

Norddeutsche Landesbank Girozentrale v Tilton
2019 NY Slip Op 32470(U)
August 20, 2019
Supreme Court, New York County
Docket Number: 651695/2015
Judge: Joel M. Cohen
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART IAS MOTION 3EFM

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NORDDEUTSCHE LANDESBANK
GIROZENTRALE, HANNOVER FUNDING
COMPANY LLC,

Plaintiffs,

- v -

LYNN TILTON, PATRIARCH PARTNERS, LLC,
PATRIARCH PARTNERS XIV, LLC, PATRIARCH
PARTNERS XV, LLC,

Defendants.

INDEX NO.	651695/2015
MOTION DATE	N/A
MOTION SEQ. NO.	013
DECISION + ORDER ON MOTION	

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HON. JOEL M. COHEN:

The following e-filed documents, listed by NYSCEF document number (Motion 013) 623, 624, 625, 626, 627, 628, 629, 630, 631, 632, 633, 634, 635, 636, 637, 638, 639, 640, 641, 642, 643, 644, 645, 646, 647, 648, 649, 650, 651, 652, 653, 654, 655, 656, 657, 658, 659, 660, 661, 662, 663, 664, 665, 666, 667, 668, 669, 670, 671, 672, 673, 674, 675, 676, 677, 678, 679, 680, 681, 696, 697, 698, 699, 700, 701, 702, 703, 704, 705, 706, 707, 708, 709, 710, 711, 712, 713, 714, 715, 716, 717, 718, 719, 720, 721, 722, 723, 724, 725, 726, 727, 728, 729, 730, 731, 732, 733, 734, 735, 736, 737, 738, 739, 740, 741, 742, 743, 744, 745, 746, 747, 748, 749, 750, 751, 752, 753, 754, 755, 756, 757, 758, 759, 760, 761, 762, 763, 764, 765, 766, 767, 768, 769, 770, 771, 772, 777, 796, 797, 831, 832

were read on this motion for SUMMARY JUDGMENT.

Plaintiffs contend that they were duped by Defendants into investing in two high-risk private equity funds that they were led to believe were relatively safe “collateralized loan obligation” funds. In response, Defendants contend that Plaintiffs are sophisticated financial institutions that are simply trying to shift the blame for their costly decision to liquidate their

investment at a loss prior to maturity (when they would have been paid in full), for independent business reasons having nothing to do with Defendants or the nature of the funds.

Defendants move for summary judgment on the grounds that Plaintiffs' claims are time-barred; that Plaintiffs did not rely on Defendants' representations (which in any event were accurate); that Plaintiffs caused their own losses by selling the notes prematurely; and that Plaintiffs' claims are precluded by a judgment rejecting a nearly identical claim brought by the Securities Exchange Commission with Plaintiffs' assistance.

For the reasons described below, the Court finds that there are disputed issues of fact that are material to Plaintiffs' claims. Accordingly, Defendants' motion for summary judgment must be denied.

BACKGROUND

Plaintiff Nordeutsche Landesbank Girozentrale is a German financial institution. Plaintiff Hannover Funding Company is a Delaware LLC, and is a commercial paper conduit administered by Nordeutsche (together "Plaintiffs" or "Nord").

Defendant Lynn Tilton ("Tilton") is the principal owner of Defendant Patriarch Partners ("Patriarch"), which served as collateral manager for two funds known as Zohar II and Zohar III ("the Funds"). The exact nature of the Funds is disputed. Defendants argue that the Funds are a modified collateralized debt obligation ("CDO") fund, which issues notes to investors in exchange for cash, invests the cash in a collateral pool of primarily distressed loans, and, through active management by Patriarch, increases the equity value of the companies. Plaintiff argues that the Funds were marketed as CDOs, but instead were used to finance leveraged buyouts and buy equity interests in high risk entities.

The Funds were created in January 2005 and April 2007, and had maturity dates of January 20, 2017, and April 15, 2019, respectively. Zohar II and Zohar III each issued over \$1 billion in Notes that were rated at issuance either AAA/Aaa or AA/Aa1 by S&P and Moody's, respectively. Before purchasing the notes in the Funds, Nord received transaction documents, marketing materials, indentures, and collateral management agreements relating to each fund, as well as an offering memorandum for the Zohar III Fund. In January 2005, Nord purchased \$75 million of notes in Zohar II. In April 2007 Nord purchased \$60 million of notes in Zohar III. The Zohar II notes were "wrapped" by insurance from MBIA Insurance Corp. ("MBIA"). MBIA guaranteed full repayment of the notes upon maturity if the funds could not afford to do so.

Patriarch contends that it invests in distressed assets and manages and restructures the underlying companies with the goal of enhancing the value of the companies. Using this model, the Funds' portfolio primarily consisted of debt obligations from deeply distressed U.S.-based portfolio companies purchased and managed by Defendants.

The Funds performed poorly. Plaintiffs claim that Defendants withheld fund performance related information from them by furnishing fraudulent Trustee Reports which concealed the actual performance of the underlying loans in the Funds. Plaintiffs were aware that the Funds had been repeatedly downgraded by the rating agencies from 2009 through 2011 due to their underperformance. Nord sold its notes for a loss of approximately \$45 million in April 2012, before the maturity date of either fund. Nord claims that it sold the notes due to their poor performance, the ratings downgrade, and the increasing capital requirements generated by the investment. Defendants claim Nord sold the notes for independent business reasons.

Plaintiffs primarily allege that instead of running the funds as advertised, Tilton and Patriarch Partners ran the Funds as private equity funds. Plaintiffs maintain that Defendants used the money from the Funds to purchase equity in the distressed assets, contrary to Defendants' purported representations, rather than using Defendants' own money. Plaintiffs further allege that Defendants collected management fees, dividends, preferred share buyouts, and income distributions from the companies that were owed to the Funds.

Plaintiffs allege they were told that Tilton and the Patriarch entities were supposed to pay for and own the underlying equity in the portfolio companies, while the Funds would make loans to the companies. Plaintiffs further allege that they understood the Funds would be entitled to an equity kicker in some cases (to participate in the upside if Defendants were successful in turning the companies around) but would not be exposed to the *downside* risk of holding equity positions. The Funds were blind CDO funds, meaning that investors were not informed of the specific borrowers to which loans were extended, but relied on the collateral managers to provide detailed and accurate information of such borrowers and the loans made to those borrowers.

On March 31, 2015, the SEC issued an order commencing an administrative proceeding against Defendants. According to Plaintiffs, the SEC investigation uncovered fraudulent behavior by Defendants, including that Defendants used the Zohar Funds to obtain control over portfolio companies, and that Defendants concealed their fraudulent behavior from investors such as the Plaintiffs. The administrative proceeding was ultimately dismissed in September 2017, finding that the alleged violations of the Investment Advisors Act of 1940 were "unproven." NYSCEF 675.

ANALYSIS

The standard for assessing a motion for summary judgment is a familiar one. “It is axiomatic that summary judgment is a drastic remedy and should not be granted where triable issues of fact are raised and cannot be resolved on conflicting affidavits.” *Brunetti v. Musallam*, 11 A.D.3d 280, 280 (1st Dep’t 2004). Upon making a motion for summary judgment, the moving party must “make a prima facie showing of entitlement to judgment as a matter of law, tendering sufficient evidence to demonstrate the absence of any material issues of fact.” *Alvarez v. Prospect Hosp.*, 68 N.Y.2d 320 (1986). If such a showing has been made, the burden shifts to the opposing party to “produce evidentiary proof in admissible form” sufficient to establish the existence of material issues of fact which require a trial in the action. *Zuckerman v. City of New York*, 49 N.Y.2d 557, 562 (1980).

As noted above, Defendants move for summary judgment on the grounds that: 1) the claims are time barred, 2) Plaintiffs did not justifiably rely on any alleged misrepresentation by Defendants, 3) Plaintiffs cannot show loss causation, and 4) the SEC Decision collaterally estops Plaintiffs’ claims. The Court will address each in turn.

Statute of Limitations

The statute of limitations for a fraud claim is six years from the date of the fraudulent act or within two years of the date the fraud was or with reasonable diligence could have been discovered. CPLR § 213(8). Defendants argue that Plaintiffs were aware of the structure of the funds from the marketing materials distributed to them in 2004 and 2006. Defendants rely on alleged disclosures of “equity upside” and “equity participation” as sufficient to inform Plaintiffs that the Funds were going to hold equity and thus be at risk of suffering a loss. As such, Defendants maintain, the claims are time barred because Plaintiffs knew or should have known

of the alleged Fraud before 2005 and 2007, when they made their investments in the respective Funds.

Defendants have not put forward incontrovertible evidence that the marketing materials and disclosures presented to Plaintiffs were sufficient to inform Plaintiffs of the alleged fraud. Previously in this case the First Department held that “that the evidence presented by defendants can be interpreted in a myriad of ways and does not facially clash with plaintiffs’ position that, even having some knowledge that the Funds had an equity component to them, they could not have known before the SEC proceeding the extent to which defendants used plaintiffs’ investment to acquire and control the Portfolio Companies, or otherwise had an obligation, based on that evidence, to further investigate.” *Norddeutsche Landesbank Girozentrale v. Tilton*, 149 A.D.3d 152, 161-162 (1st Dep’t 2017). This remains the case at this stage of the litigation. On the other hand, Plaintiffs have put forward documentary evidence and expert testimony that the structure of the Funds is as they describe, and contrary to how Defendants outlined the arrangement in their documents and disclosures. *See e.g.*, NYSCEF 712-715, 763. As such, there remain issues of fact as to whether Plaintiffs were or should have been aware of the alleged fraud in 2004 and 2006.

In addition, there are issues of fact as to whether Plaintiffs should have discovered the alleged fraud in 2012 when the SEC began its investigation into Defendants and/or through investor calls held in December 2011. Defendants argue that Mr. Weber, Managing Director of Nord, was contacted by the SEC in 2012 about the investigation into Defendants, and thus should have become aware of the alleged fraud at the time. However, Mr. Weber, in his affidavit, states that although he received an email from the SEC, he did not respond to it, nor did he speak with anyone at the SEC. NYSCEF 698, Aff. of Edward Weber at 3. Plaintiffs maintain

that their claims are timely because they first discovered the fraud in March 2015, when the SEC commenced its proceedings against Patriarch. That is a question for the finder of fact.

Finally, the December 2011 investor call upon which Defendants rely does not unequivocally show that Plaintiffs were aware of the facts they now allege were withheld from them. On the call, Ms. Tilton stated that she and Patriarch Partners would buy the equity in the distressed companies, and the Funds would make loans to the companies and participate in the equity upside of the investment. NYSCEF 632, Ex. 7 to Shapiro Aff. at 4. Plaintiffs argue this is the same misleading description that Defendants conveyed from the outset, while Defendants argue that Tilton's disclosure that the Funds would obtain an equity interest negates any claim of fraud. This is a question of fact for trial.

Justifiable Reliance

There are also issues of fact surrounding justifiable reliance. "The issue of justifiable reliance is generally a question of fact that is not amenable to summary resolution." *Ventur Group, LLC, v. Finnerty*, 689 A.D.3d 638, 639 (1st Dep't 2009). To prevail on summary judgment, a defendant must show that "plaintiff failed to make use of the means of verification that were available to it." *Id.* (quoting *UST Private Equity Investment Fund v. Salomon Smith Barney*, 288 A.D.2d 87, 88 (1st Dep't 2001)). In *Ventur Group*, the plaintiff "failed to make any effort to verify [the defendant's] representations," and summary judgment was granted. *Id.* This is not the case here.

Defendants argue they made robust disclosures about the strategy of the Funds, and Plaintiffs chose to follow through on the deal knowing full well how the Funds would operate. Defendants further argue that Nord, as a sophisticated financial institution, could and should have done enough investigation to discover how the Funds would operate, and thus could not

have *justifiably* relied upon the alleged fraudulent statements to induce them into investing in the Funds.

On the other hand, Plaintiffs contend that they reviewed the indentures, offering memorandum, collateral management agreements, and the marketing materials related to Zohar II and Zohar III, and relied on the statements in these documents. The statements, they contend, fraudulently concealed the true nature of the funds. Furthermore, Plaintiffs' claim their due diligence was robust but could not unearth the alleged misrepresentation. In performing its due diligence, Plaintiffs contend that they followed the same procedure they would for any CLO investment. NYSCEF 756, 757, Exs. XX and YY to Kim Aff. Nord did an internal review and had outside counsel review the documents provided by Defendants. *Id.*

Defendants have not shown conclusively that Plaintiffs failed to make use of the means of verification that were available to it, nor have they put forth evidence showing conclusively that Plaintiffs failed to make efforts to verify the representations. *Ventur Group*, 689 A.D.3d at 639. Again, this raises issues of fact for trial.

Loss Causation

Defendants further argue that they are entitled to summary judgment because Plaintiffs cannot demonstrate loss causation. “Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff.” *Basis PAC-Rim Opportunity Fund v. TCW Asset Management Co.*, 149 A.D.3d 146, 149 (1st Dep’t 2017) (quoting *Lentell v. Merrill Lynch & Co., Inc.*, 196 F.3d 161, 172 (2d Cir. 2005)). Defendants claim that Plaintiffs cannot maintain a fraud claim because their losses were not proximately caused by Defendants’ alleged actions.

Defendants rely heavily upon a statement by Mr. Weber in his deposition in which he testified that the “primary reason” for the sale of Zohar II was the “heavy capital usage” imposed by the investment. NYSCEF 764, Weber Deposition Trans. at 207. Defendants argue that this testimony demonstrates conclusively that there was an independent reason for Plaintiffs’ loss that had nothing to do with Defendants alleged misrepresentation.

In his deposition Mr. Weber was asked about the sale of Zohar II and explained that “in 2005 it was a triple ‘A’ asset so the capital was very, very tiny. Once it was downgraded to below investment grade then the capital became very, very high.” *Id.* at 206. Mr. Weber explained further that “[b]ecause it was below investment-grade and it was a securitization, it was a twelve hundred fifty percent risk weight, which means that it was a dollar for dollar capital reduction. So what that means was the bank was holding \$125 million of its capital base to support these transactions.” *Id.* at 205.

This testimony does not conclusively establish a defense based on loss causation. A finder of fact could determine that the decision to sell was causally linked to the alleged fraud, which Plaintiff contends led it to assume a certain level of performance, credit rating, and capital requirements, which in turn impacted whether to hold or sell the notes. A finder of fact could also reasonably conclude that had Plaintiffs known about the actual Fund structure, they would never have entered into the transaction in the first place. While Mr. Weber’s testimony might be fodder for cross-examination, it is insufficient to establish a loss causation defense as a matter of law.

Furthermore, Defendants argue that because the funds were insured by MBIA and Plaintiffs would have recovered their investment if they had held the notes to maturity. However, a finder of fact could determine that Plaintiffs made their decisions based on facts

traceable to the alleged fraud and in part on concerns about MBIA's financial condition.

NYSCEF 760, 761, Kim Aff. Exs. BBB at 26, CCC at 40-41. Defendants' reasoning would preclude a finding of loss causation with respect to the sale of virtually any insured note. That is not the law.

Other Issues of Material Fact

The evidence produced by the parties, and referenced in the Rule 19-A statements of undisputed facts, bely the notion that there are no disputed issues of material fact to be resolved at trial. The parties dispute the basic mechanics of the operations of the Funds, and whether the money used to purchase the underlying companies came from Tilton or the Funds. NYSCEF 697 at 6-7, 9. Plaintiffs also maintain that financial statements, trustee reports, and other mechanisms by which Defendant was to inform Plaintiffs of the performance of the funds concealed certain information from Plaintiffs. NYSCEF 697 at 21-22. Plaintiffs further contend that Defendants charged millions in management and agency fees while submitting no evidence of work done to earn those fees. Plaintiffs also maintain that Defendants put forth no evidence to support the claim that Tilton deferred fees. These are all issues of fact to be resolved at trial.

Collateral Estoppel

Plaintiffs' claims are not barred by the resolution of the SEC's actions against the Defendants. Collateral estoppel applies when a prior action resolved an identical issue that is decisive in the instant action, and the party to be precluded or a party in privity with it had a full and fair opportunity to contest the prior determination. *See Kaufman v. Eli Lilly & Co.*, 65 N.Y.2d 449, 455 (1985). "Under the concept of privity, collateral estoppel has been said to extend to 'those whose interests are represented by a party to the action.'" *Beuchel v. Bain*, 275 A.D.2d 65, 73 (1st Dep't 2000) (quoting *Watts v. Swiss Bank Corp.*, 27 N.Y.2d 270, 277 (1970)).

“The doctrine extends to ‘persons who were not parties to the previous action but who were connected with it to such an extent that they are treated as if they were parties.’” *All Terrain Properties, Inc., v. Hoy*, 265 A.D.2d 87, 93 (1st Dep’t 2000) (quoting *Gramatan Home Investors Corp., v. Lopez*, 46 N.Y.2d 481, 486 (1979)).

This Court previously determined that the SEC proceedings were “primarily concerned with whether Tilton misled investors about the fees they owed by making the Zohar Funds appear more valuable than they actually were,” and “did not necessarily reach the issue of whether Defendants misrepresented the purpose, operation and management of the Zohar Funds,” as alleged here. *Norddeutsche Landesbank Girozentrale v. Tilton*, 2018 WL 6809401, at *3 (Sup. Ct. N.Y. Cty. Dec. 27, 2018) (Bransten, J.). In addition, Defendants have not established that Plaintiffs were in privity with the SEC. The fact that Plaintiffs were cooperating witnesses that could potentially benefit from the outcome of the investigation does not suffice to bind them to the result in the SEC proceeding. Defendants have not shown that Plaintiffs’ were connected to the SEC to such an extent as to be treated as a party. *See PPC Broadband, Inc. v. Corning Gilbert Inc.*, 2013 WL 6817566 at *3 (N.D.N.Y December 23, 2013) (finding that Plaintiff’s claims are not barred by collateral estoppel as Plaintiff was not a party to the previous action, and Plaintiff’s interest were not adequately represented by the government). Indeed, Nord was not even listed as one of the investors included in the record in the Administrative Decision, while other similar institutional investors were. NYSCEF 675 at 10-13.

Accordingly, Plaintiffs cannot be said to have had a full and fair opportunity to litigate the issues at hand and should not be precluded from doing so here.

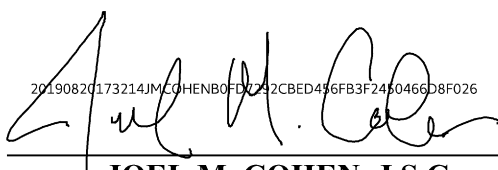
For the foregoing reasons, it is:

ORDERED that Defendants’ motion for summary judgment is Denied.

The parties are to appear for a pre-trial conference in this matter on Thursday October 17, 2019, at 3:30 p.m.

This constitutes the Decision and Order of the Court.

8/20/2019
DATE


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JOEL M. COHEN, J.S.C.

CHECK ONE:	<input type="checkbox"/>	CASE	<input checked="" type="checkbox"/>	DENIED	<input checked="" type="checkbox"/>	NON-FINAL	<input type="checkbox"/>	OTHER
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