

FINANCIAL FRAUD LAW REPORT

VOLUME 2

NUMBER 7

JULY/AUGUST 2010

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POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. ISSN 1936-5586

New York Court Throws Out Two Investor Lawsuits Involving Subprime Securities

DAVID R. GELFAND, JAY D. GRUSHKIN, AND ALUYAH I. IMOISILI

The authors examine two recent court rulings of importance to financial institution defendants, particularly investment managers, involved in subprime securities cases.

Despite the current climate of anti-Wall Street fervor from the public, two recent decisions illustrate that, at least in New York, the courts will not allow public sentiment to trump the law as it should be applied to financial institutions that dealt in subprime mortgage-related securities. In *Ambac*¹ and *Oddo*,² Judge Barbara R. Kapnick dismissed with prejudice two separate lawsuits that investors brought against their portfolio managers, a rating agency, and the sponsor of a structured vehicle, on the grounds that these plaintiffs could not state a basis in law to sue for the alleged misconduct. Indeed, Judge Kapnick's decisions show that courts are willing to apply the law strictly to limit investor lawsuits arising out of the subprime crisis.

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AMBAC ASSURANCE UK LIMITED v. J.P. MORGAN INVESTMENT MANAGEMENT

On March 24, 2010, Judge Kapnick issued an order dismissing the complaint by Ambac Assurance UK Limited (“Ambac”) against J.P. Morgan Investment Management, Inc. (“JP Morgan”). Ambac’s causes of action stemmed from JP Morgan’s alleged breach of its obligations, and fiduciary duties, arising from an investment management agreement (“IMA”) with Ballantyne Re Plc (“Ballantyne”) governing a \$1.65 billion investment portfolio. Ambac guaranteed \$900 million of structured notes issued by Ballantyne.

Background

In May 2006, Ballantyne and JP Morgan entered into the IMA, whereby JP Morgan agreed to invest in, and to serve as discretionary investment manager over, the portfolio. The portfolio’s assets funded Ballantyne’s obligations under certain notes that Ballantyne had issued to finance its operations and to meet statutory reserve requirements applicable to reinsurers of term life insurance policies.

The investment guidelines of the IMA required JP Morgan to seek a “reasonable income while providing a high level of safety of capital” and contained sector and rating specific investment restrictions for the portfolio. The IMA further required JP Morgan to comply with New York and Delaware law that bars insurance and reinsurance companies from investing more than half of their portfolios in securities backed by first or second liens in residential real estate mortgages or deeds of trust.

Ambac alleged that, contrary to the provisions of the IMA and JP Morgan’s fiduciary duties to Ambac, JP Morgan invested mostly in risky subprime and Alt-A residential mortgage-backed securities. JP Morgan continued to invest in these securities and hold them while its corporate parent allegedly was aware of the growing risk of the collapse of the subprime securities market, based on its corporate parent’s CEO’s comments in two magazines.³ Ambac alleged that JP Morgan failed to inform Ballantyne or Ambac that the portfolio did not comply with the IMA’s investment guidelines and that JP Morgan continued to hold subprime securities in the

portfolio even after JP Morgan had determined to reduce its own, and its other clients', exposure to those securities.

Under JP Morgan's management, the portfolio lost about \$1 billion. Consequently, Ballantyne did not make scheduled payments under its notes, in turn causing a call on Ambac's guarantee (Ambac made approximately \$2.5 million in guarantee payments). Ambac sued JP Morgan for breach of contract, breach of fiduciary duty, and gross negligence. JP Morgan in turn filed a motion to dismiss the complaint for failing to state a claim upon which a court could grant relief.

Court's Analysis

JP Morgan argued that Ambac could not allege that it breached the IMA because JP Morgan did not (i) breach the IMA's investment guidelines, (ii) manage the funds in a grossly negligent manner or with willful misconduct, or (iii) violate Delaware law concerning eligible investments for insurance companies. The court agreed with JP Morgan on each of these points. The court reasoned that the portfolio's mortgage-related securities were the exact type of securities that JP Morgan was allowed to invest in, according to the investment guidelines and that JP Morgan followed its "discretionary" authority. The court also explained that JP Morgan's corporate parent's CEO's comments concerned collateralized debt obligations, structured investment vehicles, and mortgage lending as a whole — not the kind of mortgage-backed securities in Ballantyne's portfolio. The court interpreted the relevant Delaware law in JP Morgan's favor, holding that the provision restricting insurance company investments was not applicable to the securities in the portfolio.

With respect to the breach of fiduciary duty and gross negligence causes of action, JP Morgan argued that they should be dismissed because the Martin Act⁴ preempted such claims. The Martin Act is New York's securities fraud law. Under the Martin Act, there is no implied private right of action. In other words, only the Attorney General may bring civil lawsuits in cases that involve securities fraud. Hence, relying on *Nanopierce*⁵, JP Morgan contended that the Martin Act also preempted Ambac's claims for breach of fiduciary duty and negligent misrepresentation. Ambac argued in response that its causes of action were not based on fraud, but

mismanagement of the portfolio, and thus the Martin Act was not applicable. The court rejected Ambac's reasoning, stating instead that Ambac premised its claims on allegations that JP Morgan was aware of the risk posed by subprime securities, but protected itself and its other clients from exposure to such securities.

As a result, the court dismissed the complaint with prejudice.

ODDO ASSET MANAGEMENT v. BARCLAYS BANK PLC

On April 21, 2010, within weeks after deciding *Ambac*, Judge Kapnick dismissed yet another investor lawsuit. In *Oddo*, Oddo Asset Management ("Oddo"), a French company, sued Barclays⁶, Solent⁷, and Standard & Poor's ("S&P," a division of the McGraw-Hill Companies, Inc.) for losses arising from two structured investment vehicles, Golden Key Ltd. ("Golden Key") and Mainsail II Ltd. ("Mainsail").

Background

Barclays set up two highly leveraged investment funds,⁸ Golden Key and Mainsail, in the Cayman Islands. These were funded through the issuance of (i) capital notes (akin to equity), (ii) mezzanine capital notes (a form of debt) (the "Mezzanine Notes"), and (iii) commercial paper (short term notes that matured every 90 days). Once funded, Golden Key and Mainsail invested in high interest rate bearing financial instruments, including mortgage-backed securities. When proceeds from the securities came in, Golden Key and Mainsail paid out the funds first to holders of the commercial paper, and then to holders of the Mezzanine Notes (the subordinate debt).

Barclays appointed Avendis Financial Services Limited ("Avendis")⁹ and Solent (who were organized in Jersey and England, respectively) to serve as collateral managers of Golden Key and Mainsail, respectively, each pursuant to a collateral management agreement. Barclays also retained S&P to issue ratings for the notes issued by Golden Key and Mainsail. In 2005 and 2006, Oddo invested over \$50 million in Mezzanine Notes issued by those issuers.

Oddo's complaint asserts the following facts. In 2007, Avendis and Solent contrived with Barclays to transfer certain subprime mortgage-

backed securities held at Barclays into Golden Key and Mainsail. Barclays sought to move the securities in order to circumvent losses on its books. Avendis and Solent willingly and actively participated in Barclays' scheme in order to maintain their relationship with Barclays. S&P facilitated Barclays' plan by confirming its ratings of Golden Key and Mainsail, notwithstanding that S&P knew that Barclays was offloading these securities at inflated prices. S&P too engaged in the scheme in order to maintain its business relationship with Barclays.

By August 2007, the portfolios of Golden Key and Mainsail declined sharply (allegedly due to the purchase of the impaired securities from Barclays), which froze the portfolios and halted additional funding. In August 2008, Golden Key and Mainsail went into receivership.

Oddo brought an action in New York Supreme Court against Barclays, S&P, and Solent for:

- Barclays' and S&P's aiding and abetting Avendis' breach of fiduciary duty,
- Barclays' tortious interference with the Golden Key-Oddo contractual relationship,
- Solent's breach of fiduciary duty,
- Barclays' and S&P's aiding and abetting Solent's breach of fiduciary duty, and
- Barclays' tortious interference with the Mainsail-Oddo contractual relationship.

The defendants moved to dismiss the complaint on a variety of grounds including lack of personal jurisdiction over some defendants, *forum non conveniens*, preemption by the Martin Act, and failure to state a cause of action.

Court's Analysis

First, the court dismissed the breach of fiduciary cause of action against Solent. The court held that there was no personal jurisdiction over

Solent because its contacts with New York were not sufficient to establish that Solent was doing business in New York and the place of injury for Oddo was in France.

Next, the court rejected the defendants' arguments that New York was an inconvenient forum, given that New York law applied to much of the litigation, the remaining defendants had significant connections with New York (Barclays and S&P were based in New York and had agreed to house the securities with a trustee, the Bank of New York), and any burden on the court would be minor.

Nonetheless, the court dismissed all of Oddo's causes of action with prejudice. With respect to the breach of fiduciary duty claims, Barclays and Solent contended (through affidavits from expert witnesses) that under English law, which governed these claims, Avendis and Solent owed no duty to Oddo because there was a contractual agreement between sophisticated parties and no fiduciary duty is owed to a purchaser of debt securities. Oddo responded that the Mezzanine Notes designated New York law to govern, and hence the fiduciary duties of Solent and Avendis (neither of which was a party to the notes) were governed by New York law. Oddo added that even if the choice of law provisions were inapplicable, New York law governed because New York had "a more significant interest" in litigating the dispute. S&P argued that under New York law no fiduciary duty existed because as a purchaser of the Mezzanine Notes, Oddo became a debt holder of Golden Key and Mainsail, and thus, a mere creditor as opposed to an equity holder.

The court agreed that under New York law (which applied because it was not different from English law on this point) debt holders, unlike shareholders, are mere creditors and, consequently, neither the investment vehicle nor its collateral managers owed debt holders fiduciary duties. Hence, the court dismissed the breach of fiduciary duty, and aiding and abetting breach of fiduciary duty, claims.

The court also dismissed the tortious interference with contractual relations claims reasoning that Oddo failed to allege any breach of the Mezzanine Notes governing Oddo's contractual relationship with Golden Key and Mainsail.¹⁰ However, the court did not address defendants' arguments about whether Oddo's claims were preempted by the Martin Act.

CONCLUSION

Financial institution defendants, particularly investment managers, involved in subprime securities cases have important lessons to learn from *Ambac* and *Oddo*.¹¹ Breach of contract claims against managers may be defeated by focusing on their discretionary authority and standard of care prescribed under investment management agreements. Moreover, these defendants may be able to dismiss breach of fiduciary duty and negligence claims as a matter of law by arguing that those claims are disguised securities fraud actions that are preempted by the Martin Act. New York courts are not inclined to impose fiduciary duties owing to debt investors (whose relationship with the issuer is defined by contractual agreement) as opposed to equity holders. Perhaps most comforting, from a defendant's perspective, is that these cases show that irrespective of public sentiment against creators and facilitators of exotic mortgage-related securities products, state courts are applying state law strictly to limit investor lawsuits arising out of the collapse of the industry and are interpreting contracts according to their plain meaning.

NOTES

¹ *Ambac Assurance UK Limited v. J.P. Morgan Investment Management*, No. 650259/09, slip op. (N.Y. Sup. Ct. Mar. 24, 2010).

² *Oddo Asset Management v. Barclays Bank Plc*, No. 109547/08, slip. op. (N.Y. Sup. Ct. Apr. 21, 2010).

³ *Ambac* based this allegation on statements that the CEO of JP Morgan's corporate parent made in *MarketWatch* and *Fortune* about the volatility of the subprime securities market and steps that JP Morgan's parent was taking in response to the downturn in subprime mortgages, including "largely [exiting] the subprime lending area."

⁴ New York General Business Law, Art. 23-A, §352, *et seq.*

⁵ *Nanopierce Techs., Inc. v. Southridge Cap. Mgmt.*, 02 Civ. 0767 (LBS), 2003 WL 22052894, at *3-4 (S.D.N.Y. Dec. 4, 2003) (holding that the Martin Act preempts claims such as breach of fiduciary duty and negligent misrepresentation which do not require proof of deceitful intent and, as a result, private litigants are barred from bringing such claims).

⁶ Barclays Bank Plc and Barclays Capital Inc.

⁷ Solent Capital Partners, LLP and Solent Capital (Jersey) Limited.

⁸ These kinds of funds are commonly referred to as “SIV-Lites.”

⁹ Avendis was not a party to the lawsuit. It is now in liquidation.

¹⁰ Oddo alleged for the first time during the motion to dismiss briefing that Golden Key and Mainsail breached the implied covenant of good faith and fair dealing. The court rejected this contention, arguing that Oddo was a sophisticated party in a position to understand the risks associated with the Mezzanine Notes, including that under prescribed circumstances Oddo would not receive interest payments and could lose its principal.

¹¹ Both decisions have been appealed to the Appellate Division of the New York Supreme Court.