# 14-1673-cv

IN THE

# United States Court of Appeals

## FOR THE SECOND CIRCUIT

FINANCIAL GUARANTY INSURANCE COMPANY,

*Plaintiff-Appellant,*

—against—

PUTNAM ADVISORY COMPANY, LLC,

*Defendant-Appellee.*

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

## REPLY BRIEF FOR PLAINTIFF-APPELLANT

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## INTRODUCTION

The district court did not question Plaintiff-Appellant FGIC's allegations that Defendant-Appellee Putnam repeatedly misrepresented to FGIC that Putnam would act independently as manager of Pyxis's assets in the best interest of Pyxis's long-term investors. Nor did the court question FGIC's allegations that Putnam was motivated to do Magnetar's bidding so that Putnam could gain a foothold in CDO management and earn above-ordinary fees. Notably, FGIC does not stand alone in making these allegations; the Massachusetts Securities Division and a group of investors in Pyxis each brought complaints against Putnam and obtained settlements.[1]

The district court dismissed FGIC's fraud claim solely on the basis that it fails to plead loss causation. That holding is erroneous for several independent reasons, none of which Putnam refutes in its appellate brief. At the threshold, the district court erred in finding that loss causation is a prerequisite at all, given New York Insurance Law § 3105's provision that, when an insurance applicant or someone acting "by the authority" of the applicant induces an insurer into issuing an insurance policy, the insurer may recover payments made under the policy without the need to show loss causation. N.Y. Ins. Law § 3105 (McKinney 2011).

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[1] *In the Matter of Putnam Advisory Co., LLC (Pyxis ABS CDOs)*, No. 2011-0035, Consent Order (Mass. Sec. Div. May 1, 2014); *Loreley Fin. (Jersey) No. 7 Ltd. v. Credit Agricole Corporate & Inv. Bank*, No. 650673/2010, Stip. Of Voluntary Discontinuance With Prejudice (N.Y. Sup. Ct. Oct. 29, 2010), Dkt. No. 103.

Seeking to evade this principle, Putnam mainly parrots the district court's reasoning that Putnam's misrepresentations were not made "by the authority" of the applicant for insurance (here, Calyon) simply because Calyon "presented" Putnam's statements to FGIC. But both Putnam and the district court disregard that FGIC alleged far more than mere presentation: Calyon, *after* seeing Putnam's written representations regarding Putnam's independence and expertise in a July 14, 2006 Pitchbook, A209-10, directed FGIC's questions to Putnam during the second half of July 2006 and thus authorized Putnam to make similar representations going forward, A212. Surely this qualifies as a plausible allegation that Calyon authorized *Putnam's making of those representations in the first instance*.

Even if FGIC were required to allege loss causation, Putnam's and the district court's conclusion that FGIC failed to do so rests on a mistaken premise: that Pyxis's default (and FGIC's resulting liability) is a *single monetary amount* that is either caused by general market forces or Putnam's fraud. In fact, loss causation is satisfied if the defendant's conduct caused "*an ascertainable portion* of th[e] loss." *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 175 (2d Cir. 2005) (emphasis added). Here, FGIC alleged that Putnam's choice of poor assets for Pyxis *exacerbated* Pyxis's default and FGIC's liability above and beyond any general market forces. In other words, even assuming *arguendo* that market forces would have caused Pyxis to default on the super senior tranche that FGIC insured, those forces did not dictate the *magnitude* of the default (and hence FGIC's liability). For example, suppose Putnam had stuck with the $145 million in prime RMBS indicated in its "target portfolio" rather than swapping these for subprime RMBS. Making the plausible assumption that only 50% of the prime RMBS would have defaulted (whereas 100% of Pyxis's subprime RMBS in fact defaulted), Pyxis would have had more valuable assets available to fund payments of principal and income to the super senior tranche. While it still may have fallen short of the full payment due to the super senior tranche, the shortfall (and hence FGIC's liability) would have been less.

Putnam devotes much of its brief to advancing alternative grounds for affirmance upon which the district court did not rely. Those grounds lack merit and should be rejected:

*First*, as to FGIC's standing, Putnam mischaracterizes FGIC as alleging only that it incurred "'potential liability of up to $900 million'" (Br. 19 (quoting A188, A245)). FGIC in fact paid a substantial amount to discharge that liability, and FGIC also clearly alleged, in a paragraph that Putnam ignores, that FGIC "*lost* millions when Pyxis defaulted." A185 (emphasis added).

*Second*, Putnam claims that FGIC has not alleged facts raising a strong inference of scienter, despite FGIC's extensive allegations that Putnam was motivated to commit fraud by the prospect of unusually large and guaranteed fees, and that Putnam engaged in a course of conscious misbehavior by secretly following Magnetar's instructions rather than exercising its own independent investment expertise.

*Third*, while Putnam concedes that it represented that it would independently control the management of the Pyxis asset pool, it asserts that it lived up to that promise and thus committed no misrepresentation. But FGIC alleges in substantial detail, based on documentary evidence specifically relating to Pyxis, that Putnam failed to do so; instead, Putnam complied with Magnetar's demands. A196, 199-208. At best, Putnam raises a factual dispute inappropriate for resolution on a motion to dismiss.

Because the district court's loss-causation holding is in error and Putnam's alternative grounds for affirmance lack merit, the judgment of dismissal should be reversed and the fraud claim reinstated. Putnam's negligence-based claims should be reinstated as well under *Bayerische Landesbank v. Aladdin Capital Mgmt. LLC*, 692 F.3d 42 (2d Cir. 2012). The district court and Putnam improperly distinguish a financial guaranty insurer such as FGIC from a CDO investor such as the plaintiff in *Bayerische*. Both an insurer and a CDO investor rely on the collateral manager's exercise of its expertise in managing the asset pool, and both are important stakeholders in the CDO—in fact, the insurer is even more important than any single investor because the CDO transaction frequently (including here) cannot proceed without the insurance.

## ARGUMENT

### I. PUTNAM'S CHALLENGE TO FGIC'S STANDING MISCHARACTERIZES THE SECOND AMENDED COMPLAINT

Putnam's argument (Br. 18-21) that FGIC lacks standing rests on a misreading of the Second Amended Complaint ("SAC"). FGIC has consistently alleged that it "lost millions" as a result of Pyxis' default. *See, e.g.*, A185 ("FGIC … lost millions when Pyxis defaulted."); A245 ("FGIC Lost Many Millions As A Direct Result Of Putnam's Fraud"); A13 ("FGIC lost millions."). These are hardly the "[a]llegations of *possible* future injury" found inadequate in *Clapper v. Amnesty International USA*, 133 S. Ct. 1138, 1147 (2013) (quoting *Whitmore v. Arkansas*, 495 U.S. 149, 158 (1990)) (alteration and emphasis by *Clapper*).

Putnam ignores these allegations and focuses instead on a separate allegation that, when Pyxis defaulted, FGIC incurred "'potential liability of up to $900 million.'" Br. 19 (quoting A188, 245). Read in context with the allegations discussed above, it is clear that FGIC was alleging that it had already paid millions to discharge its liability,[2] and the only remaining question was whether FGIC

[2] Specifically, FGIC and Calyon entered into a settlement, before FGIC filed its original complaint, under which FGIC discharged its liability to Calyon for less than the face amount of that liability. The amount of the FGIC-Calyon settlement

might obtain some further recovery from Putnam in this lawsuit that would reduce FGIC's liability.

Contrary to Putnam's suggestion (Br. 21), FGIC's actual losses are no less real (or traceable to Putnam's misconduct) because they involved FGIC's guaranty of its subsidiary's obligations rather than any obligations incurred by FGIC directly to third parties. Because FGIC's guaranty made it responsible for its subsidiary's obligations, A187, it is entirely appropriate to examine the misconduct by Putnam that led to the subsidiary's obligations. Nor does Calyon's involvement mean that FGIC's injury is not traceable to Putnam. Tort law recognizes that multiple actors can contribute to a single injury so long as each was "a substantial factor in the sequence of responsible causation." *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994) (internal quotation marks omitted). And FGIC amply alleged that both Calyon and Putnam were involved in the communications to FGIC that induced FGIC to provide the insurance. *See, e.g.*, A212 ("FGIC had e-mail correspondence with Putnam through Calyon, in which Calyon forwarded FGIC's questions to Putnam and then forwarded Putnam's responses to these questions to FGIC.").

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with Calyon is confidential, but can be inquired into (with appropriate protections) on remand so that FGIC does not obtain an excess recovery from Putnam.

## II. PUTNAM FAILS TO REFUTE THAT NEW YORK INSURANCE LAW § 3105 APPLIES HERE AND ALLOWS RESTORATION OF THE STATUS QUO ANTE WITHOUT ANY LOSS-CAUSATION REQUIREMENT

FGIC argued (Br. 22-25) that the district court committed a threshold legal error by imposing any loss-causation requirement at all because it is well-settled in the insurance-law context that an insurer need establish only transaction causation before a court will restore the status quo ante by allowing the insurer to recover payments already made under the policy. *See* N.Y. Ins. Law § 3105; 6 COUCH ON INSURANCE § 82:20 (3d ed. June 2014) ("[I]t is immaterial that there is no causal or other relationship between the actual loss which is sustained under the policy and the falsity of the representation."). FGIC explained (Br. 24-25) that the district court's basis for deeming the insurance-law rule inapplicable—that Putnam's misrepresentations were not made "by the authority of" the applicant for the insurance (Calyon)—erroneously disregards, *inter alia*, that Calyon directed FGIC's questions to Putnam *after* Calyon was already aware from Putnam's prior writings what representations Putnam was making. Putnam's responses are unpersuasive.[3]

[3] Financial guaranty insurance is covered by the New York Insurance Law. N.Y. Ins. Law § 6908 (Consol. 2014). The insurance-law rule's omission of any loss-causation requirement is illustrated by *Glickman v. N.Y. Life Ins. Co.*, 291 N.Y. 45, 49-50, 52, 50 N.E.2d 538, 538-40 (1943). The court held that an insurer could not be bound by a life insurance policy where the applicant had misrepresented in his application that he had not received medical treatment (when in fact he had

1. Putnam repeats (Br. 27) the district court's rationale that FGIC's allegations that Calyon "presented" Putnam's misrepresentations to FGIC, SPA24, do not suffice to allege that Putnam's statements were "made to [FGIC] . . . by the authority of [Calyon]," N.Y. Ins. Law § 3105(a). The court reasoned that "made" cannot simply mean "presented," and that instead the non-applicant (here, Putnam) must have been acting "by the authority of" the applicant when the non-applicant wrote (or spoke) the statements in the first instance, before they were presented to the insurer. SPA23-24.

That interpretation may have merit insofar as it ensures that the non-applicant is not held liable absent a link between the applicant and the non-applicant at the time the non-applicant made its statements. But the district court erred in applying it to the allegations here. Specifically, the court erroneously construed FGIC as alleging a one-time statement by Putnam followed by a one-

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received treatment for an ulcer); the insurer issued the policy; and the applicant/insured then died from "coronary sclerosis" rather than an ulcer. Allowing the insurer to recover based on a showing of transaction causation (without needing to show loss causation) rests on two important rationales. From the insurer's standpoint, it allows the insurer to obtain and to rely upon the applicant's representations as to the risk being insured *before* the insurer commits to provide the insurance. *See, e.g.*, *Vander Veer v. Cont'l Cas. Co.*, 34 N.Y.2d 50, 52-53, 312 N.E.2d 156, 157 (1974) ("As an insurer, the defendant is free to select its risks and it makes inquiry of matters which it deems material to the risk."). From the applicant's (or its agent's) standpoint, it removes the perverse incentive that would exist if "the insured could freely misrepresent information specifically requested and still recover on the policy if the causal connection could not be traced." *Ginsburg v. Pac. Mut. Life Ins. Co.*, 89 F.2d 158, 159 (2d Cir. 1937).

time presentation of that statement by Calyon to FGIC. To the contrary, the FGIC alleges that, *after* Calyon had already seen and presented Putnam's representations on July 14, 2006 in the Pyxis Pitchbook, A209-10 (wherein Putnam represented that it would independently exercise its expertise in pursuit of "'excellent *long term* investment results'") (quoting Pitchbook and adding emphasis), Calyon, during "the second half of July 2006," "forwarded FGIC's questions to Putnam and then forwarded Putnam's responses to these questions to FGIC," A212; *see also id.* (Putnam's answers "repeated and reinforced its [earlier] representations that it would control the selection and management of the Pyxis Portfolio"). Because Calyon had already seen the Pitchbook, Calyon knew in forwarding FGIC's subsequent questions to Putnam that Putnam would continue to give similar answers. In doing so, Calyon authorized Putnam to give those answers; put another way, Putnam acted with the "apparent authority" of Calyon in giving the answers. *See* Restatement (Third) of Agency § 3.03 ("Creation of apparent authority") cmt. b (2006) ("If the third party [here, FGIC] has observed prior interactions between the agent [Putnam] and the principal [Calyon], the third party may reasonably believe that a subsequent act or representation by the agent is authorized because it conforms to the prior pattern observed by the third party."); *see also Minskoff v. Am. Express Travel Related Servs., Inc.*, 98 F.3d 703, 708 (2d

Cir. 1996) ("The existence of apparent authority is normally a question of fact, and therefore inappropriate for resolution on a motion for summary judgment.").[4]

2. Putnam argues that FGIC does not seek to "defeat recovery" under an insurance contract within the meaning of Section 3105 because "Putnam was not a party to the Guaranty." Br. 26. But Putnam elsewhere concedes (Br. 13) that it was a party to another related contract, the Collateral Management Agreement, and thus was hardly a bystander to the Pyxis Transaction, a central component of which was the procurement of insurance from FGIC. The New York Appellate Division's recent decision in *MBIA Insurance Corporation v. Countrywide Home Loans, Inc.*, which the district court did not discuss on this point, makes clear that no more is necessary. Like Putnam, the defendant in that case was involved in the broader transaction but was not a party to the insurance policies. *See MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, 34 Misc.3d 895, 904, 936 N.Y.S.2d 513, 520-21 (N.Y. Sup. Ct. 2012), *aff'd in relevant part*, 105 A.D.3d 412, 963 N.Y.S.2d

[4] For its part, Putnam knew that the Pitchbook and its subsequent e-mails would be conveyed by Calyon to FGIC in connection with Calyon's ongoing insurance application. And Putnam soon made such statements directly to FGIC in a face-to-face meeting on August 3, 2006. A213. There is accordingly no concern that Putnam is unjustly being held responsible. Putnam is akin to a doctor who knows that his patient is applying for life insurance and provides to the patient (to forward in turn to the insurer), or provides directly to the insurer, a falsified medical report that fails to disclose the patient's health problems. New York Insurance Law § 3105 would provide scant protection if it prevented the insurer from unwinding such a policy.

21 (1st Dep't 2013). Rather, the insured entities were asset-holding vehicles that the defendant sponsored and on whose behalf it applied for insurance. 34 Misc.3d at 905. Nevertheless, the Appellate Division held that the plaintiff insurer, in seeking damages from the defendant in the amount of "payments made pursuant to an insurance policy," was permissibly seeking to "defeat[] recovery" under the insurer's policies within the meaning of Section 3105. 105 A.D.3d at 412.[5]

Contrary to Putnam's related assertion (Br. 28), the fact that a subsequent portion of the decision rejected a separate legal theory (described as "rescissory damages" or "rescission") that would have led to similar relief, 105 A.D.3d at 413, does not undermine the court's earlier holding. Putnam, like the defendant in *MBIA*, fails to "explain why 'defeat[ing] recovery thereunder' cannot refer to the recovery of payments made pursuant to an insurance policy *without resort to rescission*." *Id.* at 412 (emphasis added).[6]

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[5] *See also Syncora Guar. Inc. v. EMC Mortg. Corp.*, 874 F. Supp. 2d 328, 337 (S.D.N.Y. 2012) (approvingly citing lower court's holding in *MBIA v. Countrywide* that the insurer's fraud claim was governed by Section 3105, and thus that there was "no basis in law … to mandate that [the insurer] establish a direct causal link between the misrepresentations allegedly made by Countrywide and claims made under the policy"); *Assured Municipal Guar. Corp. v. Flagstar Bank, FSB*, 892 F. Supp. 2d 596, 601-03 (S.D.N.Y. 2012) (agreeing with *Syncora*).

[6] *MBIA* also disposes of Putnam's argument that FGIC's interpretation would improperly abrogate the common law. This argument was made by Countrywide, *see* Reply Br. And Opp. To Cross Appeal For Defendants-Appellants-Respondents at 22, *MBIA Ins. Corp. v. Countrywide Home Loans Inc.*, No. 602825/2008 (1st

3. Although this Court need not reach beyond the insurance-law context to hold that FGIC is not required to allege loss causation, general principles of New York tort law also point to that conclusion. *See* FGIC Br. 17-22. Putnam's responses are again unpersuasive. Putnam's contention (Br. 25) that FGIC waived its argument ignores that the district court found no waiver and instead addressed the argument on the merits. SPA25 n.2. And Putnam's assertion (Br. 22) that the SAC fails to allege a claim for "rescission" ignores that the SAC explicitly asks for similar relief, *i.e.*, that FGIC "be restored to the status quo ante." A252; *see also* A257 (prayer for relief seeking, primarily, "damages to restore [FGIC] to the status quo ante," and, independently and secondarily, "compensatory damages in amounts to be determined at trial"); *compare* Putnam Br. 28 (incorrectly describing the SAC's prayer as seeking "only monetary damages as a legal remedy").[7]

## III. THE SECOND AMENDED COMPLAINT IN ANY EVENT ADEQUATELY ALLEGES LOSS CAUSATION, AND PUTNAM'S ARGUMENT TO THE CONTRARY ERRONEOUSLY SIMPLIFIES DEFAULT AS AN ALL-OR-NOTHING EVENT

FGIC argued (Br. 29-39) that, even if it is required to allege loss causation to pursue restoration of the status quo ante, it satisfies that requirement. In particular,

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Dep't Dec. 17, 2012), but was rejected by the Appellate Division, 105 A.D.3d at 414 (rejecting "the parties' remaining arguments").

[7] As discussed *supra*, at 10-11, *MBIA* makes clear that there is no loss-causation prerequisite to FGIC's primary requested relief of "restor[ation] to the status quo ante" by recovery of payments made under the policy.

FGIC argued (Br. 32-33) that, even if general market conditions would have caused Pyxis to default on the super senior tranche regardless of Putnam's misconduct, default is not an all-or-nothing event that causes a loss of a single monetary amount. As FGIC explained, a plaintiff need only allege that the fraud caused "an ascertainable portion of [its] loss," *Lentell*, 396 F.3d at 175, not that the fraud caused "all" of the loss, *id.* *See also First Nationwide Bank*, 27 F.3d at 769 (defendant's conduct need only be a "substantial factor," not the exclusive factor, "in the sequence of responsible causation") (internal quotation marks omitted); *Landesbank Baden-Württemberg v. RBS Holdings USA Inc.*, --- F. Supp. 2d ---, No. 12 Civ. 5476, 2014 WL 1388408, at *19 (S.D.N.Y. Apr. 9, 2014) ("Plaintiffs have adequately alleged that the drop in the Certificates' value was caused by Defendants' misstatements in the Offering Materials, and that *the Certificates' value would have been much higher—notwithstanding the collapse in the housing market—had Defendants not committed fraud*.") (emphasis added).

Here, Putnam's selection of toxic assets could plausibly have increased the *magnitude* of the default and hence of FGIC's liability. As discussed in the Introduction, *supra*, at 3, FGIC alleges that Putnam, had it exercised the independent judgment it promised, would have purchased $145 million in prime (rather than subprime) RMBS for Pyxis, as indicated in Putnam's own "target portfolio," A215. Those prime RMBS would not have defaulted to the same extent that Pyxis's subprime RMBS in fact did.[8] If 50% of the $145 million of prime RMBS would have defaulted during the general economic crisis, compared to the 100% of $145 million of subprime RMBS in the Pyxis portfolio that in fact defaulted, Pyxis would have had more valuable assets in the collateral pool to fund payments of principal and income to the super senior tranche, and FGIC's insurance obligation would have been correspondingly less. *See* A246 (¶ 154).[9]

To the extent there is a dispute over how much less, or the exact causal sequence, it is inappropriate for resolution on a motion to dismiss. *See, e.g.*, *Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) ("[I]f the loss was caused by an intervening event, like a general fall in

[8] The SAC alleges that the mortgage loans that underlie prime RMBS are made to "'prime' borrowers, that is, those with high credit scores … and other characteristics indicating a high likelihood of repayment of the loan," whereas the mortgage loans that underlie subprime RMBS "consist of loans made to higher risk borrowers." A211. Because the SAC further alleges that some 28% of "non-Magnetar mezzanine CDOs," *i.e.*, CDOs holding subprime RMBS, did not in fact default during the economic crisis, A246-47, it is reasonable to infer that an even higher percentage of CDOs holding prime RMBS did not default during that period. *See also, e.g.*, Nat'l Ass'n Of Ins. Comm'rs and The Center For Insurance Policy & Research, *Capital Markets Special Report* (Aug. 9, 2012), *available at* http://www.naic.org/capital_markets_archive/120809.htm (last visited Aug. 20, 2014) (graphs reporting, as of January 2012, that over 50% of 2006-vintage subprime loans had defaulted, compared to 8% of 2006-vintage prime loans).

[9] Contrary to Putnam's assertion (Br. 33), the SAC expressly alleges that it was Magnetar that directed the change from prime to subprime RMBS. A236, 246-47. Additional examples in the remaining 90% of the Pyxis asset pool (*i.e.*, beyond the 10% that consisted of the $145 million in subprime RMBS) may well be identified during discovery, which has not been allowed to proceed yet.

the price of Internet stocks, the chain of causation . . . is a matter of proof at trial and not to be decided on a Rule 12(b)(6) motion to dismiss"); *Dexia SA/NV v. Bear, Stearns & Co., Inc.*, 929 F. Supp. 2d 231, 243 (S.D.N.Y. 2013) ("*Lentell* does not place upon plaintiffs the heavy burden of pleading facts sufficient to exclude other non-fraud explanations.") (internal quotation marks omitted); *MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, 87 A.D.3d 287, 296, 928 N.Y.S.2d 229, 235 (1st Dep't 2011) ("It cannot be said, on this pre-answer motion to dismiss, that MBIA's losses were caused, as a matter of law, by the 2007 housing and credit crisis.").

On that basis alone, the court's judgment of dismissal should be reversed.[10] In any event, Putnam's responses to FGIC's other arguments are unpersuasive.

1. Putnam cannot refute at the motion-to-dismiss stage FGIC's allegation that $95.5 million of known Magnetar-selected assets defaulted before the events that precipitated the financial crisis even began, and that their default could therefore not have been caused by the financial crisis. A249-50. Certainly, the question of exactly *when* the financial crisis occurred is a factual one that warrants

[10] That is so regardless whether a heightened pleading standard applies. We note that, while the standard was left undecided in *Acticon AG v. China N.E. Petroleum Holdings, Ltd.*, 692 F.3d 34, 38 (2d Cir. 2012), district courts in this Circuit have uniformly held that loss causation need be pleaded only under Fed. R. Civ. P. 8. *See, e.g.*, *In re Bristol Myers Squibb Co. Sec. Litig.*, 586 F. Supp. 2d 148, 163 (S.D.N.Y. 2008); *CompuDyne Corp. v. Shane*, 453 F. Supp. 2d 807, 828 (S.D.N.Y. 2006).

discovery and resolution at summary judgment or trial. *Cf.*, *e.g.*, *MBIA*, 87 A.D.3d at 296, 928 N.Y.S.2d at 235. And even accepting Putnam's answer to that question, it remains the case that the higher the percentage of toxic assets in the Pyxis pool, the earlier they would have defaulted, even if they would have defaulted in any event later during the crisis. A246 ("Had Putnam selected the Pyxis collateral itself, . . . Pyxis would not have defaulted as quickly . . . ."). Given the time value of money, FGIC's obligation to cover resulting shortfalls to the super senior tranche earlier rather than later is a cognizable loss caused directly by Putnam rather than by any general market forces.

2. Putnam fails persuasively to address FGIC's allegations that CDOs of comparable vintage and collateral class did not default as quickly as Magnetar's CDOs, and, indeed, that many have not defaulted at all. A246-47. Putnam responds (Br. 32) that, because of variables other than vintage and collateral class, the non-Magnetar CDOs referenced by FGIC might not be comparable to Magnetar's CDOs. But that is again a question of fact, which will require analysis by expert witnesses. Assuming the truth of FGIC's well-pleaded allegations that the non-Magnetar CDOs were comparable, it is, at a minimum, plausible that Putnam would have selected assets that would not have caused Pyxis to default with the same severity or speed as it did.

3. FGIC argued (Br. 29-31) that loss causation may be reasonably inferred from the SAC's numerous—and hardly "conclusory" (Putnam Br. 30)—allegations that the entire purpose of Putnam's fraud was to allow Magnetar to select collateral that would cause Pyxis to default, which would benefit Magnetar while harming FGIC. Contrary to Putnam's assertion that loss causation may not be inferred from purpose (Br. 30-31), numerous courts have drawn such an inference. *See, e.g.*, *ACA Fin. Guar. Corp. v. Goldman, Sachs & Co.*, 951 N.Y.S.2d 84, 2012 N.Y. Misc. LEXIS 1940, at *40-42 (N.Y. Sup. Ct. Apr. 23, 2012) (sustaining fraud claim alleging that, "[a]s Goldman Sachs and Paulson intended from the outset, . . . Paulson's influential role in selecting the reference portfolio had a direct and adverse impact on the performance of every long position in [the CDO], including the Financial Guaranty"), *rev'd on other grounds*, 106 A.D.3d 394, 963 N.Y.S.2d 210 (1st Dep't 2013); *Basis Yield Alpha Fund (Master) v. Goldman Sachs Grp., Inc.*, 115 A.D.3d 128, 980 N.Y.S.2d 21 (1st Dep't 2014) (sustaining fraud claim alleging that a CDO underwriter and structurer intentionally placed toxic assets into the CDO); *Loreley Fin. (Jersey) No. 3 Ltd. v Citigroup Global Mkts. Inc.*, No. 650212/12, 987 N.Y.S.2d 299, 301, 307-08, 2014 N.Y. App. Div. LEXIS 3300, at *3-4, 23 (1st Dep't May 8, 2014) (same).

## IV. PUTNAM'S ALTERNATIVE GROUNDS FOR AFFIRMANCE LACK MERIT

### A. The Second Amended Complaint Adequately Alleges Scienter

As Putnam recognizes, a strong inference of fraudulent intent may be established either (a) by alleging "facts . . . to show that [defendants] had both a motive and opportunity to commit fraud," or (b) by alleging facts that constitute "strong circumstantial evidence of conscious misbehavior or recklessness." Putnam Br. 37-38 (citing *Landesbank Baden-Württemberg v. Goldman, Sachs & Co.*, 478 Fed.Appx. 679, 681 (2d Cir. 2012) (summary order)); *see also O'Brien v. Nat'l Prop. Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991) (similar). The SAC satisfies both of these criteria.

#### 1. The Second Amended Complaint Alleges That The Prospect Of Assured, Lucrative Management Fees Gave Putnam A Motive To Commit Fraud

FGIC alleges that Putnam had a compelling motive to commit fraud—namely, to secure unusually large fees (with relatively little effort or risk) for serving as the collateral manager for Pyxis. A227. Putnam's motive was especially strong because Putnam was looking to gain a foothold in the CDO collateral management field. A203.

Putnam's assertion (Br. 41-42) that its fees for managing Pyxis were not unusually large focuses solely on the fee *percentage* (20 basis points rather than the customary 40 basis points for CDO collateral managers), and ignores the volume of assets to which that percentage was applied. Because Pyxis was almost four times as large as a typical CDO, the dollar value of Putnam's fees was almost twice as high as a typical CDO manager's. A201. The fees stood to be not only large, but "virtually assured" to be paid, as shown by e-mails between Magnetar, Deutsche Bank, and Calyon. A201-02, 227-228. These e-mails explained these advantages in order to justify Magnetar's demand that the collateral manager on one of its non-Pyxis CDOs ("NIB") should agree to let Magnetar terminate the manager at will; one of the e-mails expressly states that "Putnam got it. NIB doesn't." A227.[11] Moreover, Putnam secured additional lucrative deal volume, with similarly high guaranteed fees, from its cooperation with Magnetar when it was chosen as the collateral manager for Pyxis 2 a few months after Pyxis closed—which would certainly not have happened had Putnam not cooperated with Magnetar on Pyxis. *See* A203, 245.

Putnam's argument (Br. 38-42) that its fees on Pyxis and Pyxis 2, totaling $8.1 million, do not support an inference of Putnam's motive to commit fraud raises a question of fact that cannot be resolved on a motion to dismiss. Putnam's

[11] Putnam asserts (Br. 40-41) that these e-mail exchanges are irrelevant because Putnam personnel were not copied on them and they related to a different deal and collateral manager. Putnam ignores that these e-mails describe the characteristics of all Magnetar deals, including Pyxis, and that they specifically contrast collateral manager NIB's non-compliance with Magnetar's demands with Putnam's compliance with those demands.

further assertion that payment of its fees "were contingent upon the successful performance of Pyxis in all respects" (Br. 38) is belied by the fact that, because of Magnetar's control of Pyxis, Putnam continued to receive its fees long after Pyxis began to fail, and even after it suffered an event of default. A202-03. In any event, Putnam's contention (Br. 38) that, if Pyxis had not defaulted, it would have received more fees than it in fact received, is irrelevant: If Putnam had not agreed to cooperate with Magnetar's scheme, it would not have been selected to manage Pyxis—or been granted the further reward of managing Pyxis 2—and would thus have received *no* fees at all. A201, 203, 245.[12]

### 2. The Second Amended Complaint Alleges That Putnam Engaged In Conscious Misbehavior And/Or Recklessness

The SAC also sets forth numerous allegations of Putnam's conscious misbehavior and/or recklessness. For example, the SAC alleges that, while

[12] Contrary to Putnam's assertion (Br. 38-39), the desire to earn fees, including from prospective additional deals, that are both higher and more assured than normal may support an inference of motive. *See Tellabs, Inc. v. Makor Issues & rights, Ltd.*, 551 U.S. 308, 325 (2007) ("[P]ersonal financial gain may weigh heavily in favor of a scienter inference"). This Court's unpublished summary order in *Alki Partners, L.P. v. Windhorst*, 472 Fed.Appx. 7 (2d Cir. 2012) (summary order) (cited at Putnam Br. 42), is not to the contrary. Its holding that "a desire to earn transactional fees" is not sufficient to allege motive, *id.* at 10, was predicated on *Friedman v. Arizona World Nurseries L.P.*, 730 F. Supp. 521, 532 (S.D.N.Y. 1990), *aff'd*, 927 F.2d 594 (2d Cir. 1991), which merely held that "the receipt of normal compensation for professional services rendered" is not sufficient to support an inference of motive. *Alki*'s further holding that a generalized "desire to cultivate business relations" does not support an inference of motive, 472 Fed.Appx. at 10, is inapplicable here, where a concrete and lucrative opportunity (Pyxis 2) was in the offing.

Putnam was representing to FGIC that it would act independently in the best interests of Pyxis's long investors, Putnam was complicit in a "behind the scenes" side letter giving Magnetar and Deutsche Bank "veto rights" over any collateral proposed for Pyxis. A221-22.

Putnam's response again raises factual disputes inappropriate for resolution on a motion to dismiss. For example, while Putnam asserts (Br. 49) that FGIC fails to allege that the side agreement was actually executed or that Putnam was aware of it, Putnam ignores the allegations and evidence that point clearly to Putnam's involvement: (1) the side letter expressly imposed obligations on Putnam, requiring "*Calyon or the Investment Adviser [Putnam]* … promptly [to] provide . . . notification" of any proposed asset purchases, A221-22 (quoting side letter and adding emphasis); (2) Putnam acted consistently with the side letter, allowing Magnetar not only to veto such investments but directly to acquire assets for Pyxis, A222-27; and (3) evidence has come to light in lawsuits relating to other Magnetar CDOs of similar "veto" or "pre-ok" arrangements, A237-45.

Beyond the side letter, the SAC sets forth further allegations of conscious misbehavior, including that (1) Putnam willfully acquiesced in and aided Magnetar's shorting of Pyxis at the same time as it was allowing Magnetar to control collateral selection, A226-31; (2) Putnam provided FGIC with a final "target portfolio" for Pyxis that included $145 million of prime RMBS, but then, without alerting investors or FGIC, replaced all of these prime RMBS in the final portfolio with subprime RMBS that were much more likely to default, favoring Magnetar, A214-15, 236; and (3) Putnam, in collusion with Calyon, actively concealed Magnetar's involvement in Pyxis from Pyxis investors and FGIC, A218-19. These allegations together provide strong circumstantial evidence of conscious misbehavior and thus independently support an inference of scienter at the complaint stage.

### B. The Second Amended Complaint Adequately Alleges That Putnam Misrepresented That It Would Select The Pyxis Portfolio Independently

Putnam does not dispute that it represented to FGIC that it would select the Pyxis collateral itself, acting independently and in good faith in the interests of long investors. *See* A208-15, 217-18.[13] Nevertheless, Putnam asserts (Br. 48-51) that the SAC does not adequately allege that these statements were *mis*representations; in other words, according to Putnam, the SAC's allegations portray a Putnam that lived up to its promise to act independently in the best interests of Pyxis and its long investors.

[13] Putnam's assertion (Br. 54-55) that FGIC was aware that some party must necessarily be taking short positions on Pyxis' synthetic assets is irrelevant. What matters is that Putnam concealed that the party taking those positions *also controlled Pyxis collateral selection*, and affirmatively misrepresented that *Putnam* would do so.

Putnam bases this argument almost entirely on the incorrect assertion (Br. 48-49) that FGIC has not alleged that the secret side agreement granting Magnetar "veto powers" over Pyxis collateral selection was executed, *see supra*, at 21, and on a single piece of FGIC's extensive portfolio analysis, which Putnam reads (Br. 49) in isolation. Putnam ignores all of the other allegations in the SAC showing that Magnetar directed collateral selection, including: (1) evidence, disclosed in numerous lawsuits relating to Pyxis,[14] that Magnetar told Putnam what collateral it wanted in the Pyxis portfolio and that it intended to short this collateral, and that Putnam made clear its willingness to accommodate Magnetar, A219-26, 230-31; (2) evidence that Deutsche Bank described Magnetar's CDOs, including Pyxis, as "not CDOs but . . . structured separate accounts [for the benefit of Magnetar and Deutsche Bank]," and stated that "Putnam got it," A227; (3) portfolio analysis showing massive overlaps between Pyxis and other Magnetar CDOs, and other evidence of Magnetar-favored collateral in the Pyxis portfolio, A230; and (4) e-mail evidence from litigations relating to other Magnetar CDOs

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[14] Contrary to Putnam's assertion (Br. 43), FGIC may properly rely on factual allegations based on documentary evidence and testimony that has been disclosed in other cases. *See IBEW Local 9 Pension Fund v. Deutsche Bank AG*, Index No. 11-cv-4209 (KBF), 2013 U.S. Dist. LEXIS 43774, at *3-4 (S.D.N.Y. Mar. 27, 2013) (declining to dismiss where "[t]he bulk of the allegations in the Amended Complaint are drawn from alleged misconduct set forth in a [U.S. Senate] report … and [other complaints]").

showing that Magnetar exercised exactly the same control over asset selection on its other CDOs, A236-45.[15]

By contrast, the allegations in *Loreley Financing (Jersey) No. 3 Ltd. v. Wells Fargo Securities, LLC*, No. 12 Civ. 3723, 2013 WL 1294668, at *9 (S.D.N.Y. Mar. 28, 2013) (cited at Putnam Br. 37), were based exclusively on a small handful of e-mails, none of which provided direct evidence of Magnetar's involvement in asset selection, *id*. at *10-12.

## V. PUTNAM FAILS TO DISTINGUISH *BAYERISCHE* CONCERNING THE SPECIAL-RELATIONSHIP ELEMENT OF FGIC'S NEGLIGENCE CLAIMS

FGIC explained (Br. 39-44) that the SAC is indistinguishable from the complaint in *Bayerische*, 692 F.3d at 42, which this Court held sufficient to allege the special-relationship element of negligent misrepresentation. In both *Bayerische* and this case, the special relationship concerned the plaintiff's reliance on the defendant's ongoing exercise of professional expertise, discretion, and judgment in managing assets. Contrary to Putnam's suggestion (Br. 58 n.19), the SAC does not allege a different theory—which courts have frequently rejected, *see, e.g.*, *HSH Nordbank AG v. UBS AG*, 95 A.D.3d 185, 941 N.Y.S.2d 59 (1st

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[15] Putnam's assertion (Br. 13-15) that FGIC has not adequately alleged that the Pyxis portfolio failed to comply with the eligibility requirements for Pyxis is irrelevant because the misrepresentations at issue concern how Putnam was going to choose (*i.e.*, independently and in Pyxis's best interest) *among the panoply of eligible assets*.

Dep't 2012) (cited at Putnam Br. 53)—that a non-manager defendant failed to disclose certain factual details regarding the components of an investment vehicle.

Putnam's other arguments similarly lack merit.

1. Putnam contends (Br. 56-58) that a relationship approaching privity is required for a special relationship, which in turn requires that the benefit to the non-party be the "end and aim" of the transaction; and that this was established in *Bayerische* by the fact that the investor was a third-party beneficiary of the portfolio management agreement. However, *Bayerische* expressly held that the manager's duty of care arose *not* out of the contract but "out of the independent characteristics of the relationship between [the investor] and [the collateral manager]." *Bayerische*, 692 F.3d at 59. Similarly here, Putnam's duty of care arises out of facts separate from any contract: FGIC's reliance on Putnam's expertise as a collateral manager, and Putnam's knowledge and direct encouragement of such reliance by its express representations made both in the offering materials and in direct face-to-face communications that it would exercise its expertise in the interest of Pyxis's long investors and FGIC. A252-55. Further, the "end and aim" of the Pyxis transaction was to provide investors and FGIC with a portfolio selected by Putnam (not by a third party with interests directly adverse to theirs), and the procurement of insurance from FGIC or some other insurer was critical to the transaction proceeding in the first place.

2. Putnam asserts (Br. 56-58) that disclaimers in the Pyxis offering materials preclude a special relationship. But materially identical disclaimers in the *Bayerische* Offering Circular did not bar a holding that a "special relationship" was adequately pled, and neither do the disclaimers here.

*First*, one of the disclaimers on which Putnam relies advises investors not to rely on representations other than those made in the Offering Memorandum; but Putnam's representation that it would select the collateral itself was made *in the Offering Memorandum*, A250, as well as in person and by e-mail, and thus this disclaimer does not apply to it.

*Second*, the disclaimer that investors should "rely on their own examination of the co-issuers and the terms of the offering" is likewise irrelevant, because FGIC *did* rely on the "terms of the offering," one of which was that Putnam would select the collateral; moreover, FGIC did its own extensive due diligence into Putnam's expertise and investment strategies. A210-12.

*Third*, the disclaimer that Putnam was not acting in the capacity of a "fiduciary" or "financial advisor" did not bar FGIC from relying on Putnam's direct representations made in the context of the special relationship between the two parties. Putnam's case citations—*HSH*, 95 A.D.3d at 185, *M&T Bank Corp. v. Gemstone CDO VII Ltd.*, 68 A.D.3d 1747, 891 N.Y.S.2d 578 (4th Dep't 2009), and *Landesbank Baden-Württemberg v. Goldman, Sachs & Co.*, 821 F. Supp. 2d 616, 624 (S.D.N.Y. 2011)—are inapposite because (1) they involved "typical arms-length business transactions" rather than, as here, a relationship of trust and confidence predicated on FGIC's known reliance on Putnam's expertise and Putnam's representations of aligned interests; and (2) they involved allegations that the defendant misrepresented the quality of the CDO's portfolio, not, as here, that the defendant misrepresented the how (and who) of asset selection. Contrary to Putnam's assertion (Br. 58 n.19), this is a crucial distinction because, unlike in those cases, where the CDO's credit quality was verifiable, FGIC could not have known before issuing the insurance that Putnam would fail to exercise its expertise and instead cede control over collateral selection to a third party with interests adverse to FGIC's.

3. Finally, Putnam contends (Br. 62-63), relying on its loss-causation argument regarding FGIC's fraud claim, that FGIC's negligent misrepresentation and negligence claims should be dismissed. As shown in Points II and III, *supra*, and in FGIC's opening brief, the fraud claim should not have been dismissed on loss-causation grounds. The same analysis applies to the negligence-based claims. *See Krinsky v. Title Guar. & Trust Co.*, 163 Misc. 833, 839, 298 N.Y.S. 31, 37 (App. Term 1st Dep't 1937) (applying the New York insurance-law rule to "an action based upon rescission for misrepresentations") (emphasis omitted); *Process Plants Corp. v. Beneficial Nat'l Life Ins. Co.*, 53 A.D.2d 214, 216, 385 N.Y.S.2d

308, 310 (1st Dep't 1977) (predecessor to N.Y. Ins. Law § 3105 applied even to innocent misrepresentations).

## CONCLUSION

The judgment should be reversed.

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August 20, 2014

Respectfully submitted,

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/s/ Sanford I. Weisburst 8/20/2014

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