

<b>Assured Guar. (UK) Ltd. v J.P. Morgan Inv. Mgt. Inc.</b>
2017 NY Slip Op 30321(U)
February 21, 2017
Supreme Court, New York County
Docket Number: 603755/2008
Judge: Saliann Scarpulla
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SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK: PART 39

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ASSURED GUARANTY (UK) LTD., in its own right  
and in the right of OSRKNEY RE II PLC,

Plaintiff,

**DECISION/ORDER**

Index No. 603755/2008  
Motion Seq. No. 009

-against-

J.P. MORGAN INVESTMENT MANAGEMENT INC.,

Defendant.

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HON. SALIANN SCARPULLA, J.:

Plaintiff Assured Guaranty (UK) Ltd. (“Assured”) moves for partial summary judgment on the portion of its third cause of action in which it alleges that defendant J.P. Morgan Investment Management Inc. (“JPMIM”) breached the parties’ investment management agreement as a matter of law. Assured seeks an immediate trial on damages.

On December 19, 2008, Assured commenced this action in its own right and on behalf of Orkney Re II plc (“Orkney”): Orkney is a special purpose vehicle formed by reinsurance company Scottish Re (U.S.), Inc. (“Scottish Re”) to meet capital reserve requirements for certain life insurance policies that it reinsured.

In 2005, Scottish Re caused Orkney to reinsure life insurance policies, with an aggregate insured amount of approximately \$36.7 billion. Orkney then issued more than \$500 million in notes and preference shares to collateralize its excess reserves and to meet other capital requirements. Assured is the guarantor of Orkney’s payment of interest and principal on its most senior Series A-1 notes, which had an initial principal amount of \$382.5 million.

In December 2005, Orkney entered into an Investment Management Agreement (“the IMA”) with JPMIM. Under the IMA, JPMIM agreed to act as an investment manager for Orkney’s assets, which were placed into two accounts “the Reinsurance Trust Account – Economic Reserve” and “the Reinsurance Trust Account – Excess Reserve” (collectively, the “Reinsurance Trust Accounts”). The IMA stated that “subject to and in accordance with the Investment Guidelines and Clause 4(d) hereof, Investment Advisor [JPMIM] shall have complete discretion and authority, without obtaining Client’s instructions, to make such sales, exchanges, investments or reinvestments or to take any action that it deems necessary or desirable in connection with the assets in the Accounts.”

Section 4(d) of the IMA specifically provided that “with respect to the assets held in the Reinsurance Trust Account[s], investments must be made in compliance with . . . (ii) Chapter 13 of the Delaware Insurance Code, a copy of which is attached as Exhibit D-2 . . .” In addition, the IMA contained an Exhibit B entitled “Investment Guidelines,” which specified percentage limitations on investments made in certain types of asset-backed securities.

Assured alleges that JPMIM invested Orkney’s assets of approximately \$553 million “into undiversified, highly risky subprime mortgage-backed securities” and maintained these investments despite JPMIM’s knowledge that such investments posed an unreasonably high level of risk. Assured alleges that “[b]y the time Orkney and Assured Guaranty learned of JPMIM’s willful misconduct and grossly negligent conduct, the liquidity for such assets had dried up and it was too late to have Orkney exit such positions without fixing substantial losses upon fire-sale prices.” Assured claims that, as a result of JPMIM’s conduct, the assets in Orkney’s account precipitously declined in value, which rendered Orkney unable to meet its obligations to its noteholders and triggered Assured’s obligation to make payments to Orkney’s noteholders. In this action, Assured

and Orkney seek to recover damages resulting from JPMIM's breaches of fiduciary duty, acts of gross negligence, and breaches of contract.

In a decision and order dated January 28, 2010, Justice Barbara Kapnick dismissed the complaint in its entirety. However, the Appellate Division, First Department, *inter alia*, reinstated the breach of contract claim alleging that JPMIM violated the Delaware Insurance Code, for claims that accrued on or after June 26, 2007.

Assured now seeks partial summary judgment on its breach of contract claim alleging that JPMIM failed to comply with Chapter 13 of the Delaware Insurance Code.<sup>1</sup> In response, JPMIM does not separately move for summary judgment, but argues that the Court should grant summary judgment in its favor because: (a) JPMIM complied with the Delaware Insurance Code; (b) Assured failed to make a timely objection to the investments within 90 days of receiving account statements; (c) Assured cannot establish gross negligence; and (d) Assured is equitably estopped from asserting its breach of contract claim.

**Discussion**

Assured argues that it is entitled to partial summary judgment because JPMIM breached the Investment Management Agreement by failing to comply with the Delaware Insurance Code. Specifically, Assured contends that JPMIM violated Delaware Insurance Code § 1305(4), which caps an insurer's investment in non-agency mortgage-backed securities ("MBS") to 50% of all assets ("the 50% cap). Assured asserts that "JPMIM concentrated the Reinsurance Trust Accounts with non-agency MBS holdings in excess of the 50% cap" and in breach of Section 4(d) of the IMA.

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<sup>1</sup> Assured does not move on its other claims for breach of contract, breach of fiduciary duty or gross negligence, including its claim that JPMIM over-concentrated and maintained Orkney's assets in "highly risky subprime and alt-A mortgage-backed securities" despite Orkney's objective of maintaining a high level of safety of capital.

Chapter 13 of the Delaware Insurance Code establishes limitations on investments made by insurance companies. Delaware Insurance Code § 1302(a) entitled “Eligible investments” states that “[i]nsurers shall invest in or lend their funds on the security of, and shall hold as invested assets, only eligible investments as prescribed in this chapter.”

Pursuant to Delaware Insurance Code § 1305(4), an “insurer shall not at any 1 time have more than 50% of its assets invested in obligations under § 1323 of this title, exclusive of that portion of such obligations guaranteed or insured by an agency of the United States government.” Section 1323 entitled “Real estate mortgages” provides in part that “[a]n insurer may invest in bonds, notes or other evidences of indebtedness secured by first or second mortgages.”

Together, Delaware Insurance Code §§ 1305 and 1323 set forth a 50% cap on non-agency MBS investments. *Ambac Assur. UK Ltd. v. J.P. Morgan Inv. Mgmt., Inc.*, 88 A.D.3d 1, 12 (1st Dep’t 2011) (determining that plaintiff stated a claim for breach of contract based on defendant’s alleged violation of Section 1305 through investing more than 50% of assets in non-agency MBS). Generally, non-agency MBS are securities collateralized by mortgage loans that are not guaranteed or insured by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

In support of its claim that JPMIM invested the assets in the Reinsurance Trust Accounts in violation of the 50% cap on non-agency MBS, Assured submits an expert affidavit from Dr. George S. Oldfield. In his affidavit, Dr. Oldfield states, “I found that during March 2006 the amount of non-agency MBS in the Orkney Reinsurance Trust Account first exceeded 50% . . . [and] at its peak, the non-agency MBS in the Orkney Reinsurance Trust Account constituted more than 77% of

the book value of all the assets in such account.” Dr. Oldfield agreed with JPMIM expert Kenneth Lehn’s finding that the 50% cap on non-agency MBS was exceeded beginning on March 3, 2006.<sup>2</sup>

JPMIM does not submit any evidence to oppose Assured’s evidence that the assets in the Reinsurance Trust Accounts exceeded the 50% cap. In fact, JPMIM concedes that “the MBS and ABS-HEL [home equity loan asset-backed securities] in the Orkney Accounts exceeded 77% of the Accounts’ combined book value.” I therefore find that Assured sufficiently demonstrates that JPMIM breached the IMA by allowing investments in excess of the 50% cap for non-agency MBS, in violation of Delaware Insurance Code § 1305.

JPMIM nevertheless argues that JPMIM argues that it should not be held liable for breaching section 4(d) of the IMA because the parties and Scottish Re believed that the Delaware Insurance Code did not impose a 50% cap on non-agency MBS, and that investments made pursuant to the Investment Guidelines were in compliance with the Delaware Insurance Code. However, when parties to a contract require compliance with a statute – as the parties did here – the parties enter into “an agreement to comply with it as correctly interpreted, whether or not the correct interpretation was known to the parties at the time of contracting.” *Ramos v. Simplex Grinnell LLP*, 24 N.Y.3d 143, 148 (2014).

Accordingly, evidence that the parties may have thought that investments in non-agency MBS could exceed 50% under the Delaware Insurance Code, or that the investments separately met the percentages permitted by the Investment Guidelines, does not prevent a finding that JPMIM breached section 4(d) of the IMA by failing to comply with the Delaware Insurance Code. JPMIM expressly agreed that the investments would comply with the Delaware Insurance Code, regardless of the investment standards set forth in the Investment Guidelines. *See* IMA § 4(d)

<sup>2</sup> Assured states that its damages expert, Dr. Oldfield, has calculated Orkney’s damages from

JPMIM’s breach of the 50% cap to be \$110 million prior to pre-judgment interest.

This is a copy of a filing filed electronically pursuant to the New York State Court System’s Electronic Filing System (EFS) on 02/21/2017 at 10:00 AM. The filing is subject to the provisions of 22 NYCRR § 202.5-b(d)(3)(i) which, at the time of its printout from the court system's electronic website, had not yet been reviewed and approved by the County Clerk. Because court rules (22 NYCRR § 205.5[d]) authorize the County Clerk to reject filings that do not comply with the provisions of the Electronic Filing System, the County Clerk's rejection of this filing is hereby accepted for filing by the County Clerk.

("[n]otwithstanding any other provision of this Agreement or the Investment Guidelines . . .

investments must be made in compliance with the provisions of . . . Chapter 13 of the Delaware Insurance Code").

JPMIM further contends that its compliance with Section 1308 is sufficient to comply with the Delaware Insurance Code. Section 1308(a) states that "[a]n insurer may invest any of its funds in obligations rated 1 or 2 by the SVO if they are issued, assumed or guaranteed by any solvent institution created or existing under the laws of the United States or Canada or of any state, district, province or territory thereof." Although JPMIM may be able to establish that it complied with Section 1308, the First Department has already rejected JPMIM's argument that compliance with Section 1308 is sufficient to demonstrate compliance with the Delaware Insurance Code. *Ambac Assur. UK Ltd.*, 88 A.D.3d at 12 (stating that "[w]e further reject the defendant's argument that it complied with section 1308 of the Delaware Insurance Code, and that compliance with any section is sufficient to render an investment compliant with the Code").

While Assured has established that JPMIM breached the IMA by failing to comply with the Delaware Insurance Code, an issue of fact remains as to whether JPMIM's breach constitutes gross negligence. Under the IMA, the parties expressly agreed that JPMIM "shall not be liable to Client [Orkney] or its representatives for any Losses suffered by Client arising from any depreciation in the value of the Accounts or from the income derived from it . . . or other Losses that result from Investment Advisor's actions hereunder, *except to the extent such Losses are judicially determined to be proximately caused by the gross negligence or willful misconduct of Investment Advisor*" (emphasis added).

To prove gross negligence, a plaintiff must demonstrate "the type of conduct that smacks of intentional wrongdoing and evinces a reckless indifference to the rights of others." *Abacus Federal*

gross negligence is a matter to be determined by the trier of fact.” *Lubell v. Samson Moving & Storage*, 307 A.D.2d 215, 217 (1st Dep’t 2003).

Assured asserts that JPMIM’s breach of the IMA is conduct that amounts to gross negligence as a matter of law. In support of this argument, Assured submits the deposition testimony of JPMIM portfolio manager, Mark Stancher. At his deposition, Stancher testified that he created a spreadsheet listing the investment guidelines for the Orkney account, which he created “to help me understand and manage the transaction.” He further stated that he discussed “with Scottish [Re] and was assured that the portfolio met all the requirements of the various insurance code regulations” and that it was his understanding “that if the securities were purchased were within the guidelines that were in the prospectus, they would be in compliance with the various insurance regulations.” Stancher did not recall who conveyed that information to him from Scottish Re.

Stancher further testified that he did not recall whether he sought any legal advice on whether the investments complied with the Delaware Insurance Code; whether any internal discussions at JPMIM occurred regarding how to comply with the Delaware Insurance Code; or whether JPMIM undertook any steps to track the investment portfolio’s compliance with the provisions of the Delaware Insurance Code.

In addition, Assured submits the deposition testimony from other members of the team that worked with Stancher on the Orkney accounts. In their depositions, JPMIM team members Kyongsoo Noh, Jeffrey Sisko, and Cecilia Junker testified that they were unaware of the requirement that investments must comply with the Delaware Insurance Code. Further, Ron Arons testified that JPMIM’s automated “Compliance Master” software program was not programmed to measure whether Orkney’s investments in the Reinsurance Trust Accounts remained under the 50% cap.

JPMIM argues that its conduct does not amount to gross negligence, or alternatively that an issue of fact exists as to whether its conduct rises to the level of gross negligence. JPMIM points out that it did not engage in any intentional misconduct because it relied on Scottish Re’s representation that compliance with the Investment Guidelines was sufficient to satisfy the Delaware Insurance Code. JPMIM asserts that Scottish Re is “the party who sought the Delaware Code provision, received the only benefit from that provision, and is most knowledgeable about the requirements of its regulatory regime,” and that its reliance on Scottish Re was “entirely reasonable and appropriate.” In addition, JPMIM contends that the parties did not know that the Delaware Insurance Code imposed a 50% cap on non-agency MBS investments, and JPMIM did not possess any information to the contrary.

JPMIM submits deposition testimony from Orkney board member Adrian Masterson. At his deposition, Masterson testified that Orkney wanted investments of the assets held in the Reinsurance Trust Account to comply with the Delaware Insurance Code in order for Scottish Re to take reserve credit for those assets. JPMIM also submits deposition testimony from Scottish Re’s vice president of capital markets, David Webb, who explained that the Investment Guidelines were designed to be compliant with the Delaware Insurance Code. At his deposition, Webb testified that the Investment Guidelines were “the general parameters but were always subject to compliance with the Delaware and the New York requirements here which would supersede the investment guidelines. Certainly, there was no intent to put something in the guidelines that would have not been noncompliant with that, but this was always there to provide . . . the framework from which investments ultimately would need to be assessed for compliance.”

Based on the parties’ submissions, I find that Assured failed to demonstrate that JPMIM acted with gross negligence as a matter of law, and that a triable issue of fact exists as to whether

JPMIM was grossly negligent in relying on Scottish Re’s representations regarding the Delaware

Insurance Code and Scottish Re’s act of taking reserve credit in order to meet its own contractual obligation to ensure that investments complied with the Delaware Insurance Code. *Abacus Federal Savings Bank*, 18 N.Y.3d at 670; *American Home Assur. Co. v. Amerford Intern. Corp.*, 200 A.D.2d 472, 473 (1st Dep’t 1994) (holding that “summary judgment should not be granted where there is any doubt as to the existence of a triable issue”). Accordingly, I deny Assured’s motion for partial summary judgment on its breach of contract claim against JPMIM for failure to comply with the Delaware Insurance Code.

JPMIM contends that Assured’s breach of contract claim should be dismissed because Assured failed timely to object to the investments as required by the IMA. While it is true that the First Department held that the 90-day objection period contained in the IMA was reasonable, the court further stated that the 90-day period only applies to conduct apparent on the face of the statements. Because the face of the statements did not contain an indication as to whether the investments complied with the Delaware Insurance Code, JPMIM’s timeliness objection fails. *See Ambac Assur. UK Ltd. v. J.P. Morgan Inv. Mgmt., Inc.*, 88 A.D.3d 1, 12–13 (1st Dep’t 2011) (holding that where “plaintiff’s claims are based on defendant’s failure to manage the accounts in accordance with the investment objective rather than upon any specific act or transaction . . . they are based on conduct that would not have shown on any statement” and may not be dismissed based on the 90-day limitations period).

JPMIM also argues that Assured should be equitably estopped from advancing its claims based on the Delaware Insurance Code. JPMIM asserts that Scottish Re acted as Orkney’s agent, and that Orkney is therefore bound by Scottish Re’s representation that compliance with the Investment Guidelines equates to compliance with the Delaware Insurance Code.

The doctrine of equitable estoppel is applied by courts “to preclude a person from asserting a right after having led another to form the reasonable belief that the right would not be asserted, and

loss or prejudice to the other would result if the right were asserted.” *Shondel J. v. Mark D.*, 7 N.Y.3d 320, 326 (2006). I find that JPMIM fails conclusively to demonstrate that Scottish Re acted as Orkney’s agent when discussing the requirement that investments must comply with the Delaware Insurance Code, or that JPMIM reasonably relied on Scottish Re’s representations. These are issues of fact for trial and I therefore do not dismiss Assured’s breach of contract claim based on equitable estoppel at this time.

In accordance with the foregoing, it is

ORDERED that plaintiff Assured Guaranty (UK) Ltd.’s motion for partial summary judgment on the portion of its third cause of action alleging that defendant J.P. Morgan Investment Management Inc. breached the Investment Management Agreement by failing to comply with Chapter 13 of the Delaware Insurance Code is denied as to the issue of gross negligence; and it is further

ORDERED that a trial in this action shall be conducted before the Court on March 13, 2017.

This constitutes the decision and order of the Court.

DATE:

2/21/17

  
SALIANN SCARPULLA, JSC