One William St. Capital Mgt. L.P. v U.S. Educ. Loan Trust IV, LLC
2017 NY Slip Op 31079(U)
May 15, 2017
Supreme Court, New York County
Docket Number: 652274/2012
Judge: Eileen Bransten

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 3

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ONE WILLIAM STREET CAPITAL MANAGEMENT L.P., ONE WILLIAM STREET CAPITAL MASTER FUND, LTD., OWS ABS MASTER FUND II, L.P.,

Plaintiffs,

-against-

U.S. EDUCATION LOAN TRUST IV, LLC, U.S. EDUCATION SERVICING LLC, DR. HENRY HOWARD, BANK OF NEW YORK, KILDARE CAPITAL, INC.,

Defendants.

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DECISION/ORDER
Index No. 652274/2012
Motion Date: 11/28/2016
Mot. Seq. Nos. 016, 017

BRANSTEN, J.

Presently before the Court are two motions to dismiss filed by Defendant Bank of New York Mellon ("BNYM"), U.S. Education Loan Trust IV, LLC ("ELT"), U.S. Education Servicing LLC, and Dr. Henry Howard (collectively, "Moving Defendants") to dismiss the claims alleged against them in the Amended Complaint. The motions are consolidated for disposition herein.

For the following reasons, the Court Grants Moving Defendants' motions in their entirety.

I. Background

Plaintiffs are the former holders of $10 million worth of Series 2007-1B-1 Notes (the "Notes") which are backed by government-guaranteed student loans. The Notes were part of a $30 million package originally issued on October 19, 2007 by Defendant ELT pursuant to an indenture and supplemental indenture (together, the "Indenture"). Plaintiffs purchased their $10 million in notes in January 2011, while the remaining Notes were purchased by non-party Merrill, Lynch, Pierce, Fenner & Smith ("Merrill Lynch").

In 2008, the Notes converted into "Auction Rate Notes," which meant that Defendant ELT and its "auction agent," Defendant BNYM, had to hold monthly auctions of the Notes. According to the Amended Complaint,

> Such auctions involve a matching by the Auction Agent of buyers who specify the interest rate at which they are willing to buy the Notes for par and sellers who specify the willingness to sell for par, with the results determined by the lowest interest rate at which sufficient buyers will buy all the Notes offered for sale in the auction.

Am. Compl. ¶ 1.

Where ELT and BNYM failed to hold an auction, the Notes were to automatically bear an interest rate of "one-month LIBOR plus 2.50%" until redeemed or until a successful auction is held. Am. Compl. ¶ 2. The Amended Complaint alleges that Defendants failed to hold any such auction up until Plaintiffs' purchase of the Notes in January 2011. Am. Compl. ¶¶ 2-4.

At some point, Defendant Howard, principal of Defendant U.S. Education, learned from Defendant BNYM that auctions were to begin in the "near-future," and that the Notes would thus bear less than the "LIBOR plus 2.50%" interest rate currently owed under the Indenture. Am. Compl. ¶ 6. Defendant Howard allegedly concealed this fact from Plaintiffs and Merrill Lynch, who had recently purchased the Notes, and proceeded to organize an auction without telling Plaintiffs or Merrill Lynch—the only holders of the Notes. Am. Compl. ¶ 7. After the auction, Defendants took the position that the Notes' interest rate had been effectively decreased to zero, rendering the Notes of little value to investors.

Plaintiffs commenced this action in June 2012, seeking various forms of relief premised on the above facts, including payment of principal and interest on the Notes, as well as damages in tort. The Court issued a decision in this case on August 13, 2013, denying Defendants' first motion to dismiss and granting Plaintiffs leave to amend the complaint. Plaintiffs' subsequent amendments added the fraud claims against Defendants Howard and U.S. Education, as well as the aiding and abetting fraud claim against BNYM.

The Court issued a second decision in this case on July 18, 2015, denying Plaintiffs' motion for summary judgment and granting in part Defendants' motion for summary judgment. The Court held that Plaintiffs lacked standing to sue with respect to their claim for principal and interest on the Notes because Plaintiffs' "repurchase agreement" with non-party Merrill Lynch effectively removed Plaintiffs' standing to sue on the Notes subject to that agreement. *See One William Street Capital Management, LP. v. Educ. Loan Trust IV*, 2015 WL 4501194 at *4-5 (Sup. Ct. N.Y. Cty. 2015).

Six months after the decision was issued, on January 15, 2016, Plaintiffs and non-party Merrill Lynch sold all of their Notes pursuant to "a standing sell order at the monthly auction of the bonds." Am. Compl. ¶ 14. Plaintiffs subsequently sought, and were given, leave to further amend the complaint to take into account these new developments.

On June 28, 2016, Plaintiffs filed the instant Amended Complaint, alleging five causes of action against Moving Defendants and Defendant Kildare Capital. The Amended Complaint dropped all contract-based claims, asserting five causes of action in tort against the various Defendants: (1) fraud, against Defendants ELT, BNYM, U.S. Educaiton, and Howard; (2) aiding and abetting fraud, against BNYM; (3) aiding and abetting fraud, against Kildare Capital; (4) fraudulent conveyance, against ELT; and (5) surcharge, against BNYM.

On July 11, 2016, all Defendants except Kildare Capital moved to dismiss allegations of the Amended Complaint asserted against them.

II. <u>Standard of Review</u>

When considering a motion to dismiss for failure to state a claim under CPLR § 3211(a)(7), the court must "accept the facts as alleged in the complaint as true, accord plaintiffs the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory." *Leon v. Martinez*, 84 N.Y.2d 83, 87-88 (1994). While factual allegations contained in a complaint are accorded a favorable inference, bare legal conclusions and inherently incredible facts are not entitled to preferential consideration. *Sud v. Sud,* 211 A.D.2d 423 (1st Dep't 1995). The motion must be denied if the factual allegations contained within "the pleadings' four corners . . . manifest any cause of action cognizable at law." *511 W. 232nd Owners Corp. v. Jennifer Realty Co.,* 98 N.Y.2d 144, 151-52 (2002).

Where a defendant moves pursuant to CPLR 3211(a)(3), the court must grant the motion where "the party asserting the cause of action does not have legal capacity to sue." N.Y. C.P.L.R. 3211(a)(3). CPLR 3211(a)(3) is available to support motions to dismiss based on both lack of capacity and lack of standing to sue. *Brunner v. Estate of Lax*, 137 A.D.3d 553, 553 (1st Dep't 2016). Where the defendant moves based on lack of standing, the burden is on the moving defendant to establish the plaintiff's lack of standing as a matter of law. *U.S. Bank Nat. Ass'n v. Guy*, 125 A.D.3d 845, 847 (2nd Dep't 2015).

III. Discussion

Defendants move to dismiss the causes of action alleged against them in the Amended Complaint. Specifically, Moving Defendants argue that Counts One Two, Four, and Five should be dismissed as alleged against Defendants BNYM and ELT due to lack of standing, and Count One should be dismissed as alleged against Defendants Howard and U.S. Servicing for failure to state a claim.

The Court will address each argument independently below.

A. Plaintiffs' Standing to Sue Defendants BNYM and ELT under General Obligations Law § 13-107(1)

Moving Defendants first argue that the claims alleged against Defendants BNYM and ELT must be dismissed because Plaintiffs were deprived of standing to sue under General Obligations Law § 13-107(1) when Plaintiffs sold their entire $10 million stake in the Notes at issue in this case.

Significantly, Plaintiffs concede that they sold the Notes issued on January 15, 2016. *See* Compl. ¶ 14. Plaintiffs further concede that, pursuant to General Obligations Law § 13-107, the relevant contract claims passed to the purchaser of the bonds upon the sale. *Id.* ¶ 114. However, Plaintiffs argue that § 13-107 applies only to their contract-based claims, leaving them free to maintain their tort claims against Moving Defendants. Defendants disagree, contending that § 13-107 makes no distinction between tort and contract claims and instead "automatically transfers" *all* such claims to the purchaser of the bonds. For the following reasons, the Court agrees with Defendants.

General Obligations Law § 13-107(1) states the following:

> Unless expressly reserved in writing, a transfer of any bond shall vest in the transferee all claims or demands of the transferrer, whether or not such claims or demands are known to exist, (a) for damages or rescission against the

> obligor on such bond, (b) for damages against the trustee or depositary under any indenture under which such bond was issued or outstanding, and (c) for damages against any guarantor of the obligation of such obligor, trustee or depositary.

N.Y. Gen. Oblig. Law § 13-107(1). Under § 13-107(1), when a bond is sold, the buyer "receives exactly the same 'claims or demands' as the seller held before the transfer." *Bluebird Partners, L.P. v. First Fid. Bank, N.A.*, 97 N.Y.2d 456, 461 (2002) (quoting § 13-107(1)). Such a sale thus automatically assigns the seller's "bond-related" claims to the buyer "whether or not those claims were known to exist at the time of transfer." *Id.* at 458, 461.

As Defendants contend, cases applying General Obligations Law § 13-107(1) as interpreted by the *Bluebird* court make no distinction between bond-related contract claims and bond-related tort claims. *See Semi-Tech Litig., LLC v. Bankers Trust Co.*, 272 F. Supp. 2d 319, 330 (S.D.N.Y. 2003) ("to the extent that [General Obligations Law § 13-107] applied to transfers of notes prior to the record date, transferees succeeded to *any state law claims* that previously may have accrued in favor of their transferors") (emphasis added); *Ellington Credit Fund, Ltd. v. Select Portfolio Servicing, Inc.*, 837 F. Supp. 2d 162, 181 (S.D.N.Y. 2011) ("Upon a transfer of 'bonds,' § 13–107 automatically vests the transferee with *all* of the transferor's bond-related causes of action against the obligor") (emphasis added).

The cases cited by Plaintiffs in opposition do not necessitate a different conclusion. For example, the primary case relied upon by Plaintiffs, *Commonwealth of Pennsylvania*

Public School Employees' Retirement System v. Morgan Stanley & Co., 25 N.Y.3d 543 (2015), is distinguishable on the facts. In *Commonwealth*, holders of mortgage-back securities sued a placement agent and several ratings agencies for fraud when the securities lost value during the credit crisis. *Id.* at 545-548. The Court of Appeals concluded that the plaintiffs, who purchased a portion of the securities from previous holders, did not have standing to sue for fraud committed against the previous securities holders because those fraud claims were not automatically assigned to plaintiffs upon their purchase of the securities. *Id.*

There, because the defendants were placement agents and ratings agencies rather than "obligors," "trustees," or "depositories" of the securities, General Obligations Law 13-107's "automatic assignment" rule did not apply. *See* N.Y. Gen. Oblig. Law § 13-107(1). Thus, the *Commonwealth* court was left to apply New York common law, which contains no independent doctrine of "automatic assignment." *See Commonwealth of Pennsylvania Public School Employees' Retirement System*, 25 N.Y.3d at 550.

By contrast, here, Defendant BNYM is the "Trustee" of the Notes (*see* Compl. ¶ 16), and Defendant ELT is the issuer and original "obligor" of the Notes, (*see* Compl. ¶ 17). As such, there is no doubt that BNYM and ELT are directly subject to § 13-107(1)'s automatic assignment rule. *See* N.Y. Gen. Oblig. Law § 13-107(1); *Bluebird Partners, L.P.*, 97 N.Y.2d at 461.

The Court finds Plaintiff's citation to *In re Nucorp Energy Sec. Litigation.*, 772 F.2d 1486, 1493 (9th Cir. 1985) to be similarly unpersuasive because *Nucorp* relied on reasoning rejected by the New York Court of Appeals in *Bluebird.* In *Nucorp*, the Ninth Circuit declined to dismiss the plaintiff's fraud claims under New York's General Obligations Law § 13-107 when the plaintiff sold the bonds underpinning its suit, declaring that such a dismissal "would remove the remedy from those to whom the statute provides it, *i.e.,* those who were defrauded, by gratuitously giving it to those who were not defrauded and have suffered no injury under the securities law." *In re Nucorp Energy Sec. Litig.*, 772 F.2d at 1490.

However, in reversing a First Department decision which cited to *Nucorp* for this very proposition, the Court of Appeals subsequently held that under § 13-107(1), purchasers of bonds may assert any claims which the sellers could have asserted "whether or not the transferees themselves suffered any actual injuries." *Bluebird Partners, L.P.*, 97 N.Y.2d 456 at 461-462. *Bluebird* thus expressly rejected the notion that General Obligations Law § 13-107 excludes tort claims from its "automatic assignment" rule out of a concern that the purchaser of the bonds will be unable to show actual injury. *See id.*[1]

[1] In arriving at this interpretation of General Obligations Law § 13-107(1), the *Bluebird* Court ironically noted that, while § 13-107(1) was an attempt by the New York state legislature to bring its rule into conformity with other jurisdictions, most other jurisdictions no longer apply such a broad "automatic assignment of claims" rule. *See Bluebird Partners, L.P.*, 97 N.Y.2d at 461 (citing *Bluebird Partners, L.P. v. First Fid. Bank,* 85 F.3d 970, 975 (2d Cir.1996)). Nonetheless, the Court determined that it was bound to apply the law as written, declaring that "[w]hether New

Plaintiff's reliance on *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 23 N.Y.3d 549 (2014) for the proposition that § 13-107(1) distinguishes between contract claims "*on* the bond" and non-contract claims "*related* to the bond" is similarly unavailing. In *Quadrant*, the plaintiff sued the issuer of debt instruments for alleged wrongs surrounding the plaintiff's purchase of the debt, alleging causes of action based on contract, tort, and state statute. The defendant moved to dismiss, arguing that a "no-action clause" in the parties' contract barred all of plaintiffs' claims relating to the purchased debt. The *Quadrant* court applied principles of contract interpretation to determine that, because the no-action clause explicitly mentioned contract claims, the clause barred only contract-based claims but permitted by implication common law and statutory claims. *Id.* at 559-562.

As an initial matter, the Court notes that *Quadrant* is distinguishable because there, the Court of Appeals applied canons of construction to a provision of the specific contract at issue in that case, where here the Court is asked to construe the language of a New York state statute, General Obligations Law § 13-107(1). The Court further declines to extend the logic of that case to apply to § 13-107(1) because, on review, the Court of Appeals decision in *Bluebird* forecloses any such application.

York wants to make another attempt at conforming its rule to other jurisdictions or retain it in its present form is a decision for the Legislature." *Id.*

Like the contract at issue in *Quadrant*, § 13-107(1) by its language applies to claims "for damages or rescission against the obligor *on* such bond." N.Y. Gen. Oblig. Law § 13-107(1) (emphasis added). However, the *Bluebird* court described § 13-107(1) as applying more broadly to "bond-*related* claims." *Bluebird Partners, L.P.*, 97 N.Y.2d at 458 (emphasis added). Thus, while the phrase "on such bond" might otherwise restrict the statute to contract claims on the Indenture itself, the *Bluebird* Court nonetheless made it "eminently clear" that § 13-107(1) provides the purchaser with "exactly the same claims or demands as the seller had before the transfer" even if those claims are merely "related" to the bonds at issue or the Indenture which created them. *Id.* at 461. Plaintiff's proposed application of *Quadrant*'s reasoning to this case would thus impermissibly contradict *Bluebird*'s binding interpretation of § 13-107(1), and does not withstand scrutiny.

Based on the foregoing analysis, the Court concludes that, pursuant to General Obligations Law § 13-107(1), Plaintiffs' standing to bring Note-related tort claims against BNYM and ELT was automatically transferred to the Notes' purchaser upon sale on January 15, 2016. Accordingly, Counts One, Two, Four and Five are dismissed as alleged against Defendants BNYM and ELT.

B. Whether the Complaint States a Claim for Fraud against Defendants Howard and U.S. Education Servicing

Moving Defendants argue that the Complaint fails to state a claim for fraud against Defendants Howard and U.S. Education Servicing.

To state a claim for fraud, a plaintiff 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 N.Y.3d 553, 559 (2009). A claim for fraud must be pleaded with the requisite particularity under CPLR 3016 (b). *Id.*

New York follows the "out-of-pocket" rule of alleging damages in tort. Under the out-of-pocket rule, a plaintiff may only recover "for the actual pecuniary loss sustained as the direct result of the wrong." *Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 421 (1996). "Under the out-of-pocket rule, there can be no recovery of profits which would have been realized in the absence of fraud." *Id.* Thus, "a contracting party seeking only a benefit of the bargain recovery, viz., economic loss under the contract, may not sue in tort notwithstanding the use of familiar tort language in its pleadings." *17 Vista Fee Assocs. v. Teachers Ins. & Annuity Ass'n of Am.*, 259 A.D.2d 75, 83 (1st Dep't 1999).

In an attempt to show out-of-pocket damages, Plaintiffs allege that:

> when Plaintiffs sold the Notes in 2016, they were only able to do so at a discount to what would have been the Notes' value if they had paid the correct interest rate, and below the value as understood by Plaintiffs and [Merrill Lynch] when they purchased the Notes in 2011. Though Plaintiffs sold the Notes at par value, that value did not account for the several years' worth of accrued interest that Plaintiffs were denied as a direct result of Defendants' fraudulent conduct.

Am. Compl. ¶ 104. In other words, Plaintiffs assert that the par value they received upon sale of the Notes in 2016 was less than what they would have recovered had Defendants paid out the correct amount of interest between 2011 and 2016.

However, as Defendants point out, and Plaintiffs allege in the Amended Complaint, Plaintiffs sold the Notes pursuant to a "standing sell order at the monthly auction of the bonds." Am. Compl. ¶ 14. According to the Amended Complaint,

> Such auctions involve a matching by the Auction Agent of buyers who specify the interest rate at which they are *willing to buy the Notes for par* and sellers who specify the *willingness to sell for par*, with the results determined by the lowest interest rate at which sufficient buyers will buy all the Notes offered for sale in the auction.

Am. Compl. ¶ 1 (emphasis added). Plaintiffs' Notes were thus auctioned at par value regardless of the interest rate which the Notes bore—the only variable at such an auction was the future interest rate which those Notes would bear upon transfer. *See id.*

Under this auction structure, as alleged in the Amended Complaint, Plaintiffs would have received "par value" for the Notes at auction regardless of Defendants' alleged refusal to make proper interest payments on the Notes in years past. Thus, Plaintiffs' fraud claim against Defendants Howard and U.S. Education Servicing must be dismissed because Plaintiffs' receipt of par value at auction cannot serve as a basis for damages in either contract or tort.

Plaintiffs' arguments in opposition are of no avail. First, Plaintiff argues that damages should be calculated based on the value they would have received through a *private sale* of the Notes, not just at auction. However, the Amended Complaint does not allege that Plaintiffs' decision to sell the Notes at the monthly "par value" auction was induced by fraud, or that Plaintiffs were otherwise unlawfully prevented from seeking out private buyers instead of participating in the "par value" auction.

The Amended complaint thus fails to allege that Defendants' actions were the proximate cause of Defendants' failure seek more than "par value" for its Notes through a private sale. *See Laub v. Faessel*, 297 A.D.2d 28, 30 (1st Dep't 2002) (holding that "plaintiff must establish that the alleged misrepresentations or other misconduct were the direct and proximate cause of the losses claimed"). As such, Plaintiff's theory of damages predicated on lost profits from a private sale cannot stand. *See id.*

Second, Plaintiffs argue that Defendants' alleged misrepresentations led to a loss because the statements caused Plaintiffs to *retain* the Notes for longer than Plaintiffs otherwise would have. However, as noted above, Plaintiffs' sale of the Notes at auction would have yielded the same "par value" regardless of the time of sale. And, in any event, any potential value which Plaintiffs *might* have realized had they sold the Notes in an alternative fashion—or based on more complete and accurate information—is far too speculative to serve as the basis for Plaintiffs' tort claims. *See Starr Found. v. Am. Int'l Grp., Inc.*, 76 A.D.3d 25, 28 (2010) ("the loss of an alternative contractual bargain cannot serve as a basis for fraud or misrepresentation damages because the loss of the bargain was 'undeterminable and speculative.'") (quoting *Lama Holding Co. v. Smith Barney Inc.*, 88 N.Y.2d 413, 422 (1996)).[2]

Based on the foregoing analysis, the Court concludes that Plaintiffs have failed to sufficiently allege the damages element of fraud against Defendants Howard and U.S. Education Servicing. *See Starr*, 76 A.D.3d at 28. Accordingly, Count One is dismissed as alleged against Defendants Howard and U.S. Education Servicing.

[Decision continues on following page]

[2] Plaintiffs' demand for damages based on out-of-pocket expenses incurred in retaining the Notes over the period of Defendants' alleged fraud is similarly too speculative. Such a calculation would require a showing of the precise date on which Plaintiff would have sold the Notes but for Defendants misrepresentations—if Plaintiffs would have chosen to sell the Notes at all. The uncertainty involved in such a calculation "takes the claim out of the realm of cognizable damages," and is thus not an actionable basis for Plaintiffs' tort claims. *See Starr*, 76 A.D.3d at 30.

IV. Conclusion

For the foregoing reasons, Moving Defendants' motions to dismiss are granted in its entirety.

Accordingly, it is

ORDERED that Moving Defendants' motions to dismiss are GRANTED; and it is further

ORDERED that Counts One, Two, Four and Five are dismissed; and it is further

ORDERED that counsel for Plaintiffs and non-moving Defendant Kildare Capital, Inc., are directed to appear for a status conference in Room 442, 60 Centre Street, on June 6, 2017 at 11:00 A.M.

Dated: May 15, 2017
New York, New York

ENTER

Hon. Eileen Bransten, J.S.C.