IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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<tr>
<td>FINANCIAL GUARANTY
INSURANCE COMPANY,

Plaintiff,

v.

THE PUTNAM ADVISORY COMPANY,
LLC,

Defendant.</td>
<td>Case No. 12-cv- 7372 (RWS)

ECF CASE
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Contains Confidential Information Under the Court Order Dated June 3, 2015 [ECF No. 47]</td>
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PLAINTIFF'S MEMORANDUM OF LAW IN SUPPORT OF ITS MOTION FOR PARTIAL SUMMARY JUDGMENT

Date: September 21, 2018

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Plaintiff Financial Guaranty Insurance Company ("FGIC") respectfully submits this memorandum of law in support of its motion for partial summary judgment against Defendant The Putnam Advisory Company, LLC ("Putnam").

PRELIMINARY STATEMENT

This lawsuit arises out of Putnam's fraudulent and negligent misrepresentations and omissions concerning control of collateral selection for a collateralized debt obligation ("CDO") called Pyxis ABS CDO 2006-1 ("Pyxis"), and concerning the nature, quality, and concentration of the collateral to be included in Pyxis. Putnam, the collateral manager, made these representations and omissions to induce FGIC to provide a financial guaranty insurance policy on the $900 million super-senior tranche of Pyxis debt obligations (the "Pyxis Guaranty"). In 2009, after Pyxis collapsed, FGIC paid $74.5 million to commute its liability under the Pyxis Guaranty, a payment that was required as a direct and proximate result of Putnam's fraud.

In the Pyxis offering materials and face-to-face discussions with FGIC, Putnam repeatedly represented that the Pyxis collateral would be selected by Putnam, acting independently and in good faith in the interests of all Pyxis investors and FGIC. These representations were false. In fact, at the behest of the Pyxis equity investors, who created Pyxis and also shorted (*i.e.*, bet against) both the Pyxis collateral and Pyxis debt in large amounts, Putnam created a weak and highly concentrated Pyxis portfolio by excluding certain classes of assets with strong credit quality and selecting lower-quality assets in their place. Specifically, Putnam excluded all prime residential mortgage-backed securities ("RMBS") (*i.e.*, RMBS backed by prime residential mortgages, which had higher credit quality than subprime mortgages) and all "seasoned" RMBS issued before July 1, 2005 ("pre-2005H2 RMBS"), and limited the volume of assets in Pyxis with credit ratings above BBB/Baa2/BBB (just above junk bond status). At Magnetar's behest, Putnam also excluded from Pyxis any securities of

CDOs that had high exposure to prime, seasoned, or higher-rated assets, and included large exposures to Indices of low-rated, unseasoned RMBS.

This collateral selection strategy served the equity investors' interests both by making the portfolio riskier (and thus increasing the likelihood of substantial losses, which would render the equity investors' short investments highly profitable) and by ensuring the portfolio assets were highly correlated with the equity investors' short investments, thus protecting against the risk that the equity investors might suffer losses on both their equity and short investments. The strategy was contrary to the interests of debt investors and FGIC, however, because it reduced the portfolio's diversity and excluded higher-quality assets that would have provided a buffer against losses on the lower-quality assets in the event of a market downturn.

Because it knew this strategy would be unattractive to debt investors and FGIC, Putnam not only misrepresented who controlled collateral selection and omitted to disclose the equity investors' role, but also specifically misrepresented and concealed the fact that higher-quality, more diverse assets would be excluded from Pyxis. In the Pyxis offering materials, Putnam inflated the volume of prime, seasoned, and higher-rated assets that the Pyxis portfolio would contain. Subsequently, when FGIC expressed concern about the poor quality of the portfolio even with these represented assets, Putnam doubled down and knowingly allowed the CDO arranger ("Calyon") to provide FGIC with a detailed portfolio of all assets acquired and (purportedly) yet to be acquired for Pyxis, which indicated that Pyxis would contain even larger volumes of higher-quality assets than Putnam had previously represented. FGIC relied on this target portfolio in insuring Pyxis. Putnam also knowingly allowed Calyon to provide similar target portfolios to the rating agencies for the purpose of rating the Pyxis debt; those portfolios likewise inflated the amount of higher-quality assets in Pyxis. FGIC relied on the Pyxis credit ratings in insuring Pyxis.

At trial, FGIC will prove that Putnam fraudulently and/or negligently misrepresented who would select the Pyxis collateral and how much of the collateral would be higher-quality in order to induce FGIC to issue the Pyxis Guaranty. FGIC will prove that Putnam made these misrepresentations, in the interests of the equity investors and at the expense of debt investors and FGIC, in order to secure substantial fees from Pyxis and from future CDOs it hoped to manage for the equity investors (including one it was hired to manage before Pyxis even closed).

Because FGIC's claims concerning control of collateral selection rest on extensive factual evidence, much of which Putnam purports to dispute, and because FGIC's fraud claims require proof of fraudulent intent, these claims are not appropriate for summary judgment.

It is not necessary, however, to rely on disputed evidence to resolve FGIC's negligence-based claims, to the extent they are based on Putnam's misrepresentations concerning the quality of the assets to be included in Pyxis. Based on the undisputed facts, the Court can and should find as a matter of law that (i) Putnam had a "special relationship" with FGIC requiring it to provide correct information and to correct any information it knew to be false on which FGIC was relying; (ii) Putnam knew or was willfully blind to the fact that the Pyxis portfolios provided to FGIC and the rating agencies were materially false; and (iii) FGIC reasonably relied on the accuracy of these portfolios in issuing the Pyxis Guaranty. Thus, FGIC seeks summary judgment as to liability on its claims for negligent misrepresentation and negligence.

FGIC also seeks summary judgment that Putnam is liable for all losses actually suffered by FGIC pursuant to the Pyxis Guaranty. The Pyxis Guaranty, by its own terms, could not be canceled during the term of the agreement. Thus, by inducing FGIC to assume exposure under the Pyxis Guaranty, Putnam also induced it to retain that exposure for the full term of the Guaranty (absent a negotiated commutation of the Guaranty) and thus to retain exposure to any market downturn that might occur during that term. Accordingly, all of FGIC's losses under the Pyxis Guaranty were proximately caused by Putnam's misrepresentations and omissions, and FGIC can recover all such losses as damages.

FACTUAL BACKGROUND

I. Collateralized Debt Obligations

A CDO is a special purpose entity that acquires a portfolio of debt obligations and issues securities whose repayment depends on the income generated by those debt obligations. A CDO's assets can comprise, among other things, RMBS[1] and securities issued by other CDOs. Alternatively, a CDO may enter into credit default swaps ("CDS" or "swaps") referencing such assets in order to take the risk of loss on those assets, in exchange for periodic payments. (This is explained further below.) The CDO's portfolio of investments can thus consist of both assets it owns and assets it references through CDS.

To acquire its portfolio, a CDO typically raises money from investors by issuing multiple classes of debt securities ("notes") and equity securities. The cash flows from the CDO portfolio pay the CDO's expenses and cover interest and principal payments to the CDO's note holders in order of seniority; any remaining cash flows go to the CDO's equity investors.

Rating agencies typically assign credit ratings to the debt classes (or "tranches") of a CDO (as well as to the assets in the CDO's portfolio). The most senior tranches of CDOs typically receive "AAA" ratings.[2] Some CDOs have "super-senior"

[1] An RMBS trust is a special purpose financial vehicle that acquires a pool of residential mortgage loans and issues securities (RMBS) which are paid a share of the principal and interest payments on those mortgage loans.

[2] Standard and Poor's Financial Services LLC's ("S&P") highest rating for debt securities. The comparable highest ratings for Fitch Ratings, Inc. ("Fitch") and Moody's Investment Service, Inc. ("Moody's") are "AAA" and "Aaa," respectively.

tranches, which are not only AAA-rated themselves, but rank senior to another AAA-rated tranche. Super-senior (and sometimes more junior) tranches may also be protected by financial guaranty insurance, under which insurers like FGIC guarantee payment of principal and interest on insured notes in return for a premium. Like the assets in its investment portfolio, a CDO's obligations may also take the form of CDS.[3]

The interest rate on CDO notes is set according to their expected level of risk. Junior tranches offer higher interest rates because they are exposed to a higher risk of shortfalls. Senior tranches benefit from greater subordination (*i.e.*, they don't suffer losses until the junior tranches have been wiped out). The amount of subordination for a given tranche is known as its "attachment point"; if subordinate debt amounting to 40% of the aggregate principal amount of the CDO's obligations must be wiped out before the tranche takes a loss, its attachment point is 40%. Because of their higher attachment points, senior and super-senior notes bear lower interest rates. The premium paid to the insurer of a senior or super-senior tranche is typically also low (*e.g.*, 8-10 basis points), reflecting the remote risk of loss on these tranches.

When, and whether, a CDO's notes are repaid depends largely on the credit quality and performance of the CDO's portfolio. Thus, from the investor's perspective—and the insurer's perspective, in the case of insured notes—nothing is more important than the skill and judgment of the entity selecting the CDO portfolio.

For a "managed CDO," like Pyxis, the CDO's portfolio is selected by a collateral manager, and the composition of the portfolio may change over time, both before and after closing. The collateral manager has significant discretion and is expected to use its best efforts to select and manage the CDO's collateral for the benefit of all of the CDOs' investors, both debt and equity.

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[3] In that case, the CDO makes periodic payments to a CDS counterparty insurer, in exchange for guaranteeing its obligations to investors.

Collateral managers are paid a fee for their services, typically a percentage of the notional value of the transaction (*i.e.*, the total face amount of all securities issued by the CDO).

II. Credit Default Swaps

A CDO may acquire an asset, such as an RMBS or CDO security, by purchasing the security for cash. In that case, the security is called a "cash asset." Alternatively, the CDO may take on the risk of such a security without actually purchasing it, by entering into a CDS referencing the security. In that case, the CDO is said to acquire a "synthetic asset."

A CDS is similar to a credit insurance policy: in return for periodic payments (similar to insurance premiums), the protection seller agrees to make payments upon the occurrence of one or more defined "Credit Events," which generally include a payment default with respect to the referenced security, *i.e.*, a failure to pay principal or interest when due. The protection seller—and through the seller the insurer, if the protection seller is a CDO whose senior or super-senior tranches have financial guaranty insurance—has a "long" position with respect to the referenced security, since it bears the same risk of non-payment on the security that an owner of the security would have. Conversely, the protection buyer has a "short" position with respect to the referenced security, since it is in exactly the opposite position (comparable to the position of a short seller of the referenced security). Protection buyers profit from the payment defaults of the securities they have "shorted."

III. Magnetar's Long-Short Correlation Trading Strategy

Pyxis was the brainchild of Magnetar executive Jim Prusko. It was the seventh in a series of 29 "Constellation" CDOs that Prusko created in 2006-2007 to facilitate an elaborate "long/short" correlation trading strategy for Magnetar. Rule 56.1

Statement of Undisputed Material Facts ("56.1") ¶ 9. For many of these CDOs, including Pyxis, Prusko partnered with Michael Henriques of Deutsche Bank (who left Deutsche Bank shortly after Pyxis closed to join Magnetar). In early 2006, when Prusko and Henriques began to create the Constellation CDOs, the CDO market was declining significantly, largely because at that time there were few investors willing to take the risk inherent in a CDO equity position. Declaration of Sean P. Baldwin, dated September 21, 2018 ("Baldwin Decl."), Ex. [3] ¶ 202.

Magnetar and Deutsche Bank, however, were able to launch new CDOs, with both unusually large size and frequency, by taking the equity positions in the CDOs they sponsored. 56.1 ¶ 10; Baldwin Decl. Ex. [3], ¶¶ 203-08. At the same time (but not disclosed to investors), Magnetar and Deutsche Bank bet against the performance of these same CDOs, primarily by entering into CDS (as protection buyer) referencing either the assets in the CDOs' portfolios or the debt securities issued by the CDOs. 56.1 ¶ 11. Magnetar's short positions, including on Pyxis, were typically much larger than its equity investments. 56.1 ¶ 12.

Pursuant to this strategy, Magnetar and Deutsche Bank stood to gain from both the good and bad performance of the Constellation CDOs—but only if the assets underlying their short and long positions were highly "correlated" (*i.e.*, sufficiently related to one another that they would perform in a similar way under any market conditions). 56.1 ¶ 13; Baldwin Decl. Ex. [3] ¶ 76. If these assets were not highly correlated, they might perform differently from one another and Magnetar and Deutsche Bank could end up suffering losses on both their long and short positions. *Id.* If they were highly correlated, however, then gains on one would offset losses on the other. For example, if the correlated assets performed well, Magnetar and Deutsche Bank would reap large returns on their equity positions, whereas if they performed badly, Magnetar and Deutsche Bank would profit from their short investments. *Id.* Because their short investments were much larger than their long investments, Magnetar and Deutsche Bank expected the strategy to generate the most profits in the event of a substantial market downturn. 56.1 ¶ 14.

Magnetar's short investments consisted in large part of CDS under which it bought protection (often from its own CDOs) on certain ABX Indices of low-rated subprime RMBS. 56.1 ¶ 15. The assets backing these ABX Indices were all subprime RMBS (*i.e.*, RMBS backed by subprime residential mortgage loans)[4] issued after June 30, 2005 and rated BBB or BBB-. 56.1 ¶ 16. Thus, to ensure its equity positions in the Constellation CDO portfolios were correlated with its short positions, Magnetar needed to ensure that its CDOs' portfolios were limited as much as possible to investments in the ABX Indices and the assets comprising those Indices, or to similar subprime RMBS issued in the second half of 2005 or later and rated BBB or BBB- (and to CDOs backed by such RMBS). What Magnetar wanted to avoid, and instructed its CDO managers to avoid, was asset diversification from the inclusion of uncorrelated securities in its CDOs' portfolios—namely, prime RMBS, pre-2005H2 RMBS, and RMBS rated higher than BBB/Baa2/BBB (by S&P, Moody's and Fitch, respectively).

Prusko selected the collateral managers for the Constellation CDOs himself, to ensure they understood his long-short strategy and that the collateral they selected would be highly correlated with the assets Magnetar was shorting.

IV. The Pyxis CDO

Pyxis was a $1.5 billion CDO. Approximately 90% of its portfolio consisted of residential mortgage-backed securities ("RMBS"); the remainder consisted of CDOs collateralized primarily or exclusively by RMBS. 56.1 ¶ 17. 19% of the Pyxis assets

[4] A prime mortgage is one made on standard terms to a borrower with good credit. A mortgage made to a borrower with poor credit, regardless of the terms, is a subprime mortgage.

were cash assets (*i.e.*, asset-backed debt securities that Pyxis actually purchased) and 81% were synthetic assets (*i.e.*, CDS under which Pyxis sold protection to short investors on RMBS and CDOs in exchange for small premium payments). 56.1 ¶ 18.

Pyxis was a managed CDO, with a portfolio that was supposed to be selected by the collateral manager, Putnam, and that could change up to five percent a year for five years after closing at Putnam's discretion. 56.1 ¶ 30. Because of Putnam's control over collateral selection, both before and after closing, the Pyxis Offering Memorandum noted that "the performance of the [Pyxis portfolio] depends heavily on the skills of the Collateral Manager in analyzing, selecting, and managing the [portfolio]." 56.1 ¶ 33.

Pyxis was marketed to investors and the pricing on its debt tranches was set on the basis that the super-senior tranche would have financial guaranty insurance. 56.1 ¶ 35. If FGIC had not provided insurance, Pyxis would likely not have closed, in which case Putnam would not have earned its fees. 56.1 ¶ 36.

Although the Pyxis CDO itself was technically Putnam's client, Putnam regarded all Pyxis investors and FGIC as its clients, and expressly described FGIC as its client in an email to FGIC. 56.1 ¶ 37. Putnam understood that it should give Pyxis investors and FGIC the same level of service as it gave all its clients. 56.1 ¶ 38.

V. Magnetar's Selection of Putnam to Manage Pyxis

Prusko and Henriques selected Putnam as the collateral manager for Pyxis. 56.1 ¶ 19. They selected Putnam for two primary reasons: (i) Putnam was a well-respected asset manager who would attract investors to Pyxis, 56.1 ¶ 20; and (ii) Prusko had worked at Putnam for 11 years, and remained close to various senior Putnam personnel, including Carl Bell. 56.1 ¶ 21.

Prusko and Henriques made Pyxis especially attractive for Putnam in two ways. *First*, like all of Magnetar's CDOs, Pyxis was substantially larger than a typical CDO, and thus generated unusually large fees for Putnam. Although Putnam's fees as a percentage of the total Pyxis portfolio were only half that of a typical CDO manager's, the Pyxis portfolio was four times larger than a typical CDO; thus, the total fees Putnam stood to gain from Pyxis were twice as large as the manager of a typical CDO earned. 56.1 ¶ 24. Moreover, because Magnetar and Deutsche Bank had committed to buy the Pyxis equity, there was little doubt the CDO would close, as long as the CDO portfolio was selected in accordance with Magnetar's wishes. This was not the case for typical CDOs, where the biggest problem was usually to find an equity investor willing to take the "first-loss" risk. 56.1 ¶ 25.

Second, when they hired Putnam for Pyxis, Prusko and Henriques told Putnam they wanted it to manage not just one, but as many as six Constellation CDOs. 56.1 ¶ 22. Indeed, before Pyxis even closed Putnam was hired to manage a second Pyxis deal, Pyxis ABS 2007-1 ("Pyxis 2"), from which Putnam earned millions more in fees. 56.1 ¶ 23.

Before hiring Putnam, Prusko and Henriques told Bell about their long-short correlation trading strategy, 56.1 ¶ 26, and about the importance of limiting the Pyxis portfolio to low-rated, unseasoned, subprime RMBS (and CDOs backed by such RMBS) to promote this strategy. 56.1 ¶ 27. Prusko and Henriques made clear that if Putnam did not comply with these collateral constraints Magnetar and Deutsche Bank would not purchase the Pyxis equity. 56.1 ¶ 28. If that had happened, Calyon, the bank that arranged and underwrote Pyxis, would have had to find another equity investor for the deal, which as noted above would have been very difficult in that environment. If another equity investor could not be found, Pyxis would not have closed and Putnam would not have earned any fees on the transaction, much less on the additional Constellation CDOs it expected to manage.

Prusko and Henriques made clear to Putnam that they regarded Pyxis not as a typical CDO but as—in their words—a "highly structured separate account mandate" for the benefit of the equity investors. 56.1 ¶ 29. Putnam understood perfectly well what Magnetar and Deutsche Bank required of it. *Id.*

VI. Putnam's Cooperation with Magnetar's Long-Short Correlation Trading Strategy

A. At Magnetar's Behest, Putnam Excluded Prime, Seasoned and Higher-Rated RMBS from the Pyxis Portfolio, and Helped to Conceal These Facts from FGIC and the Rating Agencies

In the Pyxis offering materials, Putnam disclosed various portfolio constraints, including that the portfolio would comprise at least 80% subprime RMBS. 56.1 ¶ 39. However, Putnam did not disclose certain additional constraints that it secretly imposed on the Pyxis portfolio at Magnetar's behest. Putnam did not disclose that the portfolio would not include prime or seasoned RMBS, would only include a very limited amount of higher-rated assets, and would have a very high exposure to the ABX Indices of low-rated, unseasoned RMBS. Nor did Putnam disclose that this highly concentrated portfolio was being assembled at Magnetar's behest in order to further Magnetar's correlation trading strategy, directly contrary to the interests of Pyxis debt investors and FGIC. To the contrary, Putnam affirmatively misled investors about the volume of higher-quality assets that would be included in Pyxis.

1. The Offering Materials and July 13, 2006 Target Portfolio

Putnam and Magnetar were well aware that it was important to Pyxis investors and insurers that the Pyxis collateral be selected by an experienced asset manager, based on its own independent judgment, and that investors would be strongly disinclined to invest in a portfolio over which a short investor had substantial undisclosed influence. Thus, in the Pyxis offering materials, Putnam expressly represented that it would select the Pyxis collateral, 56.1 ¶ 30; it was an experienced and respected asset manager, 56.1 ¶ 31; it was using its own market-tested, rigorous selection process to select collateral, which was consistent with the highest industry standards, 56.1 ¶ 32; and, as noted above, the performance of the Pyxis portfolio "depends heavily" on its skill "in analyzing, selecting, and managing the [portfolio]." 56.1 ¶ 33.

Putnam was also well aware that the market viewed prime, seasoned, and higher-rated RMBS as materially less risky than subprime, unseasoned, and lower-rated RMBS, respectively, and that debt investors strongly preferred a diversified portfolio to an undiversified portfolio.[5] Thus, Putnam understood that it would be very difficult to market a portfolio consisting exclusively of subprime, unseasoned, low-rated RMBS. Such a portfolio may have furthered Magnetar's correlation trading strategy, but it was anathema to debt investors and FGIC.

Accordingly, in the Pyxis offering materials, Putnam represented to investors that the Pyxis portfolio would include at least 4% ($60 million) of prime RMBS, 56.1 ¶ 43; Putnam would take advantage of the CDS markets to "focus on seasoned product" for the portfolio, 56.1 ¶ 44; and 19% of the Pyxis portfolio would consist of RMBS rated above Baa2 by Moody's, and 41% would consist of RMBS rated above BBB by S&P, 56.1 ¶¶ 46-47. The representation that 19% of the portfolio would consist of RMBS rated above Baa2 by Moody's was made in a target portfolio Putnam prepared on July 13, 2006, which was provided to FGIC on July 19, 2006 (the "July 13 target portfolio"). 56.1 ¶ 47.

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[5] For example, Fitch's presale report for Pyxis stated that, for prime RMBS, Fitch had a "stable outlook for collateral performance and a positive outlook for ratings in the second half of 2006," whereas for subprime RMBS it had a "negative outlook for collateral performance and a stable outlook for ratings in the second half of 2006." 56.1 ¶ 41. Similarly, Putnam's Carl Bell testified that, in 2006, RMBS issued in 2004 and 2005 had "substantially de-levered" and thus "their risk profile ha[d] been reduced," "the probability of default ha[d] been reduced," and "the spread that [investors] would get paid for that investment was correspondingly less." 56.1 ¶ 42.

All of these representations were false. In fact, the Pyxis portfolio contained no prime RMBS, no seasoned RMBS at closing (and ultimately just 2.3% seasoned RMBS, which was added nearly four months after closing in January 2007), and just 15.47% of RMBS rated above Baa2. 56.1 ¶ 40.

Moreover, even these levels of higher quality assets were not sufficient for FGIC. In early August 2006, FGIC expressed serious doubts about participating in Pyxis based on the poor quality of the assets that had been "ramped" (*i.e.*, selected) for the portfolio to date. 56.1 ¶ 52. At that point, nearly all of the Pyxis collateral consisted of unseasoned subprime RMBS rated BBB or lower. FGIC wanted assurances that a material amount of higher-quality assets would be added to the portfolio going forward.

Instead of telling FGIC the truth—that the portfolio would contain no prime or seasoned RMBS and only a limited amount of higher-rated assets—Putnam doubled down on its misrepresentations in the Pyxis offering materials and the July 13 target portfolio. Putnam knowingly allowed the CDO arranger, Calyon, to provide both FGIC and the rating agencies with false target portfolios for Pyxis, which indicated the Pyxis portfolio would contain even more of these classes of higher-quality assets than the offering materials had indicated. FGIC and the rating agencies relied on these target portfolios to model and rate Pyxis, as a direct result of which FGIC was induced to assume at least $150 million more exposure under its Pyxis policy than it would have otherwise.

2. The Target Portfolio Provided to FGIC (the "Peach-Colored Spreadsheet" or "PCS")

On August 3, 2006, several FGIC representatives, including the lead Pyxis negotiator, Elizabeth Menhenett, traveled to Boston for a due diligence meeting with Putnam. 56.1 ¶ 48. FGIC's goal was to examine both Putnam's experience and expertise and its collateral selection strategy for Pyxis. 56.1 ¶ 49. During that meeting, and during a subsequent conference call with Putnam on August 7, 2006, FGIC specifically focused on, among other things, prime, seasoned, and higher-rated RMBS. 56.1 ¶ 50. Putnam provided its views of each of these types of assets, but said nothing to indicate there would no prime or seasoned assets and only a limited volume of higher-rated assets in the Pyxis portfolio. 56.1 ¶ 51.

At the same time, FGIC was expressing concern about the poor quality of the assets that had been ramped to date. 56.1 ¶ 52. Putnam had provided a summary target portfolio on July 13, 2006 that showed Putnam's plan was to select the lower-quality assets for the portfolio first and the higher-quality assets later. 56.1 ¶ 47. Thus, Calyon assured FGIC that the higher-quality assets for the portfolio were still to come. 56.1 ¶ 53. That assurance was not enough for FGIC, which wanted greater comfort about both the quality and quantity of the assets yet to be acquired.

On August 7, 2006, Elizabeth Menhenett spoke to Carl Bell and asked him to provide her with a detailed list of all the "names" (*i.e.*, assets) that had already been acquired for Pyxis *and* the names that were yet to be acquired. 56.1 ¶ 54. Instead of providing this list himself, which should have been a simple matter for Bell because he was in charge of the collateral selection process, Bell told Menhenett that she should get the list from Calyon, which he assured her had all the relevant information as to both the names that had been bought and those that were "likely but not bought yet." 56.1 ¶ 54. Menhenett reached out to Calyon for this information. 56.1 ¶ 55.

On August 8, 2006, Calyon sent FGIC a comprehensive Excel spreadsheet showing, on a line-by-line basis, the assets ramped to date for Pyxis and, highlighted in a peach color, the assets yet to be acquired for Pyxis (the "peach-colored spreadsheet" or "PCS"). 56.1 ¶ 56. The PCS contained extensive information about the credit characteristics of these assets. 56.1 ¶ 57. It indicated that the fully-ramped portfolio would contain at least 10.4% prime RMBS, at least 5.3% subprime RMBS issued before the second half of 2005, and at least 28.88% of RMBS and CDO assets rated above Baa2 by Moody's. 56.1 ¶ 57. In fact, as noted above, when Pyxis closed less than two months later, it contained no Prime RMBS, no pre-2005H2 RMBS, and just 15.47% RMBS rated above Baa2. Thus, the PCS was materially false.

Remarkably, Bell testified that he had no recollection of ever following up with either Calyon or FGIC to find out what information Calyon had actually sent FGIC. 56.1 ¶ 58. Had he done so, it would have been readily apparent that the information was false. He failed to follow up despite the fact that (i) FGIC had originally requested the information from him, not Calyon; (ii) he told FGIC to get the information from Calyon and assured it that Calyon could provide the information; (iii) Putnam, not Calyon, had responsibility for collateral selection; (iv) FGIC was Putnam's client, as Bell acknowledged, but was not Calyon's client; and (v) critically, Putnam—and especially Bell—had serious reservations about Calyon's competence and reliability.

Before the PCS was sent, Bell had repeatedly expressed frustration about Calyon's provision of incorrect information to investors and FGIC in the Pyxis Pitchbook and launch email, and about Calyon's "painful" errors in connection with the drafting of the offering memorandum, which he stated Calyon "d[id] not understand." 56.1 ¶ 73. Accordingly, on July 31, 2006, Bell insisted that Calyon send him "a post call/meeting summary for each investor conversation," so he could monitor what Calyon was saying to investors. 56.1 ¶ 74. Subsequently, on August 5, 2006, Bell complained about Calyon's performance to Henriques, who agreed that Calyon was "somewhat slop[p]y and overwhelmed." 56.1 ¶ 76.

After the PCS was sent, Putnam continued to have significant problems with Calyon. In a series of emails, Putnam noted, among other things, that it "need[ed] to review Calyon's calculations" both for technical reasons and "because it is Calyon making the calculations", 56.1 ¶ 85; Calyon's work on waterfall modeling for Pyxis seemed to be "counter to our previous discussions," 56.1 ¶ 77; Calyon was "choosing not to respond" to Putnam's requests, 56.1 ¶ 81; there was "[r]adio silence from

Calyon" in response to Putnam's requests, 56.1 ¶ 80; Calyon's guidance to attorneys on required changes to the offering memorandum was "screw[ed]-up", 56.1 ¶ 82; and Calyon made several changes to the offering memorandum that were "unacceptable to Putnam" and which Putnam found "highly concerning," and Calyon "ha[d] to slow down and get this right," 56.1 ¶ 86.

Prusko, too, expressed serious concerns about Calyon's reliability. On August 1, 2006, he told Calyon that he was "getting [the] impression you're overwhelmed," and that the length of time Calyon took to turn around Pyxis projects was "disturbing." 56.1 ¶ 75. After one issue had been raised by Putnam, Prusko emailed that Calyon's mistakes "make [Putnam] think you guys are mentally challenged." 56.1 ¶ 78. The head of Calyon's Pyxis group agreed, emailing Calyon employees that "the email below shows either our complete ignorance on the subject or our total dysfunctionality [sic] in handling such a simple issues [sic]?" 56.1 ¶ 79.

Putnam's concerns about Calyon culminated in mid-September, 2006, when Bell told Calyon it did not seem to have "looked carefully at [its] Moody's modeling results" for Pyxis, which were "not plausible." 56.1 ¶ 83. The next day, Bell took the extraordinary step of drafting a formal letter to Moody's saying: "Based on our review of Calyon provided cashflows, our independent cashflow analysis, and a review of other capital structures for similar transactions, Putnam has a significant concern that the Pyxis capital structure does not support the requested ratings from Moody's." 56.1 ¶ 84.

Despite all these concerns about Calyon's competence and reliability, and specifically about its provision of materially incorrect information to investors and its having unmonitored communications with investors, when FGIC—Putnam's client, not Calyon's—asked Putnam to provide it with the Pyxis target portfolio, Putnam told FGIC to obtain the information from Calyon and then did nothing to confirm the accuracy of the information Calyon had actually sent FGIC. This was even more egregious given that, as discussed below, just days after sending the PCS to FGIC, Calyon sent each of the rating agencies similarly false line-by-line target portfolios for Pyxis (the "Rating Agency Portfolios") to use in assigning credit ratings to the Pyxis debt tranches, on which investors and FGIC would rely. Putnam asked Calyon to send it what it sent to the rating agencies and reviewed it. Like the PCS, the information in the Rating Agency Portfolios was patently false. Yet, even after reviewing that information, Putnam still did not ask Calyon to show it the portfolio information it had sent FGIC, nor alert FGIC that Calyon had circulated materially false target portfolios to the rating agencies, which raised serious questions about the accuracy of the information sent to FGIC just days earlier.

As a result, FGIC modeled and ultimately agreed to participate in Pyxis at a 40% attachment point, based on the materially inflated percentages of prime, seasoned, and higher-rated assets disclosed in the PCS. 56.1 ¶ 59. Testimony at trial will show that, had FGIC been shown the actual Pyxis portfolio, it would not have agreed to participate on the same terms, but would, at a minimum, have insisted on an attachment point of at least 50%, in which case it would have been exposed to $150 million less risk of loss than it was. Moreover, as explained below, the Pyxis Guaranty, by its terms, could not be canceled by FGIC during the term of the agreement; thus, once FGIC issued the Pyxis Guaranty, it was necessarily exposed to all losses under the Guaranty for the duration of its term.

3. The Rating Agency Portfolios

Calyon sent the PCS to FGIC on August 8, 2006. On August 11, 2006—just three days later—Calyon sent similar target portfolios to each of the rating agencies. 56.1 ¶ 60. Putnam asked Calyon to send it the Rating Agency Portfolios so it could review them. 56.1 ¶ 61. Calyon did so on August 15, 2006, 56.1 ¶ 62. These portfolios, like the PCS, indicated that Pyxis would contain at least 10.4% prime RMBS, and they also indicated that it would contain least 20% of RMBS rated above Baa2 (they did not disclose the seasoning of the target assets). 56.1 ¶ 64. Thus, like the PCS, the rating agency portfolios were materially false.

Putnam reviewed the Rating Agency Portfolios. 56.1 ¶ 63. Moreover, on September 13, 2006, Putnam received a draft Fitch "Pyxis presale report" to review. 56.1 ¶ 65. The presale report was a document prepared by Fitch to give investors a review of the transaction as a whole from Fitch's perspective. Like the target portfolio sent to Fitch, the draft presale report stated in two places—including in a pie chart featured prominently at the top of the front page—that the Pyxis portfolio would contain 10.4% prime RMBS and 20% of assets rated above Baa2. 56.1 ¶ 66. Carl Bell personally reviewed the draft presale report and suggested one change to it, but said nothing about the percentage of prime RMBS or higher-rated assets it disclosed. 56.1 ¶ 67. Thus, the final presale report sent to investors on September 15, 2006 falsely disclosed the amount of both classes of assets in the Pyxis portfolio.

Not only did the Rating Agency Portfolios show materially false amounts of prime RMBS and higher-rated assets, but, according to Putnam's own experts, these portfolios were materially different *from one another*. On their face, the Rating Agency Portfolios showed materially different asset categories, ratings, and tranche sizes for the assets yet to be acquired—differences which, according to Putnam's own experts, were obvious from a cursory review of the portfolios. 56.1 ¶ 68. Putnam reviewed all three Rating Agency Portfolios, 56.1 ¶ 63, knew their contents, and must therefore, according to its own experts, have noticed these discrepancies; nonetheless, it did nothing whatsoever to alert either the rating agencies or Pyxis investors that they were materially different from one another, much less that they were materially inaccurate.

Instead of correcting the mistakes in the Rating Agency Portfolios, Putnam allowed the rating agencies to rate the Pyxis debt on the basis of materially false information. Based on the ratings generated as a result, the attachment point for Pyxis's super-senior AAA debt was 20.43%—*i.e.*, any Pyxis debt with at least 20.43% subordination would be rated AAA. 56.1 ¶ 69. FGIC's expert has opined that had the rating agencies reviewed the actual portfolio rather than the false Rating Agency Portfolios, the attachment point for Pyxis AAA debt would have been 26% rather than 21%—*i.e.*, because of the actual portfolio's greater risk, Pxyis debt would have to have five percentage points more subordination to obtain a AAA rating. 56.1 ¶ 70. Putnam's experts do not dispute this. 56.1 ¶ 70.

A 21% AAA attachment point was a condition precedent to Pyxis's closing. 56.1 ¶ 71. Thus, had the rating agencies received the actual portfolio rather than the false Rating Agency Portfolios, FGIC would not have closed on the terms it did. Instead, as shown in the application to FGIC's credit committee submitted for approval FGIC's participation in Pyxis, FGIC set its attachment point at approximately twice the AAA attachment point set by the rating agencies. 56.1 ¶ 72. Thus, had the rating agencies been shown the actual portfolio rather than the false Rating Agency Portfolios, FGIC would have attached at 50% rather than 40% and would have been exposed to $150 million less risk of loss than it actually was. Moreover, again as explained below, the Pyxis Guaranty, by its terms, could not be canceled by FGIC during the term of the agreement; thus, once FGIC issued the Pyxis Guaranty, it was necessarily exposed to all losses under the Guaranty for the duration of its term.

B. At Magnetar's Behest, Putnam Included a Disproportionate Share of Other Constellation CDOs in the Pyxis Portfolio

Putnam helped further Magnetar's long-short correlation trading strategy not only by excluding prime, seasoned, and higher-rated assets from the Pyxis portfolio, but also by including in the portfolio tranches of other CDOs that also excluded such assets—including a disproportionate share of other Constellation CDOs.

The ten RMBS-backed CDOs in the Pyxis portfolio contained, on average, 89.9% subprime RMBS. 56.1 ¶ 87. (Pyxis invested in one CDO backed by commercial mortgage backed securities, not RMBS.) Mirroring Pyxis, these RMBS-backed CDOs also contained, on average, just 1.6% prime RMBS, 12.9% pre-2005H2 RMBS, and 15.6% RMBS rated above Baa2. 56.1 ¶ 87. By selecting CDOs that, like Pyxis, eschewed higher-quality assets, Putnam increased the concentration of lower quality assets that indirectly as well as directly backed Pyxis, and thus increased the correlation of the Pyxis portfolio with the assets underlying Magnetar's short positions.

In addition, four of the eleven CDOs in the Pyxis portfolio, accounting for $55 million (or 44%) of the Pyxis CDO bucket, were Constellation CDOs. 56.1 ¶ 88. Three of these Constellation CDOs were purchased after Pyxis closed, when investors were already committed to the deal, and were the only CDOs purchased by Putnam after closing. 56.1 ¶ 89. Just 6% of the mezzanine CDOs rated by Moody's between 2000-2007, and just 12% between 2006-2007, were Constellation CDOs. 56.1 ¶ 90. Thus, it was highly improbable that Constellation CDOs comprised 44% of the CDOs in the Pyxis portfolio based solely on Putnam's independent decisions and without any influence from Magnetar. This was even less probable given that by late 2006, at the time these CDOs were issued and purchased for Pyxis, it was becoming very difficult to find buyers for CDO notes. If Putnam had not agreed to buy these notes, it was likely that Magnetar and/or the CDO arrangers would have had to retain the notes and assume the risk of default on them. Moreover, the risk of default was materially greater for Magnetar CDOs than for other CDOs available in the market at that time. By April 2012, 97% of Constellation CDOs had defaulted, compared to just 57% of non-Constellation mezzanine CDOs rated by Moody's between 2000-2007 and 84% of such CDOs rated by Moody's between 2006-2007. 56.1 ¶ 91.

Thus, Putnam's selection of CDOs for Pyxis both furthered Magnetar's correlation trading strategy and allowed Magnetar and/or its CDO arrangers to offload their risk on other Constellation CDOs. Again, this benefited Magnetar at the expense of Pyxis debt investors and FGIC, who had an interest in higher-quality and more diverse assets in the Pyxis portfolio.

C. At Magnetar's Behest, Putnam Included Large Blocks of the ABX Index in the Pyxis Portfolio

In addition to excluding prime, seasoned, and higher-rated RMBS, and CDOs that included such assets, from the Pyxis portfolio, Putnam also furthered Magnetar's long-short correlation trading strategy by including a large volume of both the ABX Indices and individual RMBS components of those Indices. As noted above, a large proportion of Magnetar's short positions were taken against the ABX Indices. Thus, including those Indices and their component securities in the Pyxis portfolio necessarily increased the degree of correlation between the assets underlying Magnetar's long and short positions.

The portfolio limitations in the Pyxis Indenture limited the percentage of swaps referencing the ABX Indices in aggregate, and also referencing particular series of the ABX Indices, that could be included in the Pyxis portfolio. 56.1 ¶ 92. This limitation was designed to ensure diversification in the portfolio. The percentage of Index securities in the actual Pyxis portfolio hit the specified limit for two series of the ABX Indices. 56.1 ¶ 93. Thus, the inclusion of Index component securities in addition to the Indices themselves circumvented the portfolio limitation and meant the portfolio was, in effect, exposed to roughly three times more of the ABX Indices than the Indenture permitted, drastically reducing the diversification of the portfolio.

Nor can Putnam claim it selected these assets for its own independent reasons. Carl Bell stated in an email to Prusko that Putnam only liked "about 10 of the 20 bonds" in the ABX Indices. 56.1 ¶ 94. Nevertheless, at Magnetar's insistence, Putnam selected 12 of these bonds for Pyxis, and—more importantly—exposed Pyxis to the risk on all or most of them through its investments in the ABX Indices themselves. 56.1 ¶¶ 95-96. Given Putnam's aversion to many of these securities, the only credible basis for its decision to expose FGIC to three times the permitted amount of ABX Index risk was to help further Magnetar's correlation trading strategy.

VII. FGIC's Losses

On September 6, 2006, based on the false information in the PCS and on the ratings predicated on false information in the Rating Agency Portfolios, FGIC notified Putnam that it would agree to issue the Pyxis Guaranty (technically a "surety bond") covering the Pyxis super-senior tranche. 56.1 ¶¶ 5-7, 37.[6] The super-senior tranche, and thus the Pyxis Guaranty, had a 40% attachment point (*i.e.*, it had the benefit of 40% subordination. Under the Pyxis Guaranty, FGIC agreed to pay up to $900 million to the super-senior investor (Calyon) in the event Pyxis was unable to meet its obligations to Calyon under a swap referencing the super-senior tranche. 56.1 ¶¶ 5-7.

FGIC's policy stated: "This Surety Bond may not be canceled by the Surety [FGIC] prior to termination in accordance with its terms." 56.1 ¶ 8.

Had FGIC known the truth about Pyxis—that Putnam did not select the collateral acting independently in the interests of all investors but rather, at Magnetar's behest, excluded prime, seasoned, and higher-rated RMBS from the Pyxis portfolio, as well as CDOs backed by such RMBS, and also exposed Pyxis to three times the permitted ABX Index risk—FGIC would not have agreed to insure Pyxis on the terms it did. At a minimum, assuming it agreed to participate at all, FGIC would have

[6] The Pyxis Guaranty guaranteed the obligations of a FGIC subsidiary, FGIC Credit Products LLC, under a swap with Calyon which referenced a further swap between Calyon and Pyxis referencing the Pyxis super-senior tranche. 56.1 ¶¶ 5-7.

required an attachment point of at least 50% and would thus have been exposed to $150 million less loss when Pyxis defaulted.

Within 11 months of Pyxis's closing, 25% of Pyxis's assets had suffered credit ratings downgrades. 56.1 ¶ 97. As of January 2017, Pyxis investors had been repaid only a few tens of millions of dollars of the $1.5 billion they had invested in Pyxis. 56.1 ¶ 98. In 2009, FGIC entered into a commutation agreement with Calyon by which, among other things, FGIC paid Calyon $74.5 million to discharge its obligations under the Pyxis Guaranty. 56.1 ¶ 99.

At trial, FGIC will show that, had it not commuted the Pyxis Guaranty, the losses it would have suffered thereunder based on the performance of the actual Pyxis portfolio would have been materially greater than the losses it would have suffered based on the portfolio of assets described in the PCS or a portfolio that otherwise accorded with Putnam's representations. But, in any event, as explained below (*see* Argument, Part II, *infra*), because the Pyxis Guaranty could not be canceled by FGIC during its term, all of FGIC's losses under the Pyxis Guaranty (including the commutation of that Guaranty) were proximately caused by Putnam's misconduct and are recoverable as damages.

ARGUMENT

Summary judgment is appropriate where "there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a). A dispute is "'genuine' … if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). "The relevant inquiry is 'whether the evidence presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that one party must prevail as a matter of law.'" *Olaf Sööt Design, LLC v. Daktronics, Inc.*, No. 15 CIV. 5024, 2018 WL 3462510, at *2 (S.D.N.Y. July 18, 2018) (Sweet, J.)

(quoting *Anderson*, 477 U.S. at 251-52). "[T]he mere existence of *some* alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no genuine issue of material fact." *Doe v. Alsaud*, 224 F. Supp. 3d 286, 291 (S.D.N.Y. 2016) (Sweet, J.) (emphasis in original) (quoting *Anderson*, 477 U.S. at 247-48).

"As to materiality, the substantive law will identify which facts are material. Only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment. Factual disputes that are irrelevant or unnecessary will not be counted." *Anderson*, 477 U.S. at 248.

I. Putnam Induced FGIC to Issue the Pyxis Guaranty by Means of Misrepresentations and Omissions That Were, at a Minimum, Negligent

At trial, FGIC will show that, at Magnetar's behest and to secure substantial fees on Pyxis and other Constellation CDOs, Putnam fraudulently and/or negligently misrepresented that it, and it alone, would select the Pyxis collateral and that it concealed the substantial role played in collateral selection by Magnetar and Deutsche Bank. This resulted in the exclusion of prime and seasoned RMBS from the Pyxis portfolio, the inclusion of a very limited amount of higher-rated assets, and the selection of CDOs whose portfolios likewise excluded or limited such assets (as well as a large exposure to the ABX Indices). FGIC will also show that Putnam concealed the exclusion of higher-quality assets from Pyxis by inflating the volume of such assets in target portfolios it created itself and by knowingly allowing Calyon to provide FGIC and the rating agencies with even more inflated target portfolios.

Because FGIC's claims concerning who selected the Pyxis collateral rest on a complex set of facts some of which Putnam purports to dispute, and because FGIC's fraud claims require proof of fraudulent intent, these claims do not lend themselves to summary judgment and must await trial.

However, the evidence establishing Putnam's misrepresentations and omissions concerning the volume of higher-quality assets in the Pyxis portfolio is both much more straightforward and entirely undisputed. Thus, it is not necessary to wait till trial to resolve FGIC's negligent misrepresentation and negligence claims, to the extent they are premised on those misrepresentations and omissions. Those claims can and should be resolved now as a matter of law.

Under New York law, "[t]he elements of negligent misrepresentation are that (1) the defendant had a duty as a result of a special relationship to give correct information; (2) the defendant made a false representation that he or she should have known was incorrect; (3) the defendant knew that the plaintiff desired the information for a serious purpose; (4) the plaintiff intended to rely and act upon it; and (5) the plaintiff reasonably relied on it to his or her detriment." *BNP Paribas Mortg. Corp. v. Bank of Am., N.A.*, 949 F. Supp. 2d 486, 508 (S.D.N.Y. 2013) (Sweet, J.) (citing *Hydro Investors, Inc. v. Trafalgar Power Inc.,* 227 F.3d 8, 20 (2d Cir. 2000)). "[L]iability for negligent misrepresentation [is] imposed only on those persons who possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation is justified." *Naughright v. Weiss*, 826 F. Supp. 2d 676, 688 (S.D.N.Y. 2011) (Sweet, J.) (alterations in original) (quoting *Kimmell v. Schaefer*, 89 N.Y.2d 257, 263 (1996)).

Based solely on the undisputed facts concerning the target portfolios provided to FGIC and the rating agencies, there can be no genuine dispute that Putnam had a "special relationship" with FGIC requiring it to give correct information and to correct false information on which it knew FGIC was relying; that Putnam breached that duty by providing incorrect portfolio information, and by knowingly or recklessly allowing Calyon to provide incorrect information, on which Putnam knew and intended both FGIC and the rating agencies to rely; and that FGIC reasonably relied to its detriment on the accuracy of this false information.

A. Putnam Had a "Special Relationship" with FGIC That Required It to Provide FGIC with Correct Information and to Correct False Information Concerning the Pyxis Portfolio

Under New York law, "a duty [to speak with care] exists in the commercial context when 'the relationship of the parties, arising out of contract or otherwise, is such that in morals and good conscience the one has the right to rely upon the other for information.'" *Fin. Guar. Ins. Co. v. Putnam Advisory Co., LLC*, 783 F.3d 395, 405 (2d Cir. 2015) (quoting *Kimmell v. Schaefer*, 89 N.Y.2d 257 (1996)). An investor can bring a negligence action against a CDO manager in the absence of contractual privity where the plaintiff "establish[es] that (1) the defendant had awareness that its work was to be used for a particular purpose; (2) there was reliance by a third party known to the defendant in furtherance of that purpose; and (3) there existed some conduct by the defendant linking it to that known third party evincing the defendant's understanding of the third party's reliance." *Id.* at 405-06 (quoting *Bayerische Landesbank v. Aladdin Capital Mgmt. LLC*, 692 F.3d 42, 59-61 (2d Cir. 2012)).

Where a special relationship exists, the defendant has an obligation not merely to provide correct information but also to correct information it knows to be false on which the plaintiff is relying:

> [I]n negligent misrepresentation cases based on omissions, "New York recognizes a duty by a party to a business transaction to speak in three situations: first, where the party has made a partial or ambiguous statement, on the theory that once a party has undertaken to mention a relevant fact to the other party it cannot give only half of the truth; second, when the parties stand in a fiduciary or confidential relationship with each other; and third, where one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge."

Creative Waste Mgmt., Inc. v. Capitol Environmental Servs., Inc., 429 F. Supp. 2d 582, 609 (S.D.N.Y. 2006) (quoting *Brass v. Am. Film Techs, Inc.*, 987 F.2d 142, 150 (2d Cir. 1993)); *see also Hughes v. BCI Int'l Holdings, Inc.*, 452 F. Supp. 2d 290, 303 (S.D.N.Y. 2006) (same); *Ellington Credit Fund, Ltd. v. Select Portfolio Servicing, Inc.*, 837 F. Supp. 2d 162, 201 (S.D.N.Y. 2011) (same).

Although "a determination of whether a special relationship exists is a 'factual inquiry,' " *Fin. Guar. Ins. Co.*, 783 F.3d at 407, here, based on undisputed facts, the Court can determine as a matter of law that there was a special relationship between Putnam and FGIC requiring Putnam to provide correct information and correct false information as to the content of the Pyxis portfolio. *See In re JWP Inc. Sec. Litig.*, 928 F. Supp. 1239, 1253 (S.D.N.Y. 1996), *as clarified* (June 12, 1996) ("Whether [a] special relationship exists is generally a question of fact. … If the underlying facts are not in dispute, however, the court may decide this issue as a matter of law.").

The following facts are undisputed: Putnam, as the collateral manager, had a duty to, and represented that it would, select and manage the Pyxis portfolio in the interests of all investors. 56.1 ¶ 30. Putnam regarded FGIC as its client and understood FGIC was entitled to the same level of service as all of Putnam's clients. 56.1 ¶¶ 37-38. Indeed, Putnam told FGIC directly that it was "pleased to have an investor like FGIC as a client." 56.1 ¶ 37.

In the Pyxis offering materials and the July 13 target portfolio, Putnam made affirmative (and false) representations concerning the amount of higher-quality assets and the diversity of assets that would be in the Pyxis portfolio. 56.1 ¶¶ 43-47. FGIC conducted due diligence on Putnam and its collateral selection strategy, including in a face to face meeting on August 3, 2006 and a follow up conference call on August 7, 2006, both of which specifically explored Putnam's strategy with respect to prime, seasoned, and higher-rated assets. 56.1 ¶¶ 48-51.

By August 7, 2006, FGIC was expressing serious reservations about participating in Pyxis given the poor quality of the collateral ramped to date. 56.1 ¶ 52. FGIC approached Putnam to ask for a detailed target portfolio showing the assets already acquired for Pyxis and those yet to be acquired. 56.1 ¶ 54. As the collateral manager, Putnam had access to and could have provided this information itself. Instead, Putnam told FGIC to ask Calyon for this information and assured FGIC that Calyon could provide it. 56.1 ¶¶ 54-55. Putnam knew that FGIC—its client—would rely on the information provided by Calyon in deciding whether and on what terms to participate in Pyxis. 56.1 ¶¶ 54-55. Putnam also knew Calyon was unreliable and had previously provided false information to investors, to the point that Putnam felt obliged to double-check all of Calyon's work and to monitor all communications Calyon had with investors. 56.1 ¶¶ 73-86.

Putnam also knew that FGIC, like all Pyxis investors, was relying on the Pyxis credit ratings in evaluating whether to participate in Pyxis. 56.1 ¶¶ 71-72. Under Section 4(a) of the Pyxis Securities Purchase Agreement, which governed the sale of the Pyxis securities, it was a condition precedent to closing that the Pyxis Class A-2 notes, which had just 21% subordination, would be rated AAA/Aaa/AAA by S&P, Moody's, and Fitch, respectively. 56.1 ¶ 71. Thus, Putnam knew it was a condition precedent to FGIC's issuance of the Pyxis Guaranty that the AAA attachment point for Pyxis debt be no more than 21%. Putnam also knew that the rating agencies based their credit ratings for Pyxis debt on the information in the Rating Agency Portfolios; indeed, that was the whole point of the Rating Agency Portfolios—they were, as Calyon put it, the "modeling assumption packages" for Pyxis. 56.1 ¶¶ 60-63. Thus, Putnam knew it was critical that the information provided to the rating agencies be accurate. This is confirmed by the September 20, 2006 draft letter from Carl Bell to Moody's identifying a significant modeling error by Calyon. 56.1 ¶ 84.

Based on these undisputed facts, there can be no genuine dispute that Putnam knew FGIC—its client—was relying on the accuracy of the target portfolio information in the June 13, 2006 target portfolio, the PCS, and the Rating Agency Portfolios. As the collateral manager, Putnam possessed superior knowledge to FGIC as to the assets already acquired for Pyxis and those still to be acquired. Putnam also knew that it and it alone—specifically, not Calyon—could be relied upon to provide accurate information concerning these assets.

Thus, there is no genuine dispute that Putnam had a special relationship with FGIC requiring it to give correct information and to correct any material inaccuracies in the offering materials, the June 13, 2006 target portfolio, the PCS, and the Rating Agency Portfolios. *Cf. Fin. Guar. Ins. Co.*, 783 F.3d at 406 (finding special relationship imposing duty to speak with care about selection and management of Pyxis portfolio could be established based on Putnam's representations that it would select and manage Pyxis portfolio independently and in interests of long investors and FGIC, FGIC's due diligence meetings with Putnam, FGIC's reliance on Putnam's representations, and the necessity of FGIC's participation to Pyxis's closing).

B. Putnam Knew or Was Willfully Blind to the Fact That the Target Portfolios Provided to FGIC and the Rating Agencies Were Materially False, and That FGIC Relied on Their Accuracy, Yet Putnam Did Nothing to Correct Them

Based on the undisputed facts, there is also no genuine dispute that Putnam breached its duty to give correct information to FGIC and to correct false information on which it knew FGIC was relying.

The following facts are undisputed: In the Pyxis offering materials and the July 13, 2006 target portfolio that Putnam provided to FGIC, Putnam affirmatively represented that the Pyxis portfolio would contain 4% prime RMBS, that Putnam would use CDS to "focus on seasoned product" for the portfolio, and that the portfolio would contain 19% assets rated above Baa2. 56.1 ¶¶ 43-47. All of these representations were false. 56.1 ¶ 40. As the collateral manager, Putnam necessarily knew it was false, and also knew that at no point during the Pyxis ramp-up period any prime or seasoned RMBS were actually selected for the Pyxis portfolio. 56.1 ¶ 40. However, at no point either before or after Pyxis closed did Putnam alert FGIC to the fact that the portfolio information in the offering materials and the July 13, 2006 target portfolio was materially false. 56.1 ¶ 39.

Putnam also knew that on August 8, 2006, Calyon provided FGIC with line-by-line information about the assets already acquired for the Pyxis portfolio and the assets yet to be acquired. 56.1 ¶¶ 54-55. Putnam knew this because it was Putnam who told FGIC to obtain this information from Calyon. 56.1 ¶¶ 54-55. It is undisputed that the PCS falsely showed that the Pyxis portfolio would contain 10.4% prime RMBS, 5.3% pre-2006H2 RMBS, and 28.88% assets rated above Baa2. 56.1 ¶ 57.

Putnam claims that it never followed up with Calyon to ascertain what information it had sent to FGIC, and thus did not know the content of the PCS. 56.1 ¶ 58. But that does not exonerate Putnam. Under New York law, willful blindness is equivalent to actual knowledge. *U.S. Bank, Nat'l Ass'n v. UBS Real Estate Sec. Inc.*, 205 F. Supp. 3d 386, 425 (S.D.N.Y. 2016) (holding that defendant's knowledge of contractual violations could be established by proof of willful blindness). Assuming Putnam did not ask what was in the PCS, because it "had sufficient information to impose a duty upon it to make further inquiry ... its failure to do so constituted 'willful blindness.'" *Scher Law Firm, LLP v. DB Partners I, LLC*, 97 A.D.3d 590, 591–92 (2d Dep't 2012). "'[A] willfully blind defendant is one who takes deliberate actions to avoid confirming a high probability of wrongdoing and who can almost be said to have actually known the critical facts.'" *Id.* at 592 (quoting *Global–Tech Appliances, Inc. v. SEB, S.A.*, 563 U.S. 754, 769 (2011)); *see also Viacom Int'l, Inc. v. YouTube, Inc.*, 676

F.3d 19, 35 (2d Cir. 2012) ("A person is 'willfully blind' or engages in 'conscious avoidance' amounting to knowledge where the person 'was aware of a high probability of the fact in dispute and consciously avoided confirming that fact.' " (quoting *United States v. Aina-Marshall*, 336 F.3d 167, 170 (2d Cir. 2003) (internal citation omitted))).

Based on the undisputed evidence, Putnam either knew or was willfully blind to the inaccuracies in the PCS. It is undisputed that Putnam knew Calyon was unreliable, repeatedly made serious errors, and provided false information to investors, to the point that Putnam felt obliged to double-check all of Calyon's calculations and monitor all of its communications with investors. 56.1 ¶ 73-86. Moreover, right after Calyon sent the PCS to FGIC, Putnam reviewed the Rating Agency Portfolios, which not only contained patently false information but also differed materially from one another; this should have alerted Putnam to the fact that the target portfolio sent just days earlier to FGIC likely also contained false information. 56.1 ¶¶ 60, 63. Despite this, Putnam never even asked to see, let alone double-checked, the portfolio information Calyon had prepared and sent to FGIC. Nor, despite its own acknowledgement that it should monitor Calyon's communications with investors, did Putnam take any steps to monitor what was perhaps the most critical investor communication in the entire Pyxis negotiation, given the importance of FGIC's participation to the deal. 56.1 ¶¶ 58, 74. The only credible explanation is that Putnam either knew the PCS contained materially false information or was willfully blind to that fact.

Moreover, it is undisputed that Putnam knew exactly what was in the Rating Agency Portfolios. Putnam asked Calyon to send the Rating Agency Portfolios for its review, 56.1 ¶ 61; Calyon did so, 56.1 ¶ 62; and Putnam reviewed them. 56.1 ¶ 63. These documents, on their face, disclosed materially inflated percentages of prime (10.4%) and higher-rated (20%) assets in the Pyxis portfolio. 56.1 ¶ 64. Putnam also reviewed the draft Fitch pre-sale report, which disclosed the same materially inflated percentages of prime and higher-rated assets. 56.1 ¶¶ 65-67.

Given these undisputed facts, there is no genuine dispute that Putnam knew or should have known that the disclosures concerning the Pyxis target portfolio in the Pyxis offering materials, the July 13, 2006 target portfolio, the PCS, and the Rating Agency Portfolios were all materially false, and that FGIC, both directly and indirectly, relied on the accuracy of that information. At a minimum, Putnam indisputably knew the information in the Rating Agency Portfolios was materially false, and that FGIC relied on the credit ratings issued based on that information. Nor is there any genuine dispute that Putnam failed to alert FGIC to the fact that any of this information was false. Thus, there is no genuine dispute that Putnam breached its duty to FGIC to provide correct information about the Pyxis portfolio and to correct false information on which it knew FGIC was relying in evaluating its participation in Pyxis.

C. FGIC Reasonably Relied on Putnam's Misrepresentations and Omissions

Based on the undisputed facts, there is also no genuine dispute that FGIC reasonably relied on Putnam's misrepresentations and omissions concerning the Pyxis portfolio.

The following facts are undisputed: As the collateral manager, Putnam had superior knowledge to FGIC as to the assets to be acquired for the Pyxis portfolio—indeed, Putnam had superior knowledge *to everyone* as to those assets.

Further, the portfolio information in the offering materials and the July 13, 2006 target portfolio was provided *by Putnam*, on whom FGIC was obviously entitled to rely. 56.1 ¶ 43-47.

As for the information in the PCS, it was Putnam whom FGIC asked for that information; it was Putnam who told FGIC to obtain that information from Calyon and assured FGIC that Calyon had all that information; and it was Putnam who made clear to FGIC that it regarded FGIC as its client. 56.1 ¶¶ 37-38, 54-55. On

September 6, 2006, based on the information in the PCS, FGIC notified Putnam that it would provide insurance on the super-senior Pyxis tranche with 40% subordination. 56.1 ¶ 37. Two days later, the subordinate Pyxis debt priced, based on FGIC's agreement to insure the super-senior tranche. 56.1 ¶¶ 35-36. Yet, at no time either before or after FGIC agreed to provide insurance on the super-senior tranche did Putnam (or anyone else) inform FGIC that the information in the PCS was materially false, that there would be no prime or pre-2005H2 RMBS in the Pyxis portfolio at closing, and that just 15.47% of the Pyxis portfolio would be rated above Baa2. 56.1 ¶ 39. Thus, FGIC had no reason to believe that the information in the PCS was materially false, and it had no reason not to rely on that information when it agreed to participate in Pyxis.[7]

[7] Putnam has suggested that FGIC could not reasonably rely on the PCS because on the second to last page of a seven page term sheet that followed a 252-page attachment to an email sent to FGIC on September 8, 2006—two days *after* FGIC committed to the deal and less than an hour before Pyxis priced—there was a disclosure that the Pyxis portfolio would contain just 2% prime RMBS. *See* Declaration of Sean P. Baldwin dated September 21, 2018, Ex. 82. Putnam is wrong. First, Putnam ignores that the email to which this term sheet was attached concerned the pricing of the subordinate Pyxis debt, not the super-senior or Class A-1 tranches. As the email states on its face, the super-senior (described as the "Senior Swap Aaa/AAA/AAA") and Class A-1 tranches were "Not offered" pursuant to this email. That was because FGIC and the Class A-1 investor had already agreed to the terms on which they would participate; their prior commitment was necessary before the subordinate tranches could even be priced. Thus, the content of the email was irrelevant to FGIC, who had no reason to review it. Indeed, the email was not even addressed to FGIC; it was sent to investors on September 7, 2006 (again, *after* FGIC had committed to the deal) and was only forwarded to FGIC as an "FYI" courtesy the next day. Nothing in the email sent to FGIC indicated that the attachments might differ materially from portfolio information FGIC had already seen. And the purported "disclosure" to which Putnam refers was itself materially false, since it claimed that Pyxis would contain 2% prime RMBS and 20% of assets rated above Baa2 (rather than 0% and 15.47% respectively). Finally, a week after this email was sent, the Fitch presale report was published, which stated prominently that the Pyxis portfolio would include 10.4% prime RMBS, consistent with FGIC's understanding based on the PCS. 56.1 ¶ 41.

Nor is there any genuine dispute that FGIC reasonably relied on the accuracy of the information provided to the rating agencies. The fact of FGIC's reliance follows necessarily from the fact that, under Section 4(a) of the Pyxis Securities Purchase Agreement, it was a condition precedent to Pyxis's closing, and thus to FGIC's investment in Pyxis, that any Pyxis debt with 21% or more subordination be rated AAA. 56.1 ¶ 71. Unlike Putnam, FGIC had no knowledge of the information actually provided to the rating agencies on which the Pyxis ratings were based; the only parties with access to this information were Calyon, Putnam, and the rating agencies. 56.1 ¶¶ 60-63. It is undisputed that at no time either before or after FGIC agreed to insure the super-senior swap did Putnam or anyone else advise FGIC that the Rating Agency Portfolios was materially false. 56.1 ¶ 39. Thus, FGIC had no reason to doubt that the information provided to the rating agencies was accurate and, again, reliable.[8] Accordingly, there can be no genuine dispute that FGIC reasonably relied on the accuracy of the Rating Agency Portfolios.

II. Because the Pyxis Guaranty Was Irrevocable, All of FGIC's Losses Flowing From the Policy Were Directly and Proximately Caused by Putnam's Misrepresentations and Omissions Inducing the Guaranty

Throughout this case, Putnam has argued that FGIC cannot prove "loss causation"—*i.e.*, that its misrepresentations and omissions proximately caused FGIC's losses under the Pyxis Guaranty—in large part because of the impact of the global financial crisis. That is incorrect.

At trial, FGIC will show that Putnam's misrepresentations and omissions directly and proximately caused its losses in several ways. *First*, FGIC will show that

[8] The September 8, 2006 email that Putnam argues undermines FGIC's reliance on the PCS (*see* n. __ *supra*) could not possibly have alerted FGIC to the inaccuracies in the Rating Agency Portfolios. FGIC had no way of knowing whether the information in that attachment was consistent with the information in the Rating Agency Portfolios, because it did not know what information was in the Rating Agency Portfolios.

had Putnam disclosed the true nature of the Pyxis portfolio in the PCS or Rating Agency Portfolios, FGIC would not have agreed to issue the Pyxis Guaranty on the terms it did, and would only have done so (if at all) with at least 50% subordination, meaning it would have been exposed to losses of $150 million less than it was. *See* Statement of Facts, Parts __, __, *supra*.

Second, FGIC will show that had FGIC not commuted the Pyxis Guaranty, the losses it would have suffered thereunder based on the performance of the actual Pyxis portfolio were materially greater than the losses it would have suffered based on the assets represented in the PCS or another portfolio that accorded with Putnam's representations.

Third, FGIC will show that Magnetar's Constellation CDO scheme materially exacerbated the scale of the U.S. housing crisis and thus materially contributed to the global financial crisis (which Putnam's expert has conceded was triggered by the U.S. housing crisis). In turn, Putnam, as the first well-established, respected asset manager to agree to manage one of the Constellation CDOs, played a significant role in getting the Constellation scheme off the ground and attracting both investors and other respected asset managers to the program. Thus, Putnam cannot hide behind the financial crisis to argue it was an independent intervening cause of FGIC's losses. *Fed. Housing Fin. Agency v. Nomura Holding America, Inc.*, 873 F.3d 85, 156 (2d Cir. 2017) (holding that RMBS sponsors whose misstatements concerning the credit characteristics of mortgages underlying its RMBS "may not hide behind a market downturn that is in part their own making simply because their conduct was a relatively small part of the problem.").

However, it is not necessary to await trial or to resolve any of the above issues to determine whether FGIC can prove loss causation and resulting damages. That is because the Pyxis Guaranty, by its own terms, provided that "[t]his Surety Bond may not be canceled by the Surety [FGIC] prior to termination in accordance with its terms." 56.1 ¶ 8. Because FGIC could not cancel the Pyxis Guaranty, Putnam's misrepresentations and omissions not only induced FGIC to enter into the Pyxis Guaranty but also induced it to retain its exposure under the Guaranty for the full term of the Guaranty. Accordingly, all of FGIC's losses under the Pyxis Guaranty (*i.e.*, the $74.5 million FGIC was required to pay to commute the Pyxis Guaranty) were directly and proximately caused by Putnam's misrepresentations and omissions, and can be recovered by FGIC as damages.

As this Court has held, where misrepresentations "induced both the purchase *and the retention* of [an] investment, proximate cause [*i.e.*, loss causation] has been established despite intervening business factors, including a recession in the relevant business." *Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 503-04 (S.D.N.Y. 2001) (Sweet, J.) (emphasis added), *amended on reconsideration in part*, 137 F. Supp. 2d 438 (S.D.N.Y. 2001), *abrogated on other grounds by Casey v. Merck & Co.*, 653 F.3d 95 (2d Cir. 2011) (quoting *Kaufman v. Chase Manhattan Bank, N.A.*, 581 F. Supp. 350, 354 (S.D.N.Y. 1984)). In *Primavera*, investors alleged they had been "induced to purchase and/or retain their interests in [certain] Funds based on misrepresentations … that the Funds would be (and were) valued using independent broker marks, maintained in a strict market neutral posture, and managed through the use of sophisticated, proprietary computer models." *Id.* at 488. Defendants contended that loss causation could not be established because any losses were "attributable not to the alleged primary fraud but, rather, to extraneous factors, namely, a market downturn resulting from sharp and unexpected interest rate increases … the effect of leverage and excessive negative convexity in the Funds' portfolios, and the actions of other brokers in liquidating the Funds' portfolios." *Id.* at 502-03. Noting that it was "not necessary that the drastic increase in interest rates … itself have been foreseeable," this Court held that loss causation could be established where it "could reasonably have been foreseen that the [i]nvestors would have been induced to make and/or retain their investments, which investments were then lost when the [f]unds were destroyed by the effect of rising interest rates on the heavily bullish portfolios and the margin calls by the brokers." *Id.* at 505.

Thus, the Court held that "investors who were fraudulently induced to buy and retain securities were permitted to recover the difference between the amount invested and the value of their securities once the fraud was revealed"—not merely the difference between the amount paid and the value of the article received at the time of purchase. *Id.* at 505-06 (citing *Hotaling v. A.B. Leach & Co.,* 247 N.Y. 84, 159 N.E. 870, 873 (1928)). The Court noted that where "investments ha[ve] become worthless due to subsequent events that led to the collapse of the issuer," plaintiffs have been granted recovery of their entire investment. *Id.* at 506 (citing *Hotaling*, 159 N.E. at 873); *see also Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 707-710 (2d Cir. 1980) (finding loss causation where trainee at brokerage firm misrepresented he was stockbroker and plaintiffs both purchased and retained their securities, despite their "misgivings prompted by the market behavior of the securities," in reliance on defendant's purported expertise and his assurance the stock "was going to go up"; court further held that, because "the misrepresentation was such as to induce both [plaintiffs'] purchases and their holding of the securities, their holding and its duration determined the extent of their losses."); *see also id.* at 709 (collecting cases demonstrating the "proposition that fraudulent representations may induce the retention of securities as an investment and entail liability for the damages flowing from retention"); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 187 (2d Cir. 2001) (noting that in *Marbury* "the loss in value came as a result of external market forces and not because of the trainee's lack of credentials," but the loss causation holding was nonetheless proper because "the trainee's misrepresentation as to his expertise induced plaintiffs both to purchase the securities *and to continue to hold them when they began to lose value.*") (emphasis in original); *AUSA Life Ins. Co. v. Ernst & Young*, 206

F.3d 210, 216-17 (2d Cir. 2000) (plaintiffs relied on auditors' misrepresentations of company's financial condition in making and retaining investments in company; court held "the fraud actually accomplish[ed] the result it was intended to achieve" by inducing investors to retain investments, rendering defendant liable for all foreseeable losses flowing from continued investment).

Here, FGIC's position is even stronger than that of the investors in the above cases. Putnam's misconduct not only induced FGIC to retain its exposure under the Pyxis Guaranty, but induced it *to assume an obligation to retain* that exposure for the entire term of the Pyxis Guaranty. Because the Guaranty, once issued, could not be canceled by FGIC during its term, it was not only reasonably foreseeable but *inevitable* that, as a direct result of Putnam's misrepresentations and omissions, FGIC would retain its exposure throughout any market downturn that occurred during the term of the Pyxis Guaranty, and all losses suffered under the Guaranty are therefore recoverable as damages.

This result is consistent with the policy underlying the loss causation rule. The loss causation rule averts the moral hazard that would attend an investor's ability to employ a fraud or misrepresentation claim as a form of "broad insurance against market losses." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005). In the securities context, where "[s]hares are normally purchased with an eye toward a later sale," *id.* at 342, such a hazard would be presented if an investor could choose to retain its exposure on a security and delay filing suit during the period of limitations, secure in the knowledge that it could pocket all investment gains while any losses could be assigned to the defendant. The misrepresentation claim would, in effect, serve as a free "put option" for the plaintiff's benefit and at the defendant's expense.

But this concern does not apply where the plaintiff was induced to *retain* its exposure by defendant's misrepresentations. In that case, the defendant *caused* the plaintiff to retain the exposure, and this is even more clearly the case where the exposure, once assumed, cannot be canceled during a specified period. Put another way, FGIC *could not* have enjoyed a free option on its Pyxis exposure at Putnam's expense, because it *had no* option to buy or sell its position. It issued a non-cancelable guaranty to Calyon, which was precisely "the result [Putnam] intended to achieve." *AUSA*, 206 F.3d at 212-13 (internal quotation marks omitted). The only action FGIC could take was to mitigate its losses by negotiating a commutation with its counterparty at the lowest cost it could achieve, which is precisely what it did.

This result is consistent with the recent decision of the New York Court of Appeals in *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 31 N.Y.3d 569, 2018 WL 3129387, N.Y. Slip Op. 04686 (June 27, 2018). *Ambac* held that an RMBS sponsor alleging fraud in the inducement of an insurance policy could only recover claims payments that were caused by the sponsor's alleged misrepresentations. The court held that the alleged misrepresentations related to the characteristics of individual loans rather than the transactions as a whole, and thus the plaintiff could only recover claims payments arising from loans whose characteristics had been misrepresented. Putnam's misrepresentations, by contrast, related to the Pyxis transaction as a whole—they concerned who would select the Pyxis collateral and the broad categories of collateral in and diversity of the Pyxis portfolio as a whole. Because it was not only foreseeable but inevitable that FGIC would be induced by those misrepresentations to retain its exposure to Pyxis for the term of the Pyxis Guaranty, Putnam is liable for all of FGIC's losses under the Guaranty during that term.

CONCLUSION

For the reasons set forth above, the Trusts seek partial summary judgment that (1) Putnam is liable for negligent misrepresentation and negligence in connection with the inducement of the Pyxis Guaranty; (2) all of FGIC's losses under the

Pyxis Guaranty, including from the commutation of the Pyxis Guaranty, were proximately caused by Putnam's negligent misrepresentations and omissions and by Putnam's negligence, and FGIC is entitled to recover all such losses as damages; and (3) FGIC is entitled to such further relief as the Court may deem just and proper.

Dated: September 21, 2018
New York, New York

By: */s/ Sean P. Baldwin*

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CERTIFICATE OF SERVICE

I hereby certify that all counsel of record have been served with copies of the foregoing Plaintiff's Memorandum of Law in Support of Its Motion for Partial Summary Judgment via electronic mail this 21st day of September, 2018.

/s/ William Rathgeber

William Rathgeber