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

FINANCIAL GUARANTY INSURANCE COMPANY,	:	Mot. Seq. 002
Plaintiff,	:	Index No. 652914/2014
- against -	:	Justice Friedman
MORGAN STANLEY ABS CAPITAL I INC., MORGAN STANLEY MORTGAGE CAPITAL HOLDINGS LLC, MORGAN STANLEY & CO., INC., MORGAN STANLEY, and SAXON MORTGAGE SERVICES, INC.	:	Part 60
Defendants.	:	

PLAINTIFF'S MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF'S MOTION FOR LEAVE TO FILE AN AMENDED COMPLAINT

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PRELIMINARY STATEMENT

Plaintiff Financial Guaranty Insurance Corporation ("FGIC") seeks leave to amend its complaint to plead expressly a legal theory that the First Department recently held applicable to Morgan Stanley's conduct in the *very same transaction* at issue in this suit: MSAC 2007-NC4 (the "Transaction"). On January 17, 2019, in a parallel suit brought by the trustee for this Transaction (the "Trustee Case"), the First Department held that allegations of Morgan Stanley's knowing, pervasive breaches of the warranties it provided in the Transaction could render unenforceable the "sole remedy" provision that would otherwise constrain the trustee's recovery. In reaching this decision, the First Department applied the rule that contractual limitations on liability are ineffective where there is intentional wrongdoing, bad faith, reckless indifference to contractual rights or gross negligence.

Because FGIC's existing complaint already alleges the same knowing, pervasive breaches of warranties that were central to the First Department's decision in the Trustee Case, FGIC should be permitted to amend its complaint to plead this legal theory expressly. The proposed amendments would add that the conduct originally alleged constitutes willful misconduct, bad faith, reckless indifference to FGIC's rights and/or gross negligence, and that Morgan Stanley cannot rely on any contractual limitation on remedies as a result. These proposed amendments would not prejudice Morgan Stanley because they add no new facts, but simply provide another legal avenue for FGIC to obtain the same relief it has always sought, *i.e.*, full compensatory damages, including the recovery of all claim payments FGIC must make due to Morgan Stanley's contractual breaches. The First Department's decision in the Trustee Case relating to the *same Transaction* at issue here establishes that there is a *prima facie* basis for this amendment.

Additionally, the proposed amendments assert a "failure to notify" claim against defendant MSAC. FGIC advised Morgan Stanley of its intent to add this "failure to notify" claim long ago, sending Morgan Stanley a proposed amended complaint on October 20, 2016. In the joint letter sent to the Court on September 21, 2018 as part of a coordinated effort to address "failure to notify" claims across the Part 60 RMBS cases, Morgan Stanley consented to the amendment FGIC had proposed in 2016. In light of the recent First Department decision in the Trustee Case, FGIC has augmented its "failure to notify" allegations to contend that MSAC's failure to provide the contractually-required notice of breaches also constitutes willful misconduct, bad faith, reckless indifference to FGIC's rights and/or gross negligence. These new allegations (added since the 2016 draft) do not add any facts beyond those that FGIC shared with Morgan Stanley in 2016.

Because Morgan Stanley will suffer no prejudice and there is a meritorious basis for the amendment, leave to amend should be granted.

BACKGROUND

1. FGIC Alleged Knowing, Pervasive Breaches in the Original Complaint

On September 23, 2014, FGIC filed a complaint in this matter asserting claims for fraudulent inducement and breach of contract in connection with the Transaction, for which Morgan Stanley served as depositor and sponsor.[1] Dkt. 1 ("Comp."). In its original complaint, FGIC alleged that Morgan Stanley knew at closing that it was in breach of many of the representations and warranties provided to FGIC and other Transaction participants. In particular, FGIC alleged that, based on Morgan Stanley's extensive knowledge of New Century's

[1] The defendants, which are collectively referred to as "Morgan Stanley," are Morgan Stanley ABS Capital I Inc., Morgan Stanley Mortgage Capital Holdings LLC, Morgan Stanley & Co., Inc., Morgan Stanley, and Saxon Mortgage Services, Inc.

shoddy underwriting practices and its own due diligence review, Morgan Stanley knew that the loan-level warranties it provided about the characteristics of the individual Mortgage Loans underlying the Transaction (*see* Comp. ¶¶ 90-94) were false at the time the Transaction closed, and Morgan Stanley continued to discover breaches of the warranties after closing. (*Id.* ¶¶ 13-14, 49, 94, 97, 174-76.) Based on these allegations, FGIC sought compensatory damages, including the recovery of all claim payments. (*Id.* at ¶ 17, p. 78 (Prayer for Relief).)

FGIC further alleged that, after losses on the Transaction began to mount, FGIC retained consultants to review the Mortgage Loans, finding defects in every one of the approximately 800 Mortgage Loans they reviewed. (*Id.* ¶¶ 9, 95-105.) Additionally, the Trustee and Freddie Mac (as a certificate owner) demanded repurchase of 441 loans, but Morgan Stanley willfully refused to comply with its contractual repurchase obligation. (*Id.* ¶¶ 10-11, 106-11.)

2. Discovery Has Proceeded On the Allegations in the Original Complaint

Morgan Stanley filed a motion to dismiss, which challenged FGIC's claim for recovery of all of its claims payments as damages, which this Court denied on January 23, 2017. Dkt. 117. Discovery proceeded based on FGIC's original complaint. The fact discovery deadline was November 17, 2017, and both sides served opening expert reports by August 7, 2018. (Affirmation of Henry J. Ricardo in Support of Plaintiff's Motion for Leave to File an Amended Complaint ("Ricardo Aff.") ¶ 3.) On September 13, 2018, the First Department affirmed in part and reversed in part this Court's decision denying Morgan Stanley's motion to dismiss. *Fin. Guar. Ins. Co. v. Morgan Stanley ABS Capital I Inc.*, 164 A.D.3d 1126 (1st Dep't 2018). The First Department dismissed FGIC's fraud claim on the basis that it sought the same damages FGIC is entitled to recover for its breach of contract claims, but otherwise affirmed this Court's decision. *Id.* at 1128.

3. The First Department Found that the Trustee Adequately Alleged Willful Misconduct and Gross Negligence by Morgan Stanley

The Trustee filed a parallel lawsuit against Morgan Stanley regarding the same Transaction. On December 10, 2015, this Court granted in part and denied in part Morgan Stanley's motion to dismiss the Trustee's complaint. *Deutsche Bank National Trust Co. v. Morgan Stanley Mortgage Capital Holdings LLC*, Index No. 652877/14. Doc. 79 (N.Y. Sup. Ct. Dec. 11, 2015). Specifically, this Court dismissed the Trustee's claim for compensatory damages as inconsistent with the "sole remedy" clause contained in the Transaction documents. *Id.* at 23-25.

On January 17, 2019, the First Department reversed that holding, finding that the Trustee adequately alleged gross negligence on the part of Morgan Stanley, rendering the sole remedy provision unenforceable. *See* Ricardo Aff. Ex. 1; *Matter of Part 60 Put-Back Litig.*, 2019 NY Slip Op 00368 at 3, 12-13 (1st Dep't Jan. 17, 2019) (hereinafter "*Trustee Decision*"). In particular, the First Department referred to the Trustee's allegations of the pervasive breaches found in *a sample of loans reviewed by FGIC* before suit was filed. *Trustee Decision* at 12. FGIC's existing complaint describes this same loan review and its findings of pervasive breaches. (Comp. ¶¶ 95-105.)

4. FGIC's Proposed Amendment

FGIC now moves for leave to file an amended complaint in order to allege expressly that Morgan Stanley's knowing, pervasive breaches of warranties and its willful refusal to repurchase breaching loans—all of which were alleged in FGIC's original complaint—constitutes the intentional wrongdoing, bad faith, reckless indifference to FGIC's rights and/or gross negligence (collectively, "willful misconduct/gross negligence") addressed in the First Department's recent decision in the Trustee Case. Additionally, the amendments allege Morgan Stanley's willful

blindness to these same pervasive breaches as to which the original complaint alleged Morgan Stanley had actual, constructive or inquiry notice. There are no new factual allegations in the proposed amended complaint, only a new legal conclusion drawn from the existing allegations. (*See* Ricardo Aff. Exs. 5, 6, 7.) FGIC seeks to plead expressly that due to Morgan Stanley's willful misconduct/gross negligence, FGIC's recovery is not limited by any contractual provision.[2]

The amended complaint also adds allegations and a cause of action related to Morgan Stanley's failure to provide prompt written notice of breaches of warranties that it discovered after the Transaction closed. Except for new allegations that this failure to notify constitutes willful misconduct/gross negligence, FGIC shared these "failure to notify" allegations with Morgan Stanley in 2016. (Ricardo Aff. Ex. 3.) In September 2018, Morgan Stanley consented to an amendment to include the failure to notify allegations that FGIC circulated in 2016. (Ricardo Aff. Ex. 4.)

ARGUMENT

I. FGIC SHOULD BE GIVEN LEAVE TO AMEND UNDER CPLR 3025(b)

Under CPLR 3025(b), leave to amend "should be freely granted, absent prejudice or surprise resulting therefrom, unless the proposed amendment is palpably insufficient or patently devoid of merit." *MBIA Ins. Corp. v. Greystone & Co., Inc.*, 74 A.D.3d 499, 499 (1st Dep't 2010) ("*Greystone*") (citations omitted). FGIC's amendment easily meets this standard.

[2] In its decision denying Morgan Stanley's motion to dismiss, this Court rejected Morgan Stanley's argument that loan repurchase is FGIC's "sole remedy" for reasons not repeated here. Dkt. 117 at 5-6. Morgan Stanley chose not to brief this aspect of the decision on appeal. The proposed amendments provide a different legal basis to reach the same result, even as to FGIC's claim for breach of the loan-level warranties.

A. Morgan Stanley Will Not Be Prejudiced by FGIC's Amendment

Leave to amend should be denied only if Morgan Stanley will suffer significant prejudice, that is, "some special right lost in the interim, some change of position or some significant trouble or expense that could have been avoided had the original pleading contained what the amended one wants to add." *Barbour v. Hosp. for Special Surgery*, 169 A.D.2d 385, 386, (1st Dep't 1991); *see also O'Halloran v. Metro. Transp. Auth.*, 154 A.D.3d 83, 86 (1st Dep't 2017) ("A party opposing leave to amend 'must overcome a heavy presumption of validity in favor of [permitting amendment].") (quoting *McGhee v. Odell*, 96 A.D.3d 449, 450 (1st Dep't 2012)). Mere delay, additional expense, and exposure to greater liability are *not* sources of prejudice sufficient to overcome New York's liberal policy in favor of granting leave to amend. *See Kocourek v. Booz Allen Hamilton, Inc.*, 85 A.D.3d 502, 503-05 (1st Dep't 2011) ("[M]ere tardiness is insufficient to defeat a motion to amend."); *Jacobson v. McNeil Consumer & Specialty Pharms.*, 68 A.D.3d 652, 654 (1st Dep't 2009) ("Prejudice does not occur simply because a defendant is exposed to greater liability or because a defendant has to expend additional time preparing a case."). Rather, leave to amend should only be denied if Morgan Stanley "has been hindered in the preparation of [its] case or has been prevented from taking some measure in support of [its] position." *Loomis v. Civetta Corinno Constr. Corp.*, 54 N.Y.2d 18, 23 (1981).

Morgan Stanley can claim no prejudice here because all of the facts supporting FGIC's new allegations of willful misconduct/gross negligence have been part of this case since its outset. In particular, the original complaint alleged that: (1) Morgan Stanley knew of pervasive breaches of the loan-level warranties before the Transaction closed based on its longstanding relationship with New Century and the loan file diligence Morgan Stanley conducted (Comp. ¶¶ 13-14, 49, 94, 97, 174); and (2) Morgan Stanley continued to discover breaches of the loan-level

warranties after closing (*id.* ¶ 175-76) and willfully disregarded and frustrated its contractual obligation to repurchase breaching loans (*id.* ¶¶ 10-11, 106-11).[3] Indeed, FGIC pursued a claim for fraudulent inducement that was part of the case through the entirety of fact discovery and through the service of each side's opening expert reports.[4] Thus, Morgan Stanley had a full opportunity to conduct discovery concerning FGIC's allegations of knowing and pervasive breaches. But even if that had not been the case, whether Morgan Stanley engaged in willful misconduct is a subject that is entirely within Morgan Stanley's knowledge, and not something for which Morgan Stanley would need to take discovery.

The First Department has consistently held that no prejudice results from an amendment that merely adds a new legal theory premised on previously-alleged facts, and that such amendment should be freely granted. *See Jacobson*, 68 A.D.3d at 654 (defendants not prejudiced by second amended complaint because it "did not allege any new facts or occurrences, but merely set forth an additional legal theory," and "the initial pleading provided sufficient notice of the series of occurrences from which the [plaintiffs'] claims arise"); *Panto v. J & M Salvage Co.*, 157 A.D.2d 582, 583 (1st Dep't 1990) (no prejudice from amendment because "the amended pleading only add[ed] a new theory of recovery based on the identical facts alleged in the original pleading"); *All-Boro Air Conditioning Corp. v. Wales & Ward, Inc.*, 92 A.D.2d 486, 487 (1st Dep't 1983) (no prejudice from amendment to add fraud claim because "the cause of action for fraud, while alleging a new theory, is based upon facts already alleged in the pleadings"); *Burrell v. Shelton*, 88 A.D.2d 573, 574 (1st Dep't 1982) (no prejudice from

[3] The amendments also allege Morgan Stanley's "willful blindness" to these pervasive breaches. This conclusion is based on the same facts supporting FGIC's existing allegations that Morgan Stanley had actual, constructive and/or inquiry notice of pervasive breaches. (Comp. ¶¶ 119, 173, 174.)

[4] The only expert reports served after the First Department dismissed FGIC's fraud claim were FGIC's reply expert reports. Because FGIC had filed a motion for leave to appeal from this ruling to the Court of Appeals, FGIC's reply expert reports continued to address subjects relevant to FGIC's fraud claim.

amendment after trial on partial claims because "no new facts [were] being alleged, only a new theory," and "the original pleading gave notice of the occurrence relied on").

Consistent with these authorities, FGIC's amendment merely adds a new legal theory to existing facts. Moreover, while Morgan Stanley's willful misconduct/gross negligence prevents Morgan Stanley from relying on any contractual limitation on FGIC's recovery, FGIC has always sought to recover damages sufficient to compensate it for all its claim payments. The proposed amendment adds a new avenue to reach that result.

Indeed, Morgan Stanley endorsed and benefitted from this liberal standard in the Trustee Case, where it obtained leave to amend its answer to add a statute of limitations defense after the First Department's decision in *Deutsche Bank National Trust Company (SABR 2007-BR1) v. Barclays Bank PLC* and *Deutsche Bank National Trust Company v. HSBC Bank, USA*, 156 A.D.3d 401 (1st Dep't 2017). Citing New York's heavy presumption in favor of granting leave, Morgan Stanley argued that the Trustee would not be prejudiced by the amendment because it would require no additional discovery; that any required discovery would be in the sole possession of the Trustee; that the Trustee would not have litigated the case differently had the defense been asserted in the original answer; and that Morgan Stanley moved expeditiously to amend after the First Department decision provided a legitimate reason for seeking leave. (*See* Ricardo Aff. Ex. 2 at 8:24-9:8, 13:9-14:10.) This Court agreed and granted Morgan Stanley leave to amend. *Matter of Part 60 RMBS Put-Back Litig.*, 2018 NY Slip Op 32679(U), ¶ 26 (Sup. Ct., N.Y. Cnty. Oct. 18, 2018). The same is true here: FGIC's amendment requires no new discovery (and if it did, that discovery is solely in Morgan Stanley's possession), changes nothing about how Morgan Stanley would have approached this case, and follows a First

Department decision specifically addressing Morgan Stanley's willful misconduct/gross negligence in this same Transaction.

Finally, the proposed amendment adds a "failure to notify" claim based on defendant MSAC's failure to notify other Transaction participants of breaches of the loan-level warranties of which MSAC became aware. FGIC advised Morgan Stanley of its intent to add such a claim and sent a proposed amended complaint to Morgan Stanley on October 20, 2016. (Ricardo Aff. Ex. 3.) In the parties' joint letter to the Court on September 21, 2018, Morgan Stanley consented to the amendments proposed at the time. (Ricardo Aff. Ex. 4 at 5-6.) While FGIC now seeks to augment its "failure to notify" allegations by also pleading willful misconduct/gross negligence, they include no additional factual allegations beyond those that were shared with Morgan Stanley in 2016, and do not require Morgan Stanley to take additional discovery. Morgan Stanley will therefore suffer no prejudice as a result of the addition of the "failure to notify" claim and corresponding allegations.

B. FGIC Has Shown a *Prima Facie* Basis for Its Proposed Amendment

On a motion for leave to amend, a plaintiff "need not establish the merit of its proposed new allegations," but rather only that they are "not palpably insufficient or clearly devoid of merit." *Greystone*, 74 A.D.3d at 500 (citations omitted). This standard is "demonstrably different from the standards applied to either a CPLR 3211 motion to dismiss or a CPLR 3212 motion for summary judgment." *Daniels v. Empire-Orr, Inc.*, 151 A.D.2d 370, 371 (1st Dep't 1989) (citation omitted); *see also Thompson v. Cooper*, 24 A.D.3d 203, 205-06 (1st Dep't 2005) (standard on motion to amend "is much less exacting than on a motion for summary judgment").

A proposed amendment must be sustained unless "the alleged insufficiency or lack of merit is clear and free from doubt." *Daniels*, 151 A.D.2d at 371. Moreover, "[a] party opposing leave to amend must overcome a heavy presumption of validity in favor of permitting

amendment." *McGhee v. Odell*, 96 A.D.3d 449, 450 (1st Dep't 2012) (internal quotation marks and formatting omitted). "Once a prima facie basis for the amendment has been established, that should end the inquiry[.]" *Pier 59 Studios, L.P. v. Chelsea Piers, L.P.*, 40 A.D.3d 363, 365-66 (1st Dep't 2007) (citation omitted); *see also Miller v. Cohen*, 93 A.D.3d 424, 425 (1st Dep't 2012) (reversing denial of motion for leave to amend that "prematurely reached the merits of the proposed amendment, which was adequately pleaded and not clearly devoid of merit"); *532 39 Realty, LLC v. LMW Eng'g Grp. LLC*, 2012 N.Y. Misc. LEXIS 5333 at *26-27 (Sup. Ct., N.Y. Cnty. 2012) (Friedman, J.) (granting leave to amend complaint that was "potentially meritorious").

FGIC's allegations of willful misconduct/gross negligence easily meet this standard because the First Department has already ruled that the very acts alleged here amount to gross negligence under the more onerous motion-to-dismiss standard. *See Trustee Decision* at 3, 12-13. Gross negligence is "conduct that smacks of intentional wrongdoing and evinces a reckless indifference to the rights of others." *Abacus Fed. Sav. Bank v. ADT Sec. Servs., Inc.*, 18 N.Y.3d 675, 684 (2012); *Trustee Decision* at 10. In the Trustee Case, the First Department held that the Trustee adequately pleaded gross negligence by Morgan Stanley in connection with the Transaction because "the FGIC sampling of 800 of the mortgage loans in question manifested breaches of representations and warranties in 100% of those loans" and the mortgage loans breached Morgan Stanley's representations and warranties "on various grounds, including departures from defendants' own underwriting guidelines as to disclosure of the borrowers' income, debt obligations, employment status, use and occupancy of the property securing their loans, and appraisal value of the property, which were either known or should have been known to defendants by the time the securitization deal closed." *Trustee Decision* at 12-13. The First

Department held that these alleged "pervasive, knowing breaches" constituted gross negligence, rendering the sole remedy clause in the Transaction Documents unenforceable. *Id.*

Each of the allegations cited by the First Department in support of its ruling in the Trustee Case appears in FGIC's original complaint. The original Complaint alleges, for example, how Morgan Stanley "disregarded the results of its reviews and diligence, and designated for securitization loans that it knew were defective," (Comp. ¶ 14); how Morgan Stanley "likely discovered numerous breaches of the Loan Warranties at the time of the closing of the Transaction," putting it on notice of "similar breaches throughout the Mortgage Pool" (*id.* ¶ 174); and how FGIC retained third-party consultants to review a sample of approximately 800 non-performing loans, finding defects in *every* loan reviewed that breached Morgan Stanley's representations and warranties, including those regarding fraud in the reporting of borrower income, assets, and intent to occupy the residence, and compliance with applicable underwriting guidelines related to borrower income, employment status, debt-to-income ratio, and loan-to-value ratio (*id.* ¶¶ 95-105). Under the First Department's decision in the Trustee Case, these allegations are sufficient to plead willful misconduct/gross negligence. Accordingly, FGIC's amendment is not "palpably insufficient or clearly devoid of merit," *Greystone*, 74 A.D.3d at 499, and should be allowed.

CONCLUSION

For all of the reasons set forth above, FGIC respectfully submit that the Court should grant FGIC's motion for leave to file an amended complaint.

Dated: New York, New York
February 26, 2019

Respectfully submitted,

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CERTIFICATION

Pursuant to Commercial Division Rule 17, I hereby certify that this Memorandum of Law is 3,376 words in length, excluding the caption, table of contents, table of authorities, and signature block. This word count was prepared using the Microsoft Word 2010 application.

/s/ *Henry J. Ricardo*
Henry J. Ricardo