Structured Finance Litigation Update

12/15/2010

Waivers Not Always a Bar to Claims: Judge Scheindlin of the Southern District of New York dealt a blow to defendants in securities fraud cases in an October 29, 2010 decision in *King County v. IKB Deutsche Industriebank*. The court denied defendant Morgan Stanley's motion to dismiss, holding that fraud claims against Morgan could proceed despite liability and reliance waivers in securities disclosures because "the information required to confirm or disprove the validity of the [representations] was peculiarly within Morgan Stanley's knowledge." The court also rejected Morgan Stanley's argument that, because it had no direct contact with the plaintiffs during the marketing or sale of the securities, it could not possibly be responsible for any misstatements the plaintiffs relied upon. Invoking the so-called "group pleading doctrine," which permits third parties intimately involved in a fraud to be treated as insiders with primary liability rather than as secondary actors shielded from liability for aiding and abetting federal securities fraud under *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the court held that Morgan Stanley had been so intimately involved in the structuring, marketing and rating of the securities at issue that it was responsible for statements made in the securities filings.

The court also allowed allegations of common law fraud to proceed, finding that the plaintiffs had sufficiently pled a claim that Morgan Stanley, due to its actual knowledge of the alleged fraud and provision of "substantial assistance" to further the alleged scheme, had aided and abetted the primary fraud alleged against IKB and the ratings agencies. The plaintiffs originally brought a class action against IKB, a German bank, its CEO, and the rating agencies alleging fraud in connection with the collapse of Rhinebridge, a structured investment vehicle created, managed, and issued by IKB. Morgan Stanley, the co-arranger and placement agent on Rhinebridge, was added as a defendant in an amended complaint filed in June. The plaintiffs allege that the defendants fraudulently misrepresented the value of Rhinebridge and its debt securities, and were aware that the high credit ratings presented to investors were fraudulent and the mortgage-backed assets were likely to default. Judge Scheindlin denied motions to dismiss filed by IKB and the ratings agencies earlier this year. *See King County v. IKB Deutsche Industriebank, AG*, No. 09-cv-8387 Slip Op. (S.D.N.Y. Oct. 29, 2010).

Fraud and Contract Claims in CDS Case Survive Motion to Dismiss—"Peculiar Knowledge" Strikes Again: New York Supreme Court Judge Scheinkman handed plaintiff MBIA, represented by our own Peter Calamari and Philippe Selendy, a victory in an August 19, 2010 opinion denying defendant Royal Bank of Canada's motion to dismiss fraud and breach of contract claims. The case concerns RBC's marketing of a credit default swap (CDS) on the Logan III CDO, which RBC arranged, as well as contractual claims in connection with two other RBC CDOs. The court upheld MBIA's fraud claims because, although the contracts and marketing materials contained disclaimers, MBIA sufficiently alleged that RBC had "peculiar knowledge" of essential facts regarding the collateral's quality. In particular, MBIA sufficiently alleged that RBC had "access to crucial loan information, which Plaintiffs may [have] been able to discover but only through extraordinary effort or great difficulty." The court accepted MBIA's argument that it lacked first-hand access to the data and that it was not standard in the industry to perform "a complete loan-level, forensic reevaluation" of a CDO's collateral prior to entering a CDS, as would have been required to verify RBC's representations. The court also found that the collateral's credit ratings were not simply statements of opinion, but were actionable statements of fact regarding the supposed creditworthiness of the collateral. In upholding MBIA's contract claims, the court sustained MBIA's allegation that RBC provided collateral "that was not qualified to be AAA rated, as promised," even though the credit default swaps bore AAA ratings. The court also held that Deutsche Bank's "verification" of RBC's credit event notices "did not relieve RBC of its obligations under the agreements," in part because MBIA alleged, pursuant to the contracts, that Deutsche Bank's verifications reflected "manifest error." *See MBIA Insurance Corp. v. Royal Bank of Canada*, No. 12238/09 (N.Y. Super. Ct. Westchester County, Aug. 19, 2010).

Failure to Satisfy Purchaser Requirement Leads to Dismissal: Ruling that a federal securities class action may not include claims related to securities the named plaintiffs did not buy, Judge Mariana R. Pfaelzer of the Central District of California dismissed a putative class action accusing Countrywide Financial Corp. of fraud related to over 400 pools of residential mortgage-backed securities (RMBS). The plaintiffs, led by the Maine State Retirement System, claimed that Countrywide had made false and misleading statements or omissions concerning its loan origination practices in public offering documents. The court granted plaintiffs 30 days to file an
amended complaint.

In addition to limiting the case to claims on securities actually in the portfolio of the named plaintiffs, Judge Pfaelzer held that those wishing to sue individually on claims dismissed from the class action for lack of standing could not benefit from tolling of

the statute of limitations under the so-called *American Pipe* doctrine, which tolls the statute of limitations on a claim covered under a putative class action. Under this interpretation of *American Pipe*, the claimants face increased uncertainty because they could lose the benefit of tolling if the class action claim they are relying upon is also dismissed for lack of standing.

Judge Pfaelzer ordered the plaintiffs to amend their complaint to eliminate those securities for which the named plaintiffs do not have standing to bring claims, and, for the remaining claims, to more specifically allege which claims should benefit from tolling under *American Pipe* and why. *See Maine State Retirement System v. Countrywide Financial Corp.*, No. 10-cv-00302, (C.D. Cal. Nov. 4, 2010).