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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: BERNARD J. FRIED, Justice PART 60

E-FILE

MBIA Insurance Corp. et. al.,

PLAINTIFFS

- v -

Merrill Lynch, Pierce, Fenner & Smith, Inc.,, et. al.,

DEFENDANTS

INDEX NO. #601324-2009

MOTION DATE ____

MOTION SEQ. NO. #001

MOTION CAL. NO. ____

The following papers, numbered 1 to ____ were read on this motion to/for ____

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE ____ FOR THE FOLLOWING REASON(S):

This motion is decided in accordance with the accompanying memorandum decision.

SO ORDERED

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Dated: 4/21/2010

J.S.C.
HON. BERNARD J. FRIED

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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 60
--X

MBIA INSURANCE CORPORATION and
LACROSSE FINANCIAL PRODUCTS, LLC,

Plaintiffs,

Index No. 601324/09

-against-

MERRILL LYNCH, PIERCE, FENNER & SMITH
INCORPORATED and MERRILL LYNCH
INTERNATIONAL,

Defendants.

--X

For Plaintiffs MBIA Insurance Corporation and LaCrosse Financial Products, LLC

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Jay B. Kasner, Esq.

FRIED, J.:

In this action involving further fall-out from the mortgage-backed securities melt-down, defendants Merrill Lynch, Pierce, Fenner and Smith Inc. and Merrill Lynch International (together, Merrill Lynch) move for an order dismissing the amended complaint (complaint) brought by MBIA Insurance Corporation (MBIA) and LaCrosse Financial Products, LLC (LaCrosse)(together, plaintiffs).

This action involves 11 credit default swap contracts (CDSs) whereby LaCrosse sold credit protection to Merrill Lynch, in relation to underlying security, held by Merrill Lynch, in the form of "collateral debt obligations" (CDOs) worth approximately $5.7 billion. The CDSs were insured by MBIA, a "monoline insurer" of extensive experience. In return for a fee, or premium, MBIA essentially guaranteed to Merrill Lynch, by execution of financial guarantee insurance policies (guarantees)(Merrill Lynch Aff. in Support, Ex. 4), that the CDOs would continue to prosper. According to plaintiffs, the four CDOs[1] were divided into tranches, or pieces, of ascending ratings, such that the lowest-rated tranches would suffer losses before the higher-rated tranches, affording the higher tranches a buffer, denoted as subordination. This subordination allegedly was meant to protect the more valuable investments in the higher tranches in case of a failure of the lower-rated securities in the various CDOs.

The documents which created the CDSs include an ISDA Master Agreement and Schedule (Schedule)(Merrill Lynch Aff. in Support, Ex. 2) and swap confirmations (confirmations)(*id.*, Exs. 32-37), between LaCrosse and Merrill Lynch, and offering circulars, pitch books and other materials, issued by Merrill Lynch as arranger and marketer of the CDOs. Merrill Lynch also provided letters from various ratings agencies assigning credit ratings to each tranche of the CDOs, so as to allow MBIA to assess the quality of the CDOs before it decided to insure those investments. (*See e.g.* Merrill Lynch Aff. in Support, Exs. 19-26.)

According to the complaint, Merrill Lynch, as an underwriter of billions of dollars worth of CDOs, entered into a scheme to "offload billions of dollars in deteriorating U.S. subprime

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[1]The CDOs are identified as Broderick CDO 2, Ltd., Highridge ADS CDO 1, Ltd., Broderick CDO 3, Ltd. and Newbury Street CDO, Ltd.

mortagages and other collateral that Merrill Lynch held on its books by packaging them into CDOs or hedging their exposure through swaps with insurers." Complaint, ¶ 28. As part of what is called "de-risking" or "mitigation" practices, Merrill Lynch allegedly "engaged in a scheme to package and repackage its most toxic assets" into the CDOs it marketed to plaintiffs and others. *Id.*, ¶ 31.

Plaintiffs maintain that Merrill Lynch made substantial fraudulent misrepresentations in its offering materials which induced plaintiffs to enter into the CDSs and guarantees. The alleged misrepresentations are: (1) that the quality of the CDOs' collateral had a very high credit rating, which was, however, not warranted; (2) that the insured CDO tranches had significant subordination protection, when they did not; (3) that the ratings of the CDO tranches were themselves of "AAA" quality; and (4) that the default rates of comparable CDOs was very low, regardless of the fact that the collateral underlying the CDOs at issue was, basically, junk.

In their complaint, plaintiffs bring causes of action for fraud (first cause of action); fraud by omission (second cause of action); negligent misrepresentation (third cause of action); breach of contract (fourth cause of action); breach of the covenant of good faith and fair dealing (fifth cause of action); and "action to enforce contractual rights" (sixth cause of action). In their prayer for relief, plaintiffs ask for, along with money damages, rescission of the CDS contracts.

Merrill Lynch claims that plaintiffs' suit is a "classic case of buyer's remorse" (Merrill Lynch Memorandum of Law, at 3), and that all of plaintiffs' fraud claims are barred by specific disclaimers in the documents; that their negligent misrepresentation and fraud by omission claims must fail for lack of a confidential or fiduciary duty between the parties; that the breach of contract and breach of the covenant of good faith and fair dealing claims are duplicative of the unavailing fraud claims, and thus, are dismissible; and that plaintiffs may not seek rescission and damages at the same time.

> On a motion to dismiss pursuant to CPLR 3211, we must accept as true the facts as alleged in the complaint and submissions in opposition to the motion, accord plaintiffs the benefit of every possible favorable inference and determine only whether the facts as alleged fit within any cognizable legal theory.

Sokoloff v Harriman Estates Development Corp., 96 NY2d 409, 414 (2001); *see also Leon v Martinez*, 84 NY2d 83 (1994). A motion brought pursuant to CPLR 3211 (a) (1) "may be granted where 'documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law.'" *Held v Kaufman*, 91 NY2d 425, 430-431 (1998), quoting *Leon v Martinez*, 84 NY2d at 88; *Foster v Kovner*, 44 AD3d 23, 28 (1st Dept 2007)("[t]he documentary evidence must resolve all factual issues and dispose of the plaintiff's claim as a matter of law").

A cause of action for fraud requires a showing of a representation of "a material existing fact, falsity, *scienter*, deception and injury [internal quotation marks and citation omitted]." *New York University v Continental Insurance Company*, 87 NY2d 308, 318 (1995); *see also Serino v Lipper*, 47 AD3d 70 (1st Dept 2007). Each of these elements must be pled with particularity. CPLR 3016 (b); *Papp v Debbane*, 16 AD3d 128 (1st Dept 2005); *La Salle National Bank v Ernst & Young LLP*, 285 AD2d 101 (1st Dept 2001).

The gist of plaintiffs' action for fraud is its contention that Merrill Lynch "capitalized on its unique knowledge of the billions of dollars of deteriorating assets held on its books in order to offload the risk of these assets onto Plaintiffs." (Plaintiffs' Memorandum of Law, at 1). Plaintiffs maintain that Merrill Lynch had specific, present knowledge as of the date it entered into the CDSs with plaintiffs that the underlying collateral was failing, and yet, trumpeted the integrity of the CDOs through false ratings and specific misrepresentations in the offering documents.

In the Financial Guaranty Insurance Policy between MBIA and Merrill Lynch, MBIA

represented that MBIA, "in consideration of the payment of the premium and subject to the terms of this financial guarantee insurance policy ..., hereby unconditionally and irrevocably guarantees to Merrill Lynch International ..., without the assertion of any defenses to payment, including fraud in the inducement or fact," the full payment on behalf of LaCrosse of any insured amount. (Merrill Lynch Aff. in Support, Ex.4, at 1) (introduction). This document further states that "MBIA hereby irrevocably waives for the benefit of [Merrill Lynch], ... all defenses to payment (including all affirmative rights asserted as defenses to payment) ... whether asserted by way of counterclaim, setoff, deduction, abatement, recoupment, suspension, deferment or otherwise." *Id.*, ¶ 12. Paragraph 12 goes on to relate a sweeping disclaimer of reliance on, among many other things, "any assertion that MBIA (A) was not acting for its own account, (B) was not capable of assessing or understanding (on its own behalf or through independent professional advice) and accepting the terms, conditions and risks of issuing the Policy, (C) was not capable of assuming the risks of the Policy ... ."

The ISD Master Schedule between LaCrosse and Merrill Lynch (Merrill Lynch Aff. in Support, Ex. 3), which references the confirmations between these parties (*see e.g.* Merrill Lynch Aff. in Support, Exs. 32-36), contains specific disclaimers on the part of LaCrosse. Provision (5) (b) (ii) describes the "Relationship Between Parties" as follows:

> (1) [LaCrosse] is not relying on any advice, statements or recommendations (whether written or oral) of the other party regarding the Transaction. other than the written representations expressly made by that other party in this Agreement and in the Confirmation);
>
> (2) (a) [LaCrosse] has the capacity to evaluate (internally or through independent professional advice) the Transaction (including decisions regarding the appropriateness or suitability of the Transaction) and has made its own decision to enter into the Transaction; (b) it understands the terms, conditions and risks of the Transaction and is willing to accept those terms and conditions and to assume (financially and otherwise) those risks.

LaCrosse further represents here that "it acknowledges and agrees that the other party [Merrill Lynch] is not acting as a fiduciary or advisor to it in connection with the Transaction." *Id.*, Part 5, ¶ (b) (ii) (2) (d).

Merrill Lynch points to language in the offering materials, such as the pitch books, which concern plaintiffs' obligation to conduct their own due diligence before entering into the transactions, and Merrill Lynch's lack of responsibility if plaintiffs fail to act accordingly. For instance, the pitch books say, in upper-case letters, that: "ANY INVESTOR INTERESTED IN PURCHASING THE SECURITIES SHOULD CONDUCT ITS OWN INVESTIGATION AND ANALYSIS OF THE PRODUCT AND CONSULT WITH ITS PROFESSIONAL ADVISORS AS TO THE RISKS INVOLVED IN MAKING SUCH A PURCHASE." *(See e.g.* Merrill Lynch Aff. in Support, Ex.11, at 3.*)* Further, the offering circulars reiterate that "IT IS EXPECTED THAT PROSPECTIVE INVESTORS INTERESTED IN PARTICIPATING IN THIS OFFERING ARE WILLING AND ABLE TO CONDUCT AN INDEPENDENT INVESTIGATION OF THE RISK POSED BY AN INVESTMENT IN THE OFFERED SECURITIES" (*id. e.g.*, Ex. 7, § vi), and that, because of the investor's obligations to assess the integrity of the investment, the investment is "APPROPRIATE ONLY FOR INVESTORS CAPABLE OF (A) ANALYZING AND ASSESSING THE RISKS ASSOCIATED WITH DEFAULTS, LOSSES AND RECOVERIES ON, REINVESTMENT OF PROCEEDS OF AND OTHER CHARACTERISTICS OF ASSETS SUCH AS THOSE INCLUDED IN THE COLLATERAL AND (B) BEARING SUCH RISKS AND THE FINANCIAL CONSEQUENCES THEREOF AS THEY RELATE TO AN INVESTMENT IN THE OFFERED SECURITIES … ." *Id.*

It is plaintiffs' position that they were entitled to rely on the AAA ratings assessed by the

ratings agencies as an indication of the high quality of the collateral, and that Merrill Lynch somehow manipulated those ratings to hide the infirmities of the investments at the time the contracts were executed.[2] Plaintiffs complain that, as a matter of industry practice and common sense, they were not required to do a forensic analysis of the collateral before entering into the CDOs and guarantees, with an eye to detecting possible fraud.

In *Citibank, N.A. v Plapinger* (66 NY2d 90 [1985]), the Court of Appeals set down the now-familiar doctrine that a specific (rather than general) disclaimer in a guarantee bars the guarantor's claim for fraud in the inducement, where the guarantor specifically disclaimed reliance on the very information which it now claims caused it to be misled. The Court in *Plapinger* further held that a clause declaring the agreement absolute and unconditional, and containing a waiver of affirmative defenses, "reinforc[es]" the specificity of the disclaimer. *Id.* at 95; *see also Raven Elevator Corp. v Finkelstein*, 223 AD2d 378, 378 (1st Dept 1996)(guarantor barred from asserting defense of fraud in the inducement where there is a "absolute and unconditional disclaimer and waiver" in the guarantee "which specifically precluded the guarantor from raising any defenses or counterclaims relating to the underlying debt"); *see also Sterling National Bank v Biaggi*, 47 AD3d 436 (1st Dept 2008); *General Trading Co., Inc. v A & D Food Corporation*, 292 AD2d 266 (1st Dept 2002). The *Plapinger* Court also noted the importance of the fact that the guarantee in question had been the product of "extended negotiations between sophisticated business people" involved in a "multimillion dollar" transaction. *Citibank N.A. v Plapinger*, 66 NY2d at 95; *see also WestRM-West Risk Markets, Ltd. v Lumbermens Mutuality Casualty Co.*, 314 F Supp 2d 229 (SD NY 2004). A

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[2]Plaintiffs posit the theory that there may have been some collusion between the ratings agencies and Merrill Lynch, but do so without factual support.

"generalized boilerplate exclusion" that was "not the product of negotiation" and "did not waive defenses to its own validity" could not bar a claim or counterclaim for fraud in the inducement. *WestRM-West,* 314 F Supp at 235.

In a discussion of *Plapinger*, the court in *JPMorgan Chase Bank v Liberty Mutual Insurance Company* (189 F Supp 2d 24 [SD NY 2002]), found that the *Plapinger* rule cannot be construed too broadly, but must be limited to a disclaimer that is "a clear indication that the disclaiming party has knowingly disclaimed reliance on the specific representations that form the basis of the fraud claim." *Id.* at 27. That is, a "general sweeping disclaimer" will not suffice. *Id.*

In the present case, the guarantees, and the CDSs they guaranteed, were the product of intensive negotiations among the parties, whose sophistication and business acumen and experience cannot be overstated. MBIA and LaCrosse specifically stated that they were able to evaluate the validity of the CDOs, and were specifically warned that the transaction was appropriate only for sophisticated investors capable of analyzing the risks, including the risk related to the type of collateral involved in the transaction.

In the guarantees, Schedule and confirmations, plaintiffs represented that, not only were they able to assess the integrity of the CDOs, but actually would evaluate the underlying collateral from which the CDOs originated. It is this very ground-level assessment that plaintiffs now say they were not responsible for, and could not be expected to do.

The plaintiffs represented to Merrill Lynch that they were aware of the need to, and were fully capable of, acquiring the knowledge sufficient to assess the worth of the overall transactions for themselves, including the nature of the collateral, and that they represented that they would do so. To allow them to now disavow their express and specific promise not to raise the affirmative

defense of fraud would be to allow them to "condone [plaintiffs'] own fraud in 'deliberately misrepresenting [their] true intention' *(Danann Realty Corp. v Harris* [5 NY2d 317, 323 (1959)]) when putting their signatures to their 'absolute and unconditional' guarantee." *Citibank, N.A. v Plapinger,* 66 NY2d at 95. As such, plaintiffs cannot now bring a claim for fraud in the inducement, fraud by omission, or negligent misrepresentation, all of which require a claim of reasonable reliance on representations plaintiffs expressly stated they were not relying on. LaCrosse, as signatory to the disclaimers in the Schedule and confirmations is likewise barred by language alerting LaCrosse to respond with care to a transaction effected by documents (such as the pitch books and offering circulars[3]) that "bespeak caution" about the very disclaimers LaCrosse would now disavow. *See Olkey v Hyperion 1999 Term Trust, Inc.*, 98 F3d 2, 5 (2d Cir 1996).

I am not swayed by plaintiffs' argument that the waiver language in the guarantees, as read pursuant to *Citibank, N.A. v Plapinger* (66 NY2d 90, *supra*), are limited to affirmative defenses of fraud, and not affirmative claims, such as are at issue here. *Plapinger* specifically states that the explicit disclaimer rule applies to counterclaims (i.e., affirmative claims) brought against another party. *Id.*; *see also Sterling National Bank v Biaggi*, 47 AD3d 436, *supra* (court properly dismissed counterclaims for fraud, as well as affirmative defenses, as a result of a defendant's explicit waiver of his right to plead affirmative defenses). To rule otherwise would support an untenable "race to the courthouse" (as Merrill Lynch argues)(Reply Memo., at 4), allowing plaintiffs the benefit of the causes of action for fraud solely because they brought this action before Merrill Lynch could bring

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[3]Plaintiffs admit in their complaint that the confirmations incorporate the offering circulars. Complaint, ¶ 95.

a claim against the plaintiffs to recover on the various contracts and guarantees.[4]

A cause of action for breach of contract requires allegations of the existence of a contact, that plaintiff performed under the contract, that defendant breached the contract, and that plaintiffs sustained damages. *JP Morgan Chase v J.H. Electric of New York, Inc.*, 69 AD3d 802 (2d Dept 2010); *Furia v Furia*, 116 AD2d 694 (2d Dept 1986).

In plaintiffs' cause of action for breach of contract, plaintiffs allege, among other things, that the various agreements, including especially the confirmations to the CDSs, indicated that plaintiffs were entering into a transaction in which Merrill Lynch would be delivering notes not merely "nominally" rated AAA (S&P)/Aaa(Moody's) (Plaintiff's Memorandum of Law, at 42), but ones exhibiting the credit quality an AAA rating was supposed to represent. (*See* Plaintiffs' Ex. 37, at 3.) Plaintiffs maintain that, while rated AAA, the insured or wrapped notes in the CDOs were, in actuality, not of the quality an AAA rating should have indicated (that is, that the rating was, essentially, bogus), amounting to a breach of contract.

The confirmations (which are the only documents which plaintiffs provide as a basis for the alleged promise of AAA/Aaa ratings), only state that the notes would be rated "AAA (S&P)/Aaa (Moody's)," which, apparently, they were. However, plaintiffs had a right to expect that the AAA ratings were backed by intelligence which could verify that the notes were actually of the "credit

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[4]In paragraph 108 of the complaint, the last paragraph before the prayer for relief, plaintiffs allege that "[Merrill Lynch] has made and continues to make improper demands for payment under the policies based upon the CDS Contracts," but, apparently, Merrill Lynch has yet to bring an action against plaintiffs. Plaintiffs claim, in paragraph 108, that "MBIA has been harmed and will continue to be harmed" by Merrill Lynch's demands, but does not specify the damages these demands have occasioned absent any action on the part of Merrill Lynch.

quality" an AAA rating implied. Plaintiffs may claim that the wrapped notes were not qualified to be AAA rated, as promised, regardless of the label they carried, as a claim for breach of contract.

As to the issue of subordination, Merrill Lynch claims that there is no express right to any fixed level of subordination in the agreements, and that plaintiffs are merely trying to add obligations to the agreements which are not there. Plaintiffs respond that the confirmations, CDS contracts, and other related documents, such as the offering circulars, ensure specific seniority levels for the wrapped tranches, which did not materialize as events unfolded.

Plaintiffs' claim that they did not receive the promised levels of subordination is not sufficiently supported by the agreements. Again, plaintiffs, while referring to other documents, only point to the confirmations to establish that certain promised levels of subordination were not established.

This argument is based on language in the confirmations indicating simply that the class of notes would be "Class A-2 Second Priority Senior Secured Floating Rate Notes due 2050." *See e.g.*, Plaintiffs' Ex. 37, at 2. Plaintiffs follow this with a tortured argument in their brief (at 41), attempting to create a promise of certain levels of subordination based on language in an Indenture (Plaintiffs' Ex. 11, at 86-87), as qualified by the language in the confirmation. However, the argument does not convince. Plaintiffs have not shown where they were promised certain levels of subordination, or how Merrill Lynch failed to provide that protection, based on the confirmations. Therefore, no breach of contract has been pled on this issue. The language of the confirmations does not create a factual question.

Merrill Lynch also argues that plaintiffs' breach of contract cause of action should simply be dismissed as duplicative of their failed fraud claims. While at least on one occasion the Appellate

Division, First Department, has determined that a breach of contract claim may be duplicative of an insufficient fraud claim, and so, be dismissed outright (*see Parmasteelisa, S.p.A. v Lincolnshire Management, Inc.*, 16 AD3d 352 [1st Dept 2005]), the more general rule is that it is the fraud cause of action which will give way if it is shown to be but a breach of contract action with a tacked-on allegation that the defendant did not intend to fulfill the terms of the contract at the time that the contract was executed. *See e.g. Moustakis v Christie's, Inc.*, 68 AD2 3d 637, 637 (1st Dept 2009)("a simple breach of contract is not to be considered a tort unless a legal duty independent of the contract itself has been violated [internal quotation marks and citation omitted]"); *Linea Nuova, S.A. v Slowchowsky*, 62 AD3d 473 (1st Dept 2009). As such, the breach of contract cause of action at issue will not be dismissed merely because plaintiffs were unsuccessful in pleading fraud on the same allegations.

However, plaintiffs' cause of action for breach of the implied covenant of good faith and fair dealing is properly dismissed as duplicative of the breach of contract claim. *See Rather v CBS Corp.*, 68 AD3d 49 (1st Dept 2009). Further, the nebulous claim for an "action to enforce contractual rights" is dismissed. Such claim is not a recognizable cause of action.

Finally, plaintiffs may not seek rescission, as that remedy is not appropriate where money damages will recompense the plaintiffs, as is the case here.

Accordingly, it is

ORDERED that the motion to dismiss brought by defendants Merrill Lynch, Pierce, Fenner and Smith Inc. and Merrill Lynch International is granted solely as to the dismissal of the first, second, third, fifth, and sixth causes of action, and is otherwise denied; and it is further

ORDERED that the remainder of the action shall continue; and it is further

ORDERED that defendants are to serve an answer to the first amended complaint within 20 days of service of a copy of this order with notice of entry.

Dated: 4/7/2010

ENTER:

J.S.C.

HON. BERNARD J. FRIED