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

MBIA INSURANCE CORPORATION, Plaintiff, - against - CREDIT SUISSE SECURITIES (USA) LLC, DLJ MORTGAGE CAPITAL, INC., and SELECT PORTFOLIO SERVICING, INC., Defendants.	Index No. 603751/09

DEFENDANTS CREDIT SUISSE SECURITIES (USA) LLC, DLJ MORTGAGE CAPITAL, INC. AND SELECT PORTFOLIO SERVICING, INC.'S MEMORANDUM OF LAW IN SUPPORT OF THEIR MOTION TO DISMISS THE COMPLAINT

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Credit Suisse Securities (USA) LLC ("CS Securities"), DLJ Mortgage Capital, Inc. ("DLJ") (together with CS Securities, "Credit Suisse") and Select Portfolio Servicing, Inc. ("SPS") (collectively, "Defendants") submit this memorandum of law in support of their motion to dismiss the following causes of action from the Complaint of MBIA Insurance Corporation ("MBIA"): Fraudulent Inducement (First); Breach of Representations and Warranties (Second); Breach of Implied Duty of Good Faith and Fair Dealing (Fourth); Material Breach of the Insurance Agreement (Fifth); Indemnification (Seventh); and Reimbursement (Eighth).

I. PRELIMINARY STATEMENT

This dispute arises out of a $900 million securitization of 15,000 closed-end second-lien residential mortgages ("closed-end seconds" or the "loans"). As alleged in the Complaint, DLJ acquired each of the loans from unaffiliated third-party originators. Those loans then were pooled into a securitization, known as Home Equity Mortgage Trust 2007-2 ("HEMT 2007-2"), by Credit Suisse. In connection with a sale of securities in HEMT 2007-2, Credit Suisse obtained a non-cancellable, non-rescindable certificate guaranty insurance policy (the "Policy") from MBIA — the largest "monoline" insurer in the world — that guaranteed the payment of principal and interest on certain securities backed by the closed-end seconds.

HEMT 2007-2 is documented in a set of detailed and complicated contractual agreements, none of which are attached to MBIA's Complaint. As part of those agreements, Credit Suisse made certain representations and warranties, including a representation that each of the loans was underwritten to the applicable underwriting guidelines of the loan originator — of which there were dozens. Those documents also provided specific contractual procedures in the event MBIA claimed that any particular loan was not underwritten to the appropriate guidelines.

Of course, since the issuance of HEMT 2007-2, the U.S. economy has experienced the worst downturn since the Great Depression and the U.S. housing market an unprecedented collapse. As a result, the risk insured against by MBIA has occurred and MBIA has been called upon to begin making payments on the Policy. Rather than simply acknowledging this obligation — for which it was paid hundreds of thousands of dollars in fees and premium payments — MBIA instead has chosen to bring the current lawsuit, alleging, *inter alia*, (i) that it was somehow duped into issuing the Policy in the first place (Cause of Action 1); (ii) that, based on an after-the-fact examination by MBIA's consultant of a small percentage of loan files, DLJ breached contractual representations and warranties about the nature of the entire pool of 15,000 loans at issue (Causes of Action 2 and 5); (iii) that DLJ and SPS allegedly violated the implied covenant of good faith and fair dealing (Cause of Action 4); and (iv) that MBIA is allegedly entitled to indemnification and costs (Causes of Action 7 and 8). Each of these claims should be dismissed.

The tactic of claiming fraud once the insured-against risk occurs is as old as insurance companies themselves, and simply does not work as a legal matter for a sophisticated insurer that "operates the largest financial guarantee insurance business in the industry."[1] As a matter of law, a sophisticated party like MBIA cannot establish a required element of fraud, justifiable reliance, if it failed to do appropriate due diligence before entering into the relevant transaction. By its Complaint, MBIA alleges that Credit Suisse made various pre-contractual representations about the loans in the pool. Yet, remarkably, MBIA also admits in the Complaint that it chose to conduct ***no due diligence*** of the underlying loan files before issuing the Policy. Thus, MBIA expressly alleges that "[g]iven the large number of loans involved, and the limited amount of

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[1] MBIA 2008 Form 10-K, filed March 2, 2009, p. 48 (Attached as Exh. C to the Affirmation of Stan Chelney in Support of Defendants' Mot. to Dismiss Compl., dated Feb. 5, 2010 ("Chelney Aff."), submitted herewith). For purposes of ruling on Defendants' motion to dismiss, the Court may consider documents referenced in the complaint and public documents whose contents are "essentially undeniable." *See Webster v. New York*, No. M-65923, 2003 WL 728780, at *1 (N.Y. Ct. Cl. Jan. 30, 2003) (citations omitted) (Attached as Exh. K to the Appendix of Unreported Cases Cited in Defendants' Mem. of Law in Support of Their Mot. to Dismiss ("App."), submitted herewith).

time to complete the transaction, it was impossible for MBIA to review the loan files in the pool to determine whether each borrower could repay." Compl. ¶ 23.[2] Rather than demand more time to conduct due diligence or walk away from the deal — options plainly available to any large, sophisticated insurer — MBIA issued the Policy. *Id.* ¶¶ 39 & 42. MBIA's admission is fatal to its fraud claim. Under clear First Department authority, discussed in Part III.A, *infra*, justifiable reliance is a key element to a claim of fraud and a sophisticated party like MBIA cannot establish — as a matter of law — that it justifiably relied on alleged representations where it failed to make use of the verification means available to it, such as reviewing the loan files here.

The Complaint also alleges that, notwithstanding MBIA's failure to conduct any independent due diligence on the loan files, MBIA was provided copious amounts of information about the nature of the pooled loans, both in the form of a "loan tape," which listed data about each of the 15,000 underlying loans, and through written disclosures in a Prospectus and Prospectus Supplement. If MBIA had read the information, it surely would have understood the nature of the risk it was insuring. In any case, MBIA cannot now demonstrate that it justifiably relied on allegedly contrary representations by Credit Suisse. Nor was MBIA entitled to ignore this information and instead rely on Credit Suisse's "strong institutional pedigree" and impressive stature as a financial institution (*see* Compl. ¶ 25) in blindly deciding to issue the Policy.

Moreover, both MBIA's fraudulent inducement claim, as well as its cause of action for breach of the implied covenant, are defective because they are duplicative of MBIA's contract causes of action. By way of example, MBIA alleges that CS Securities fraudulently misrepresented that the closed-end seconds were originated in compliance with underwriting

[2] Defendants accept the allegations in MBIA's complaint as true for purposes of this motion only.

guidelines, Compl. ¶ 28, while similarly alleging that DLJ breached a contractual representation regarding compliance with underwriting guidelines. Compl. ¶¶ 48-49. Because MBIA's fraud allegations simply restate the allegedly breached contractual representations and warranties, the fraud and breach of the implied duty of good faith causes of action should be dismissed.

MBIA's claims for breach of contractual representations in Causes of Action 2 and 5 fare no better. While MBIA generally alleges a breach of representations by DLJ as to specific loans, it does not allege which loans are implicated, what representation DLJ allegedly knowingly made with respect to a particular loan, or how any given representation was false. *See, e.g.*, Compl. ¶ 7 ("The loan-level warranties concerned the attributes of each of the individual loans in the securitized pool."). Instead, MBIA alleges that it has reviewed a limited number of loan origination files, which were equally available to it before it issued the Policy, and identified supposed breaches of representations and warranties in almost 80% of the files. *See id.* ¶ 68. MBIA's generalized allegations are insufficient to put Defendants on fair notice of its breach of contract claims.[3]

Finally, MBIA's remaining claims in Causes of Action 7 and 8 for indemnification and reimbursement of claim payments, respectively, are wholly dependant on its defective contract claims, and therefore should also be dismissed.

In short, now that the U.S. housing market has collapsed in the greatest financial crisis since the Great Depression, rather than make good on its insurance obligations, MBIA is trying

[3] By contrast, Defendants do not move to dismiss Cause of Action 3, for alleged breaches of the repurchase protocol set out by the parties' contracts. Although Defendants dispute the allegations that any given loan must be repurchased and note that the claim is premature, such claim is at least plead with specificity as to each loan at issue because MBIA identified such loans in three repurchase demands.

Defendants also do not move to dismiss Cause of Action 6, for SPS's alleged breach of access rights and servicing obligations. Defendants dispute the allegations against SPS, and believe the facts will defeat this claim.

The filing of this motion extends Defendants' time to respond to those causes of action on which it has not moved for dismissal. *Chagnon v. Tyson*, 783 N.Y.S.2d 29, 11 A.D.3d 325, 326 (App. Div. 1st Dep't 2004).

to shift the risk of loss to Defendants. For the reasons set forth below, Defendants request that the Court dismiss MBIA's first, second, fourth, fifth, seventh, and eighth causes of action.

II. FACTUAL BACKGROUND

A. Credit Suisse Approaches MBIA About Insuring The April 2007 Transaction

In early 2007, CS Securities approached MBIA and other monoline[4] insurers seeking bids for a certificate guaranty insurance policy in connection with a securitization of approximately 15,000 closed-end seconds with an aggregate outstanding principle balance of approximately $900 million (the "Transaction"). Compl. ¶¶ 20-21. DLJ purchased the loans from various unaffiliated originators, but did not originate any of the pooled loans and did not deal directly with the borrowers. *Id.* ¶ 24. These loans were then sold to a trust identified as "HEMT 2007-2," which in turn sold securities in the form of certificates to investors. *Id.* ¶¶ 24, 35-36. CS Securities was the underwriter of the Transaction. *Id.* ¶ 2. After the close of the Transaction, SPS became the servicer of the loans, responsible for, among other things, collecting principal and interest payments from the borrowers. *Id.*

By the time of the Transaction, the U.S. housing market was beginning to weaken. As disclosed in the HEMT 2007-2 Prospectus, "Recently, the residential mortgage market in the United States has experienced a variety of difficulties and changed economic conditions that may adversely affect the performance and market value of [the] securities." Prospectus, dated April 20, 2007 (Chelney Aff., Exh. E), 7. CS Securities sought a policy to guaranty the principal and interest payments on certain senior classes of securities in the event that, due to borrower delinquencies or defaults, the loans did not generate sufficient cash flows to cover such payments. Compl. ¶ 2.

[4] A "monoline" insurer insures principal and interest payments on a note or bond, whether issued by a municipal entity or in connection with a securitization. Generally, they insure no other type of risk. *See* 2-3 Wolcott B. Dunham, Jr., Nicholas F. Potter & John Dembeck, *New Appleman New York Insurance Law* § 31.01 (2d ed. 2009).

B. MBIA Conducts No Due Diligence On The Loans Before Issuing the Policy

After CS Securities first approached MBIA about insuring the Transaction on March 2, 2007, MBIA had nearly two months to decide whether to issue the Policy, which was not issued until April 30, 2007. *See* Compl. ¶ 22 & n.3. MBIA alleges, however, that it was "impossible" to review individual loan files during this time period, *id.* ¶ 23, which "did not contemplate or afford MBIA the opportunity to undertake its own review of the thousands of individual loan files comprising the proposed loan pool." *Id.* ¶ 42. Whether it was possible to review every loan in the pool is largely irrelevant. What MBIA concedes in its Complaint is that it reviewed no loan files — that is, it insured a $900 million transaction apparently without opening a single loan origination file or conducting ***any*** independent due diligence.

MBIA decided not to conduct any due diligence of the loans although it had never previously insured a mortgage-backed securitization for CS Securities. *Id.* ¶ 23. MBIA was not, however, unfamiliar with such transactions. As one of the leading monoline insurers in the world, MBIA had extensive experience insuring such transactions: Through the second quarter of 2007, when HEMT 2007-2 closed, MBIA had insured more than $67 billion worth of residential mortgage-backed securitizations, including 22 securitizations of closed-end seconds.[5]

C. Before MBIA Issued The Policy, Credit Suisse Provided It With Detailed Information About The Loans

Notwithstanding MBIA's lack of due diligence, the Complaint does allege that MBIA had significant information before agreeing to issue the Policy. First, MBIA alleges that Credit Suisse made various pre-contractual representations about its pedigree; about prior securitizations by Credit Suisse; about the due diligence that Credit Suisse performed when it

[5] MBIA Selected Exposures, available at http://www.mbia.com/investor/structfin.html (Chelney Aff., Exh. D). *See also* MBIA 2008 Form 10-K, filed March 2, 2009 (Chelney Aff., Exh. C), 11.

obtained the loans at issue; and about the quality of the loans in the pool. Compl. ¶¶ 25-29. As discussed below, however, none of these pre-contractual representations alters or excuses MBIA's independent obligation as a sophisticated party to conduct its own due diligence.

In addition, while MBIA concedes it did not conduct any review of the loan files at issue (Compl. ¶ 42), it is undisputed that this was not because MBIA did not have access to or significant information about the loans, or that it could not obtain any other information it wanted. Credit Suisse provided detailed information about the characteristics of the pooled loans to MBIA before MBIA issued the Policy. Perhaps most significantly, Credit Suisse provided MBIA a copy of the "loan tape," which provides detailed information about each of the loans in the securitization. Compl. ¶ 28. Before the closing, Credit Suisse also provided to MBIA the Transaction's Prospectus, dated April 20, 2007, and the Prospectus Supplement, dated April 27, 2007 (the "ProSupp"), which further detail the characteristics of the pooled loans. *See* Compl. ¶ 36.[6]

Among other things, the loan tape and the ProSupp disclose information about borrowers' credit scores, debt-to-income ("DTI") ratios, combined loan-to-value ("CLTV") ratios, and other characteristics of the pooled loans. *See id.* ¶ 28. The CLTV ratio compares a borrower's total indebtedness (first and second mortgages) on a property to the property's appraised value. Many of the closed-end seconds in the Transaction had CLTV ratio between 95% and 100% at the time of origination, meaning that the amount of the first loan and the closed-end second combined to equal the full value of the property, and any decline in property value could result in the borrower owing more than the value of the property. *See* ProSupp (Chelney Aff., Exh. E), at S-30 (stating that 10,171 of the Transaction loans, representing

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[6] MBIA had the opportunity to review and edit both of these documents in advance of issuing the Policy on April 30, 2007.

70.45% of the aggregate outstanding balance, had CLTV ratios of 95.00 to 100%). In the event that this situation leads to default and foreclosure, because a closed-end second is secured only by a junior lien, there may not be sufficient proceeds to pay off both the senior and junior lien. *Id.* at S-10; *see* Compl. ¶ 23.

The materials provided to MBIA also disclosed that many of the pooled loans were underwritten primarily based on the strength of the housing market. For example, the documents disclosed that the pool included many "NINA" — "no income/no asset" loans — that is, loans as to which the underwriting guideline provided that the borrower "is not required to state his or her income or assets, and, therefore, no verification of such mortgagor's income or assets is undertaken by the originator." Prospectus (Chelney Aff., Exh. E), at 32. The Prospectus also disclosed that the pool included loans underwritten to "reduced documentation" and "stated income/stated asset" guidelines, or loans originated without verification of a borrower's income and/or assets. *Id.* Because of the lack of verification, the underwriting of these loans is "based primarily or entirely on the estimated value of the mortgaged property and the LTV ratio. . . ." *Id.*

The Prospectus also makes clear what MBIA surely understood about home values: "No assurance can be given that the values of any . . . properties . . . have remained or will remain at their levels on the dates of origination of the related mortgage loans." *Id.*, at 33. In the event that values declined, the risk to MBIA would increase, particularly because the loans in the pool were all second liens.

Other disclosures made in the Prospectus and ProSupp and provided to MBIA before it issued the Policy include the following:

- The various loan originators applied underwriting standards that were not as strict as Fannie Mae and Freddie Mac guidelines. ProSupp at S-1, S-5;

Prospectus at 7 & 31.

- Applicable underwriting standards could vary significantly among the originators. Prospectus at 31.

- Individual loans in the pool might not comply with each criterion even of these "less strict" underwriting standards, as long as "the loan is in substantial compliance with the underwriting standards." *Id.*

- A particular loan might comply with the underwriting standards despite the fact that one or more of the criteria were not satisfied, as long as "other factors compensated for the criteria that were not satisfied." *Id.*

- Neither CS Securities nor any affiliate had re-underwritten any of the mortgage loans. *Id.*

- One of the originators of the pooled loans, New Century Mortgage Corporation, was in bankruptcy, which may have "adversely affected its ability to originate mortgage loans in accordance with its customary standards." ProSupp at S-20.

As discussed below, many of these disclosed risks are precisely what MBIA now claims were misrepresented to fraudulently induce it to issue the Policy.

D. <u>MBIA Issues The Policy As Part Of The Transaction</u>

Without any review of the loan files and with full knowledge of the risks involved in insuring a securitization of closed-end seconds, on April 30, 2007, MBIA issued the Policy. Compl. ¶ 39. The Policy is "noncancelable by MBIA for any reason," and requires MBIA "unconditionally and irrevocably to pay" any deficiency amounts on the insured securities issued by HEMT 2007-2. Policy (Chelney Aff., Exh. F) at 4. MBIA also is a party to the Insurance Agreement, dated as of April 30, 2007, between, among others, MBIA, DLJ and SPS (the "Insurance Agreement") (*Id.*, Exh. G); Compl. ¶ 34.

Although the Policy is "noncancelable," the complex set of interrelated Transaction Documents provide a very specific remedy to MBIA in the event that it claims any loan breached a representation or warranty (or otherwise was improperly part of the Transaction). The Pooling and Servicing Agreement, dated as of April 1, 2007, between, among others, DLJ and SPS (the

"PSA") (together with the Policy, the Insurance Agreement, and other documents of the Transaction, the "Transaction Documents") (Chelney Aff., Exh. H), details a repurchase protocol whereby MBIA and certain other parties to the Transaction may demand that DLJ repurchase loans under certain circumstances. *Id.* ¶ 50. Specifically, in Schedule IV of the PSA, DLJ makes representations and warranties to MBIA and other parties with respect to the pooled loans. *Id.* ¶ 48. These representations and warranties relate to, among other things, the underwriting and stated loan characteristics of each of the pooled loans. *Id.* Pursuant to the PSA's repurchase protocol, if MBIA (or another party) makes a written claim of a breach of a representation or warranty, then DLJ must, within 90 days of notice of such a claimed breach, repurchase any loan for which there is a breach of a representation and warranty that "materially and adversely affects" MBIA's interests in that particular loan. *Id.* ¶ 50. Accordingly, in the event a repurchase demand as to a specific loan is made, DLJ is obligated to repurchase that specific loan if (1) there is a breach of a representation and warranty as to that loan that (2) materially and (3) adversely affects MBIA's interests in that loan.

E. After The Global Recession, MBIA Conducts Post-Loss Underwriting and Issues Its Repurchase Demands

When it issued the Policy in early 2007, MBIA understood the ever-present risk of unforeseen macroeconomic conditions: "Recessions, increases in corporate, municipal or consumer default rates . . . and other general economic and geopolitical conditions could adversely impact the Company's prospects for future business, as well as the performance of MBIA Corp.'s insured portfolio and the Investment Portfolio." MBIA 2006 10-K (Chelney Aff., Exh. B) at 25. As the world now knows, that is exactly what happened: "During the fourth quarter of 2008, disruptions and volatility in the credit markets reached unprecedented levels." MBIA 2008 10-K (Chelney Aff., Exh. C) at 29.

As MBIA was required to make payments under its Policy, it belatedly decided to conduct a review of a sample of the loan files – the very same documents it chose not to review prior to issuance of the policy. Compl. ¶¶ 60 & 68. Based on this post-loss underwriting review, from August to November 2009, MBIA demanded the repurchase of approximately 1,200 loans pursuant to the repurchase protocol set forth in the PSA. *Id.* ¶ 76. MBIA's Complaint does not allege that, as to any particular loan, there has been a breach of a representation or warranty that materially and adversely affects its interests in that loan. Instead, it sweepingly alleges that the 1,200 "breaching loans contained one or, in most cases, more than one defect that constituted a breach of one or more of DLJ's numerous representations and warranties," and that, without any specificity, these breaches materially and adversely affected its interests. *Id.* ¶¶ 69 & 71. As to 564 of these loans, MBIA alleges that DLJ has failed to comply with the repurchase protocol by failing to repurchase within 90 days of notice any loan for which there is a breach of a representation or warranty that "materially and adversely affects" MBIA's interests in the loan. *Id.* ¶¶ 50 (quoting Section 2.03(e) of the PSA) & 77. In other words, at the time MBIA filed its Complaint, it had only allowed the full 90-day notice period to run for these 564 loans, or less than 4% of the entire pool of mortgages.

III. <u>ARGUMENT</u>

A complaint must be dismissed under N.Y. C.P.L.R. 3211(a)(1) if "the documentary evidence submitted conclusively establishes a defense . . . as a matter of law." *Leon v. Martinez*, 638 N.E.2d 511, 513, 84 N.Y.2d 83, 88, 614 N.Y.S.2d 972, 974 (1994). The documentary evidence submitted here, along with MBIA's own allegations, "conclusively establishes" that MBIA's causes of action for Fraudulent Inducement and Breach of the Implied Duty of Good Faith and Fair Dealing should be dismissed as a matter of law. Defendants also move to dismiss MBIA's causes of action for Breach of Representations and Warranties, Material Breach of the

Insurance Agreement, Indemnification, and Reimbursement on the ground that they fail to state causes of action. *See* N.Y. C.P.L.R. 3211(a)(7) (Consol. 2009).

A. The Fraudulent Inducement Claim Should Be Dismissed Because MBIA Is a Sophisticated Plaintiff Who Could Not Justifiably Rely on Alleged Misrepresentations As a Matter of Law

To state a claim for fraudulent inducement, a plaintiff must plead in detail: (1) that the defendant represented that a material fact was true but knew that the representation was false; (2) that the defendant made the misrepresentation for the purpose of inducing the plaintiff to rely on it; (3) that the plaintiff was justified in relying on the misrepresentation and did not know that the representation was false; (4) that the misrepresentation both caused the plaintiff to enter the transaction and caused the loss that the plaintiff alleges; and (5) damages. *E.g., N.Y. Univ. v. Cont'l Ins. Co.*, 662 N.E.2d 763, 769, 87 N.Y.2d 308, 318, 639 N.Y.S.2d 283, 289 (1995); *see* N.Y. C.P.L.R. 3016(b) (Consol. 2009). MBIA's fraudulent inducement claim fails as a matter of law because MBIA has not — and cannot — sufficiently plead that it justifiably relied on any representations made by CS Securities.

1. MBIA Cannot Establish Justifiable Reliance Because It Admits that It Did No Due Diligence of the Loan Files Before Issuing The Policy

MBIA admits in the Complaint that it ***did not do any due diligence as to the loans at issue*** before deciding to issue the Policy: "[T]he timing of the Transaction did not contemplate or afford MBIA the opportunity to undertake its own review of the thousands of individual loan files comprising the proposed loan pool." Compl. ¶ 42. As a sophisticated monoline insurer whose core business consists of insuring principal and interest payments on, among other things, mortgage-backed securities, as a matter of law, MBIA's failure to avail itself of readily available information or conduct ***any*** due diligence defeats the claim that it was entitled to rely on the representations of CS Securities. The First Department has ruled:

> As a matter of law, a sophisticated plaintiff cannot establish that it entered into an arm's length transaction in justifiable reliance on alleged misrepresentations if that plaintiff ***failed to make use of the means of verification that were available to it, such as reviewing files of the other parties.***

UST Private Equity Investors Fund, Inc. v. Salomon Smith Barney, 733 N.Y.S.2d 385, 288 A.D.2d 87, 88 (App. Div. 1st Dep't 2001) (emphasis added) (affirming dismissal of fraud claim for lack of adequate due diligence).

The First Department faced a similar situation in *DDJ Mgmt., LLC v. Rhone Group, LLC*, in which it affirmed the dismissal of a fraud claim brought by investors who lost $40 million in a bankruptcy. 875 N.Y.S.2d 17, 60 A.D.3d 421, 424 (App. Div. 1st Dep't 2009), *leave to appeal granted by* 918 N.E.2d 963, 13 N.Y.3d 710, 890 N.Y.S.2d 448 (2009). The court held that dismissal was appropriate because plaintiffs had not "discharged their own affirmative duty to exercise ordinary intelligence and conduct an independent appraisal of the risks they [were] assuming." *Id.* Having failed to insist on examining the company's books and records for themselves, plaintiffs "cannot now properly allege reasonable reliance on the purported misrepresentations." *Id.*; *see, e.g.*, *Dragon Inv. Co. II LLC v. Shanahan*, 854 N.Y.S.2d 115, 49 A.D.3d 403, 404 (App. Div. 1st Dep't 2008) (affirming dismissal of fraud claim where sophisticated plaintiff waited a year before inquiring into alleged misrepresentations); *Valassis Commc'ns, Inc. v. Weimer*, 758 N.Y.S.2d 311, 304 A.D.2d 448, 449 (App. Div. 1st Dep't 2003) (affirming dismissal of fraud claim where sophisticated plaintiffs "failed to verify the accuracy of that information, as they could have").

Likewise, a federal court recently dismissed a fraudulent inducement claim similar to MBIA's on the ground that, as a matter of law, a sophisticated mortgage insurer could not rely on pre-contractual representations of the mortgage lender. *See United Guar. Mortgage Indem. Co. v. Countrywide Fin. Corp.*, __ F. Supp. 2d __, 2009 WL 3199844 (C.D. Cal. Oct. 5, 2009)

("*UGMI*") (App., Exh. J). In *UGMI*, a mortgage insurer issued insurance for loans making up part of a multi-billion dollar securitization.[7] *Id.* at *1. After many of the loans began defaulting in mid-2007, the insurer brought suit against the lender, claiming that the lender had falsely represented that the mortgage loans were originated "in strict compliance with [the originator's] underwriting standards and guidelines . . . ." *Id.* at *3-4. The court dismissed the insurer's fraudulent inducement claim, stating that "any reasonable mortgage insurer that (1) was conducting multibillion-dollar bulk transactions and (2) had an express right to audit or sample the underlying loan files before the transaction closed, would engage in some degree of auditing or sampling of the underlying loan files to be insured." *Id.* at *19.

Here, the Complaint alleges that MBIA failed to do exactly what the *UGMI* court required – it did not "undertake its own review of the thousands of individual loan files comprising the proposed loan pool." Compl. ¶ 42. This failure was despite the fact that it "had never previously insured a mortgage-backed securities transaction for Credit Suisse." *Id.* at ¶ 23. Based on the Complaint, it is clear that what MBIA now asserts as fraud (which Defendants vigorously dispute) is a claim based on facts that could easily have been identified simply by opening a sample of loan files, which were equally available to MBIA. Given these alleged facts, it was unreasonable as a matter of law for MBIA to proceed without conducting any independent due diligence. MBIA's "own allegations defeat its claims." *UGMI*, 2009 WL 3199844, at *19.[8]

[7] Mortgage insurers provide loss protection on individual mortgages. The insurance covers the lender's loss after foreclosure of a mortgaged property. *See UGMI*, 2009 WL 3199844, at *3.

[8] While MBIA's assertion that it could not have done any effective due diligence over a two-month period (*see* Compl. ¶ 42) strains credulity, what is relevant is that the Complaint alleges that no diligence review was performed at all. *See DDJ Mgmt*, 875 N.Y.S.2d at 17. It was, of course, MBIA's business decision to issue the Policy, and accept a premium in return, without performing any diligence on the underlying loans or insisting to see the books and records. It is not, however, MBIA's prerogative to do so, and then claim it was defrauded once the loss occurs.

2. According To The Complaint, MBIA Was Provided With Detailed Information That Defeats Its Claim of Reliance As a Matter Of Law

Although MBIA's decision not to conduct its own diligence of the underlying loan files would defeat its claim to justifiable reliance even if it had not been given information regarding the loans, MBIA ***was given*** information that put it on notice of the precise concerns of which it now claims it was unaware. Credit Suisse gave MBIA a loan tape with detailed information about each of the loans in the pool, as well as spreadsheets reflecting information about thousands of loans in the pool. Compl. ¶¶ 28-29. Furthermore, the ProSupp fully disclosed the underwriting standards that MBIA now claims are "defective," *id.* ¶ 27, and the possibility that a borrower's income may not be "reasonable or adequate to repay the loan." *Id.* ¶ 32. *See* Prospectus at 7 (guidelines allowed borrowers with high ratios of payments to income); 31 (loans could be given to borrowers who did not meet all of the underwriting criteria); 32 (loans included "stated income/stated asset" and "no income/no asset"). MBIA therefore cannot claim that it was misled about these risks. *See UST Private Equity Investors Fund, Inc.*, 733 N.Y.S.2d at 385.

3. MBIA Was Not Justified in Relying On The Alleged Representations Because Defendants Possessed No Unique Information About The Loans

Furthermore, as MBIA alleges, Defendants did not originate the loans in the pool and, therefore, possessed no unique information about the loans. Compl. ¶ 24 (stating that DLJ "had not itself originated the loans," but instead had "acquired the loans through multiple channels from various 'originators' that had dealt directly with the borrowers"); *see, e.g., Duane Thomas LLC v. 62 Thomas Partners, LLC*, 751 N.Y.S.2d 441, 300 A.D.2d 52 (App. Div. 1st Dep't 2002) (affirming dismissal of fraud claim where information was "not peculiarly within defendants' knowledge"); *Curran, Cooney, Penney, Inc. v. Young & Koomans, Inc.*, 583 N.Y.S.2d 478, 183 A.D.2d 742, 743 (App. Div. 1992) (recognizing that "if the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing . . . he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations"); *Elghanian v. Harvey*, 671 N.Y.S.2d 266, 249 A.D.2d 206 (App. Div. 1st Dep't 1998) (same).

The Complaint alleges that CS Securities conducted its own due diligence on loans it did not originate and provided some of the due diligence information to MBIA. Compl. ¶ 29. While MBIA chose to conduct none of its own due diligence on these files, it does not — and indeed could not — allege that somehow Credit Suisse had any information that MBIA could not have obtained and reviewed prior to issuing the Policy. Indeed, MBIA now asserts its claim of massive fraud based solely on a review of files that were equally available to it prior to issuing the Policy.

As with any of the many mortgage-backed securitizations in which it had previously participated, MBIA had three options: (1) take advantage of the opportunity to conduct proper due diligence; (2) demand more time to do diligence, assuming the two month interval was truly insufficient; or (3) walk away. *See DDJ Mgmt*, 875 N.Y.S.2d at 17 ("even if there was no such express right [to review books and records], plaintiffs could have insisted on the right to review the books and records prior to making the loan"). The fourth option proposed here — make the calculated business decision to proceed with the deal without conducting any due diligence of the loan files and then claim fraud if the deal turned sour — ignores MBIA's own obligations and controlling New York case law.

4. The Remaining Extra-Contractual <u>Allegations Do Not Support A Fraud Claim</u>

Nor can MBIA claim to have justifiably relied on CS Securities's alleged representations about Credit Suisse's impressive stature in the financial industry. For example, CS Securities allegedly "assured MBIA that Credit Suisse was a pillar of the financial industry," that it had a "strong institutional pedigree," and "that its mortgage-backed securities business . . . had a track record of success." Compl. ¶¶ 25, 26. MBIA further alleges that "Credit Suisse Group was at the time the second largest commercial bank headquartered in Switzerland . . . ." *Id.* at ¶ 26. Regardless of their truth or falsity, such comments are an insufficient foundation for a claim of fraudulent inducement. Such "mere puffery, opinions of value or future expectations" cannot support a fraud claim. *Sidamonidze v. Kay*, 757 N.Y.S.2d 560, 304 A.D.2d 415, 416 (App. Div. 1st Dep't 2003); *accord, e.g., Elghanian*, 671 N.Y.S.2d 266.

B. The Fraudulent Inducement Claim Should Be Dismissed Because It Is Duplicative Of MBIA's Contract Claims

To survive a motion to dismiss a fraud claim, a plaintiff must plead misrepresentations or omissions that are independent of any contract between the parties. As the First Department recently put it:

> In a fraudulent inducement claim, the alleged misrepresentation should be one of then-present fact, which would be ***extraneous to the contract*** and involve ***a duty separate from or in addition to that imposed by the contract.***

The Hawthorne Group, LLC v. RRE Ventures, 776 N.Y.S.2d 273, 276, 7 A.D.3d 320, 323 (App. Div. 1st Dep't 2004) (internal citation omitted) (emphasis added) (dismissing fraud claims arising from alleged breaches of warranties in a finder's fee agreement); *see, e.g., J.E. Morgan Knitting Mills, Inc. v. Reeves Bros., Inc.*, 663 N.Y.S.2d 211, 243 A.D.2d 422, 423 (App. Div. 1st Dep't 1997) (dismissing duplicative fraud claim that alleged that defendants knew contractual warranty was false when made); *Giannisis v. Maniatis*, 559 N.Y.S.2d 251, 252, 160 A.D.2d 629, (App. Div. 1st Dep't 1990) (where fraud claim "relates to the cause of action for breach of contract, the fraud cannot be the basis for a separate cause of action"). MBIA's fraudulent inducement claim fails because it is based on alleged "misrepresentations" that are, in essence, nothing more than alleged breaches of provisions in the Transaction Documents. Indeed, MBIA has brought several contract claims based on the same set of facts.

Here, as part of the complex and detailed Transaction Documents, the parties agreed to a very specific process — the Repurchase Protocol — to address claims of breaches of representations and warranties. *See* Compl. ¶ 50. By its Complaint, MBIA attempts to recast what are plainly contract claims into allegations of fraud. But a comparison of MBIA's fraud allegations with its contract allegations reveals their substantial overlap:

Fraud Allegation	**Contract Allegation**
The loan schedule provided to MBIA misrepresented "material information about each loan" of the Loans. Compl. ¶¶ 28, 32.	Defendants breached the representation providing that the "information set forth in the Mortgage Loan Schedule . . . is complete, true and correct in all material respects." Compl. ¶¶ 48-49.
CS Securities misrepresented that the loans were "underwritten to strict guidelines created or approved by Credit Suisse. Compl. ¶ 28.	Defendants breached representations in the contract that "[t]he Mortgage Loan complies with all the terms, conditions and requirements of the originator's underwriting standards in effect at the time of origination." Compl. ¶¶ 48-49.
Credit Suisse would "vouch for the New Century loans by providing express contractual representations and warranties about their quality." Compl. ¶ 29.	The loan pool "is replete" with breaches of contractual warranties about the quality of the loans. Compl. ¶ 49.

As this comparison demonstrates, the alleged "misrepresentations" cited by MBIA are "nothing more than what was announced to be the contractual warranty itself, and accordingly cannot be extraneous to the contract." *Pramco III, LLC v. Partners Trust Bank*, No. 2006/02318, 2007 WL 1574479, at *3 (N.Y. Sup. Ct. May 31, 2007) (App., Exh. H).

Numerous cases applying New York law have held that fraud claims must be dismissed in similar circumstances. The Southern District of New York, applying New York law, recently held that negligent misrepresentation and fraud claims must be dismissed as duplicative of breach of contract claims where the tort claims alleged that defendant "made the representations and warranties to tell Plaintiff 'we've checked on certain aspects of the mortgage loan pool and they meet the following criteria.'" *LaSalle Bank Nat'l Ass'n v. Citicorp Real Estate, Inc.*, No. 01 Civ. 4389, 2002 U.S. Dist LEXIS 23323, at *33-34 (S.D.N.Y. Dec. 5, 2002) (App., Exh. D). And a New York trial court recently dismissed a similar fraudulent inducement claim in *HSH Nordbank AG v. UBS AG*, No. 600562/08, 2008 WL 4819599 (N.Y. Sup. Oct. 21, 2008) (App., Exh. B). In *HSH Nordbank*, the plaintiff claimed that it was fraudulently induced by the defendant's misleading disclosures to enter into a credit default swap in connection with a synthetic collateralized debt obligation. *Id.* at *3. In dismissing the fraud claim, the court recognized that "it is inarguable that a cause of action for breach of contract cannot be expanded into a claim sounding in fraud merely by alleging that the defendant never intended to comply with the terms of the contract." *Id.* at *4; *see AJW Partners, LLC v. Cyberlux Corp.*, 873 N.Y.S.2d 231, 2008 WL 4514171 at *3 (N.Y. Sup. Ct. Sept. 19, 2008) (dismissing fraud claim because "fraud allegations are derived directly from the terms of the Agreements"); *In re Enron Corp.*, No. 04 Civ. 1367 (NRB), 2005 U.S. Dist LEXIS 2134, at *44 (S.D.N.Y. Feb. 14, 2005) (App., Exh. C) (applying New York law to dismiss duplicative fraudulent inducement claim).[9]

It should be noted that the First Department's ruling in *First Bank of the Americas v. Motor Car Funding, Inc.*, 690 N.Y.S.2d 17, 257 A.D.2d 287 (App. Div. 1st Dep't 1999), which allowed a fraud claim based on a breach of contractual warranties, held only that the presence of a ***general*** representation in a contract does not neutralize ***specific*** misrepresentations of fact that are both (1) collateral and (2) extraneous to the contract. As the Southern District of New York

[9] The Fifth Circuit recently dismissed a fraud claim in similar circumstances. *See Lone Star Fund V (US), LP v. Barclays Bank PLC*, __ F.3d __, 2010 WL 60897 (5th Cir. Jan. 11, 2010) (App., Exh. E). In *Lone Star*, a purchaser of mortgage-backed securities from Barclays asserted a fraud claim based on the allegation that certain representations about the loans "were false when made." *Id.* at *3. The court held that Barclays had made no actionable misrepresentations, because contract warranties and prospectuses had provided that if any of the loans did not meet Barclays' representations, Barclays would repurchase or substitute them. *Id.* at *4 ("As a sophisticated investor placing a $60 million investment in the trusts, [the purchaser] has no basis to ignore these provisions or their consequences.").

explained in *In re Enron Corp.*, in which it dismissed a fraudulent inducement claim based on alleged misrepresentations that overlapped a contractual warranty:

> Although the court [in *First Bank*] held that the alleged misrepresentations breached the general underwriting warranty in the underlying agreement, it appears that the misrepresentations also concerned matters relating to the individual loans that were not specifically addressed by that general warranty.

2005 U.S. Dist. LEXIS 2134 at *44 n.44; *see also Savasta & Co., Inc. v. Interactive Planet Software Motion Inc.*, No. 0602425/2005, 2008 WL 2563485, at *4 (N.Y. Sup. Ct. N.Y. County June 12, 2008) (App., Exh. I) (granting partial summary judgment for defendant on fraud claim and distinguishing *First Bank* on ground that alleged misrepresentations at issue fall within scope of contractual warranties).[10] Because MBIA's fraudulent inducement claim is based simply on the allegation that Credit Suisse breached provisions in the contract, and in light of the fact that MBIA has alleged breaches of contract based on the very same allegations, the fraudulent inducement claim should be dismissed.[11]

C. **MBIA's Breach Of Contract Causes Of Action For Breach Of Representations And Warranties, Breach Of The Insurance, Agreement Indemnification, And Reimbursement Should Be Dismissed**

1. MBIA Has Failed To Allege Breaches On A Loan-Level Basis

When properly stripped of MBIA's meritless fraud allegations, Causes of Action 2 and 5 present nothing more than a series of individual breach of contract cases concerning alleged

[10] Defendants acknowledge two recent non-controlling decisions in similar lawsuits brought by MBIA, which did not dismiss the fraud claim as duplicative of related contract claims. *See MBIA Ins. Co., LLC v. Residential Funding Co. LLC*, No. 603552/2008 (N.Y. Sup. Ct. N.Y. County Dec. 22, 2009) (Fried, J.) ("*Residential Funding*") (App., Exh. G); *MBIA Ins. Corp.v. Countrywide Home Loans*, No. 602825/2008 (N.Y. Sup. Ct. N.Y. County Apr. 8, 20097/8/09) (Bransten, J.) ("*Countrywide*") (App., Exh. F). Both of these decisions, however, are factually distinguishable from the present action. Additionally, Defendants respectfully submit that these rulings are not consistent with the general rule discussed above, and note that the Appellate Division has not yet spoken on these cases.

[11] MBIA's fraudulent inducement claim should be dismissed for the independent reason that New York's "economic loss" rule restricts a plaintiff that has not suffered personal or property injury to contract damages. *Carmania Corp. v. Hambrecht Terrell Int'l*, 705 F.Supp. 936, 938 (S.D.N.Y. 1989).

breaches of ***loan-level*** representations and warranties in the PSA. As MBIA acknowledges, these representations and warranties address the "attributes of ***each of the individual loans*** in the securitized pool." Compl. ¶ 7 (emphasis added). MBIA can state a claim, therefore, only if it alleges that Defendants breached a contractual obligation as to any particular loan. *See Americorp Fin., Inc. v. St. Joseph's Hosp. Health Ctr.*, 180 F.Supp.2d 387, 390 (N.D.N.Y. 2001) (claim for breach of contract adequately alleged when complaint describes terms of agreement and describes provisions breached as result of acts at issue). These causes of action fail to state a claim for breach of contract and should be dismissed.

MBIA's defective pleading of these causes of action is highlighted when compared to Cause of Action 3 for breach of the Repurchase Protocol, which Defendants do not move to dismiss. While Defendants deny the merit of this cause of action, it at least identifies the specific alleged loan-level breaches about which MBIA complains.[12] The same cannot be said for MBIA's second and fifth causes of action, both of which allege that DLJ breached the Insurance Agreement. The second cause of action, entitled "Breach of Representations and Warranties," alleges that DLJ materially breached transaction-level representations and warranties in the Insurance Agreement and the loan-level representations and warranties in the PSA, breach of which constitutes an event of default under the Insurance Agreement. *Id.* ¶¶ 53 n.8, 90. The fifth cause of action, entitled "Material Breach of the Insurance Agreement," similarly alleges that DLJ breached the loan-level representations and warranties and frustrated the loan-level repurchase remedy. *Id.* ¶ 102. But unlike in the breach of the Repurchase Protocol cause of

[12] MBIA alleges that (1) the PSA requires DLJ to repurchase, within 90 days of notice, any loan for which there is a breach of a representation and warranty that materially and adversely affects MBIA's interest in that loan; (2) it discovered breaches of representations and warranties as to 1,214 specific loans; (3) DLJ was notified in a series of repurchase demands of these loan-level breaches that materially and adversely affect MBIA's interests in the identified loans; and (4) DLJ did not repurchase 564 of these loans within 90 days of notice, as required by the Repurchase Protocol. Compl. ¶¶ 50, 76-77.

action, MBIA does not tie these alleged breaches of representations and warranties to specific loans (or specific representations and warranties). Instead, it sweepingly alleges that DLJ has breached the Insurance Agreement based on MBIA's post-loss underwriting of a sample set of loan files. *Id.* ¶ 68. Because MBIA has not made any attempt to state these causes of action in terms of the specific loans or alleged loan-level defects identified in the repurchase demands, Defendants cannot evaluate these causes of action. *See Atkinson v. Mobil Oil Corp.*, 614 N.Y.S.2d 36, 205 A.D.2d 719, 720 (App. Div. 1994) (pleadings must be sufficiently particular to give notice of transactions or occurrences intended to be proved as well as material elements of each cause of action); *Kramer v. Loeb, Rhoades & Co.*, 246 N.Y.S.2d 243, 20 A.D.2d 634 (App. Div. 1st Dep't 1964) (granting motion to dismiss where it was "impossible to determine [from complaint] which transactions out of a great number plaintiff complains about"). The second and fifth causes of action should be dismissed.

2. MBIA's Indemnification And Reimbursement Causes Of Action Should Be Dismissed Because They Depend On The Breach Of Insurance Agreement Causes Of Action

MBIA's seventh cause of action for indemnification for DLJ's breach of a representation and warranty and eighth cause of action for reimbursement of payments made due to DLJ's failure to repurchase a loan are entirely dependent on the breach of the Insurance Agreement causes of action; therefore, they should be dismissed as well. *See* Compl. ¶¶ 110 & 113.

D. The Cause Of Action For Breach Of The Implied Duty Of Good Faith And Fair Dealing Should Be Dismissed Because It Alleges No Unique Fact Of Injury Apart From The Contract Claims

MBIA's cause of action for breach of the implied duty of good faith and fair dealing should be dismissed because it is duplicative of the breach of contract claims. *See, e.g., R.I. Island House, LLC v. N. Town Phase II Houses, Inc.*, 858 N.Y.S.2d 372, 377, 51 A.D.3d 890, 895-96 (App. Div. 2008); *N.Y. Univ. v. Cont'l Ins. Co.*, 662 N.E.2d at 770; *Rather v. CBS Corp.*, 68 A.D.3d 49, 886 N.Y.S.2d 121, 127 (App. Div. 1st Dep't 2009). Moreover, any related damages must be recovered in the context of the breach of contract claims. *Levi v. Utica First Ins. Co.*, 786 N.Y.S.2d 3, 12 A.D.3d 256, 258 (App. Div. 1st Dep't 2004).

MBIA's claim is based on the allegation that DLJ and SPS failed to provide MBIA with access to information necessary to effectuate the Repurchase Protocol. Compl. ¶ 97. As MBIA acknowledges, however, its right of access to information and records is the subject of an express contractual provision — MBIA's sixth cause of action alleges a breach of this very provision. Compl. ¶ 105; PSA § 3.07. The breach of access rights claim targets not only the same behavior as the implied duty claim — denial of access to information about the mortgage loans — but also the same harm to MBIA — frustration of its ability to enforce its contract rights against Defendants. *See* Compl. ¶ 108. MBIA's fourth cause of action should be dismissed.

E. Plaintiff's Request For Punitive And Consequential Damages Should Be Stricken

Because MBIA's only viable causes of action are for breach of contract, its prayers for punitive and consequential damages must be stricken. *See Rocanova v. Equitable Life Assurance Soc'y of U.S.*, 634 N.E.2d 940, 944, 83 N.Y.2d 603, 613-14, 612 N.Y.S.2d 339, 343 (1994) (holding that punitive damages are not available for breach of contract and affirming dismissal of punitive damages based on implied duty claim where claim did not allege "egregious tortious conduct" or "pattern of similar conduct directed at the public generally"). And even if MBIA's fraudulent inducement or implied duty causes of action were properly pleaded, they do not allege the type of conduct sufficient to sustain a request for punitive damages. *See id.*; *accord Walker v. Sheldon*, 179 N.E.2d 497, 498-99, 10 N.Y.2d 401, 405, 223 N.Y.S.2d 488, 491 (1961).

Consequential damages are available only in limited circumstances. *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co.*, 886 N.E.2d 127, 130, 10 N.Y.3d 187, 192-93, 856 N.Y.S.2d 505, 508 (2008); *see also Kenford Co., Inc. v. County of Erie*, 493 N.E.2d 234, 235-36, 67 N.Y.2d 257, 261-62, 502 N.Y.S.2d 131, 132-33 (1986) (declining to award lost profits). Where the claim for consequential damages involves parties to a contract, courts look to circumstances surrounding the contract to determine whether such damages were reasonably contemplated by the parties. *Bi-Economy Mkt., Inc.*, 886 N.E.2d at 130, 10 N.Y.3d at 193, 856 N.Y.S.2d at 508. MBIA has not alleged anything to suggest that the parties here foresaw consequential damages. *See Kenford Co., Inc. v. County of Erie*, 537 N.E.2d 176, 180, 73 N.Y.2d 312, 321-22, 540 N.Y.S.2d 1, 5 (1989) (noting that it would be "irrational" to hold that defendant provided a guarantee that plaintiff would receive all hoped-for financial benefits, even in event of breach). For example, the Insurance Agreement lays out a long list of possible damages, but does not include damages such as lost profits. Ins. Agreement (Chelney Aff G), § 3.04. MBIA's prayer for consequential damages should be stricken.

F. <u>MBIA's Demand For A Jury Trial Should Be Stricken</u>

By written agreement, parties may expressly waive their right to a jury trial on any claim. *Tiffany at Westbury Condo. v. Marelli Dev. Corp.*, 826 N.Y.S.2d 623, 34 A.D.3d 791 (App. Div. 2006). MBIA's demand for a jury trial should be stricken because the parties expressly waived "any right to a trial by jury trial." Ins. Agreement (Chelney Aff., Exh. G), § 6.09. This waiver is effective despite MBIA's fraudulent inducement cause of action. *See Tiffany at Westbury Condo.*, 826 N.Y.S.2d at 623 (waiver is effective even if party joins claim for which it otherwise has right to jury trial).

IV. <u>CONCLUSION</u>

For the reasons set forth above, Defendants respectfully request that the Court grant their motion to dismiss.

Dated: February 5, 2010

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