the Offering Documents allegedly misrepresented that

the Certificates had been assigned high "investment grade" ratings by Standard & Poors (S&P) and Moody's Investor Services (Moody's), and one of the primary reasons why S&P and Moody's assigned such high ratings was because defendants had given them falsified information regarding the Certificates' underlying loans. It is further alleged that all of the 37 Certificates have now been downgraded to speculative "junk" status or below, and 23 of the 37 Certificates now have a credit rating of a "D" by S&P and/or "C" by Moody's, indicating they are in default (*see* amended complaint, ¶¶ 62-64; 78-80; 94-96; 108-110; 122-124; 136-138; 151-153; 167-169; 182-184; 196-198; 210-212; 226-228; 240-242; 255-257; 272-274; 289-291; 306-308; 321-323; 335-337; 350-352; 362-364; 376-378; 390-392; 405-407; 419-421; 431-433; 528-535).

Finally, as an essential aspect of the mortgage securitization process, the issuing trust for each RMBS offering must obtain good title to the mortgage loans that were part of the offering. At least two documents, a promissory note and a security instrument (either a mortgage or a deed of trust), must be validly transferred to the issuing trust. It is alleged that defendants, despite their representations in the Offering Documents, failed to ensure the timely transfer of these documents to the issuing trust within three months of the closing dates of the offerings, and, in turn, the trusts have lost their

tax-free status and are subject to corporate "double taxation." Also, since the documents were not properly transferred at the closing of the offerings, the trusts cannot foreclose on the loans, because they cannot prove they own the mortgages (*see* amended complaint, ¶¶ 65; 81; 97; 111; 125; 139; 154; 170; 185; 199; 213; 229; 243; 258; 275; 292; 309; 324; 338; 353; 365; 379; 393; 408; 422; 434; 536-552).

The amended complaint alleges that defendants hired nonparty Clayton Holdings, Inc. (Clayton), an independent third-party due-diligence provider, to assess the quality of the loans underlying the Certificates to determine whether the loans complied with underwriting guidelines, were supported by valid appraisals, and had other valid characteristics. It is alleged that 36.8% of the mortgage loans tested did not comply with underwriting guidelines and did not possess adequate factors to warrant an exception to those guidelines. Further, defendants allegedly included 56.3% of those identified defective loans into the RMBS offerings they sold to plaintiffs despite knowing the loans were defective (*see* amended complaint, ¶¶ 508-513; 565).

Plaintiffs allege that when they were deciding to purchase the Certificates, they reasonably relied on defendants' false statements and misrepresentations in the Offering Documents (amended complaint, ¶ 608). Plaintiffs allege that they did not learn of, and had no means by which they could have learned of,

defendants' misrepresentations and omissions prior to purchasing the Certificates, because such information was peculiarly within defendants' knowledge and control and defendants "refused to allow plaintiffs, the assigning entities or other investors access to such information" (amended complaint, ¶ 654). Plaintiffs allege that defendants "refused as a matter of course" to share access to the loan files and/or Clayton and similar due diligence reports, as it was "industry custom and practice" not to share such information (*id.*).

The amended complaint sets forth five causes of action: (1) common-law fraud, (2) fraudulent inducement, (3) aiding and abetting fraud, (4) negligent misrepresentation, and (5) rescission based upon mutual mistake. Defendants now seek to dismiss the amended complaint on the grounds that certain plaintiffs lack standing, all claims are time-barred, and that the amended complaint fails to state a claim.

Analysis

Motion to Dismiss Standard

On a motion to dismiss, "[t]he court must accept the facts alleged in the complaint as true and accord the plaintiffs the benefit of every possible favorable inference" (*Leon v Martinez*, 84 NY2d 83, 87 [1994])." However, "factual allegations that do not state a viable cause of action, that consist of bare legal conclusions, or that are inherently incredible or clearly

contradicted by documentary evidence" are not presumed to be true on such a motion (*Skillgames, LLC v Brody*, 1 AD3d 247, 250 [1st Dept 2003]). Fraud claims, as alleged here, must be pled with particularity, stating each circumstance constituting fraud in detail (CPLR 3016 [b]).

Motion to Dismiss for Failure to State a Claim

On June 13, 2014, this court issued a decision in a separate, but similar case, *Phoenix Light SF Limited, et al. v The Goldman Sachs Group, Inc., et al.*, index No. 652356/2013 (43 Misc 3d 1233[A], 2014 NY Slip Op 50917[U] [Sup Ct, NY County 2014]) dismissing the complaint for failure to plead justifiable reliance (the Goldman Decision). On June 18, 2014, admittedly, as a result of the Goldman Decision, plaintiffs in the present action filed an amended complaint in an attempt to cure any potential deficiencies identified by the Goldman Decision. Thus, the question to be examined is whether plaintiffs have sufficiently pled justifiable reliance in support of their claims for fraud.

To state a claim of fraud under New York law, the complaint must allege (1) "a 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]). These allegations must be pled in particular detail

(*id.*; CPLR § 3016 [b]).

As stated in the Goldman Decision, under New York law, there is an affirmative duty imposed on sophisticated investors, such as plaintiffs, "to protect themselves from misrepresentations made during business acquisitions by investigating the details of the transactions" (*Global Mins. & Metals Corp. v Holme*, 35 AD3d 93, 100 [1st Dept 2006]).

> "If the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations"

(*DDJ Mgt., LLC v Rhone Group L.L.C.*, 15 NY3d 147, 154 [2010] [internal quotations and citations omitted]).

The amended complaint still fails to allege that plaintiffs made an inquiry in regard to acquiring the loan files and/or the due diligence reports summarizing those loan files, i.e., the information that would have uncovered the fraud, and that, after such inquiry, defendants denied them access. Even accepting as true the allegations that it was common practice for defendants to "refuse" to share such information with investors such as plaintiffs, there was still no inquiry, at the very least, by plaintiffs as to why it was not defendants' practice to share these materials (*see Graham Packaging Co., L.P. v Owens-Illinois, Inc.*, 67 AD3d 465, 465 [1st Dept 2009] [finding that, even if

defendants could not have learned of certain information by the exercise of reasonable diligence, as sophisticated entities represented by counsel, defendants should have at least inquired about such information]). Admittedly, plaintiffs, as sophisticated investors, entered into these deals without even questioning why such important information was not shared, a red flag to say the least.

The allegations clearly show that plaintiffs accepted what was presented to them without any true due diligence. Plaintiffs cannot claim justifiable reliance when they turned a blind eye to the information they needed to confirm that their investments were sound. Once again, the nature of the risk being assumed could have been ascertained from reviewing these loan files and/or due diligence reports and plaintiffs never asked for them nor inquired as to why it was not common practice to share them (*see HSH Nordbank AG v UBS AG*, 95 AD3d 185, 195 [1st Dept 2012]). If plaintiffs had inquired about the loan files and due diligence reports, and were actually refused them, not only would it have been an indication that something was awry, but also, they would be able to claim justifiable reliance here.

The amended complaint also alleges that plaintiffs received multiple "assurances" as to the "accura[cy] and reliab[ility]" of the "loan characteristics and underwriting standards set forth in defendants' Offering Documents" (amended complaint, ¶ 656 [b]-

[d]). It is alleged that these "assurances" included "written representations and warranties provided by parties with direct access to information concerning the loans' true characteristics and credit quality" (amended complaint, ¶ 656 [b]). Plaintiffs allege that these representations and warranties were described by defendants in the Offering Documents (*id.*).

> "[W]here a plaintiff has gone to the trouble to insist on a written representation that certain facts are true, it will often be justified in accepting that representation rather than making its own inquiry. Indeed, there are many cases in which the plaintiff's *failure* to obtain specific, written representation is given as a reason for finding reliance to be unjustified"

(*DDJ Mgt., LLC v Rhone Group L.L.C.*, 15 NY3d at 154).

However, plaintiffs have failed to plead that they actually asked defendants for these warranties and representations that the facts contained in the Offering Documents were true. In fact, the allegations make clear that plaintiffs never asked for warranties and representations from defendants, and merely relied on the ones given by other parties to defendants, and not them directly. Plaintiffs once again chose not to act with due diligence and chose not to take the initiative to insist on warranties and/or representations made directly from defendants to them. Plaintiffs failed to obtain specific, written representations from defendants, and their failure shows a lack of due diligence on their part.

Based on the allegations set forth in the amended complaint,

plaintiffs have failed to allege justifiable reliance, and, in turn, all of the fraud claims are dismissed, because to state a claim for fraudulent inducement, as well as aiding and abetting fraud, plaintiff must allege the basic elements of fraud (*see High Tides, LLC v DeMichele*, 88 AD3d 954, 957 [2d Dept 2011]; *Oster v Kirschner*, 77 AD3d 51, 55 [1st Dept 2010]).

Plaintiffs also fail to state a claim for rescission. Plaintiffs argue that their rescission claim based on mutual mistake is actionable, because the transfer of title, a vital step in the securitization process, did not properly and timely occur; thus, plaintiffs argue that there was no meeting of the minds.

"Generally, a contract entered into under a mutual mistake of fact is voidable and subject to rescission. The mutual mistake must exist at the time the contract is entered into and must be substantial" (*Matter of Gould v Board of Educ. of Sewanhaka Cent. High School Dist.*, 81 NY2d 446, 453 [1993] [internal citations omitted]).

Here, plaintiffs allege that the Offering Documents represented that "the depositor will sell, without recourse, to the trust, all right, title and interest in and to each mortgage loan, including all principle outstanding as of, and interest due on or after, the close of business on the cut-off date" (amended complaint, ¶ 541). This representation in the Offering Documents

was a future obligation. Thus, the parties could not have been mistaken about the status of the transfers at the time the contract was entered into based on this representation of something that was to occur in the future. Plaintiffs' allegation that the underwriter defendant, Morgan Stanley & Co., believed that the mortgages and notes were assigned to the trust and/or trustees at the time the Certificates were purchased by plaintiffs directly is conclusory and is in conflict with the allegations that defendants failed to make the transfer (*see* amended complaint, ¶¶ 542-543).

Plaintiffs also fail to state a claim for negligent misrepresentation. To state such a claim, the following must be alleged: "(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] [citations omitted]).

Plaintiffs allege that defendants possessed extremely unique and special knowledge and expertise, which created a duty, because they had exclusive control over the loan files and due diligence reports on the underlying loans and they had superior knowledge of its own underwriting procedures. However, "[a] company's knowledge of the particulars of its own business is not

the type of unique or specialized knowledge" that creates a duty (*MBIA Ins. Co. v GMAC Mtge. LLC*, 30 Misc 3d 856, 864, 2010 NY Slip Op 20537 [Sup Ct, NY County 2010]). Further, "a special relationship does not arise out of an ordinary arm's length business transaction between two parties" (*MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, 87 AD3d 287, 296 [1st Dept 2011] [citations omitted]). These were ordinary arm's length business transactions between sophisticated parties and did not create any duty supporting a claim of negligent misrepresentation.

Accordingly, it is

ORDERED that defendants' motion to dismiss is granted on the ground of failure to state a claim, and it further

ORDERED that the portion of defendants' motion to dismiss based on standing and timliness is denied as moot; and it is further

ORDERED the amended complaint is dismissed with costs and disbursements as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly.

Dated: April 16, 2015

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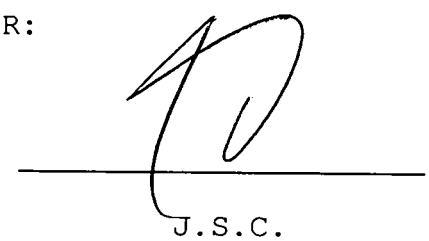

J.S.C.

CHARLES E. RAMOS