Memorandum

April 22, 2010

New York Court Enforces "Big Boy" Disclaimers in Credit Default Swap Transaction but Permits Novel Credit Rating Claim to Proceed

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"New York court enforces Big Boy provisions to dismiss fraud claims in credit default swap transaction."

A New York trial court recently enforced contractual disclaimers of reliance ("Big Boy" provisions) in a credit default swap ("CDS") context. In *MBIA Insurance Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, No. 09- 601324 (N.Y. Sup. Ct. Apr. 7, 2010), the court granted Merrill Lynch's motion to dismiss plaintiffs' fraudulent inducement, fraudulent omission and negligent misrepresentations claims.[1] The court, however, let stand a breach of contract claim in which it was alleged that promised AAA-rated securities were not truly AAA-rated (even though they were so rated) – because they did not deserve the AAA rating.

BIG BOY

In earlier articles, we concluded that although a duty to disclose may arise in certain situations among sophisticated parties to an arms-length transaction, particularly where one party possesses superior knowledge that is not readily available to its counterparty, New York state and federal courts permit parties to contractually modify disclosure obligations. *Superior Knowledge and the Duty to Disclose,* October 8, 2009. We also examined the enforceability of "Big Boy" provisions in cases in which sophisticated parties specifically disclaim reliance on any representations by their counterparties and agree to conduct independent investigations prior to entering a transaction. *Non-Reliance Provisions and Claims Of Insider Trading,* November 2006.

The decision in *MBIA Insurance Corp. v. Merrill Lynch* pits MBIA's argument that Merrill Lynch had a duty to disclose arising from its superior knowledge against Merrill Lynch's defense based on the parties' "Big Boy" provisions. The decision reaffirms our view that courts in New York will enforce specific disclaimers of reliance in arms-length transactions between sophisticated parties, particularly where the parties (1) disclaim both reliance and duty to disclose and (2) represent that each party will conduct its own independent investigation of the underlying transaction. The court in this case, however, did not address the precedent in which disclaimers were not enforced because the court found willful misconduct or intentional wrongdoing.[2]

1 *See* Order on Motion to Dismiss, *MBIA Insurance Corp. v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, No. 09-601324 (N.Y. Sup. Ct. Apr. 7, 2010), available at http://www.mbia.com/investor/legal_proceedings.html.

2 *See generally Sommer v. Federal Signal Corp.*, 79 N.Y.2d 540, 554 (1992); *Kalish-Jarcho, Inc. v. City of New York*, 58 N.Y.2d 377, 385 (1983).

The facts in *MBIA v. Merrill Lynch* are as follows: MBIA's subsidiary, LaCrosse Financial Products LLC ("Protection Seller"), entered into eleven credit default swaps with various counterparties ("Protection Buyers") pursuant to which it sold protection on eleven purportedly "senior" and "super senior" tranches of four collateralized debt obligations ("CDOs") with a total notional value of approximately $5.7 billion. With respect to each CDS contract, MBIA ("Financial Guarantor") executed a Financial Guaranty Insurance Policy pursuant to which it guaranteed Protection Seller's payment obligations to Protection Buyer under the related CDS contract. This is a standard structure for financial guarantees of structured products.

The documents that created each CDS included an ISDA Master Agreement, Schedule and a swap confirmation referencing the indenture pursuant to which the wrapped notes of the relevant CDO were issued. The Protection Seller had access to the offering circulars, pitch books and other material Merrill Lynch issued as arranger and marketer of the CDOs. Merrill Lynch also procured letters from rating agencies assigning credit ratings to each debt tranche of the CDOs.

MBIA and LaCrosse Financial sued Merrill Lynch seeking money damages and rescission of the credit default swaps, claiming that they relied, to their detriment, on various materials in entering the CDSs and guarantees that turned out to be false. In their First Amended Complaint, MBIA and LaCrosse Financial alleged that Merrill Lynch engaged in a fraudulent scheme to "offload billions of dollars of deteriorating U.S. subprime mortgages and other collateral that Merrill held on its books by packaging them into CDOs or hedging their exposure through swaps with insurers" and then marketing those "toxic assets" to plaintiffs.[3] The truth, according to plaintiffs, was that by the closing date of the CDOs, the underlying collateral had degraded so significantly that MBIA, the Protection Seller, was exposed to an immediate risk of loss. MBIA claimed that as a result of Merrill Lynch's alleged fraud, MBIA faced expected losses nearing a half-billion dollars.

The gist of plaintiffs' duty to disclose argument was that Merrill Lynch, "as the arranger, broker-dealer, and warehouse provider for each of the CDOs at issue" had loan-level data that provided it with "real-time information concerning the declining credit quality of the collateral," but that "Merrill Lynch did not disclose this superior knowledge to MBIA but instead marketed the CDS Contracts based on ratings, and related indicia of credit quality, that it knew to be false and misleading. Merrill Lynch did not disclose to MBIA that it knew the ratings were false or that it used alternative indicia of credit quality for its own books. In effect, Merrill Lynch sold the deals to MBIA based on one set of values—the ratings of the wrapped tranches and collateral—while marking its own books based on materially different valuations derived from loan-level performance data."[4]

Moreover, plaintiffs argued that "Merrill Lynch knew that it had procured the ratings on the basis of inadequate information—including its nondisclosure of the problems in loan-level performance—and that the ratings did not fairly reflect the actual credit quality of either the CDO tranches or the collateral."[5] As a result of Merrill Lynch's alleged foregoing superior knowledge, plaintiffs claimed the offering materials fraudulently misrepresented (1) the "A- or above" credit quality of the collateral underlying the CDOs; (2) the "senior" or "super-senior" subordination protection of the insured CDO tranches; (3) the "AAA" ratings of the CDO tranches; and (4) the historical default rates of comparable CDOs.

The court granted Merrill Lynch's motion to dismiss the fraudulent inducement, fraudulent omission and negligent misrepresentation claims based on the specific disclaimers in the parties' agreements and the

3 Unless otherwise noted, the quotations herein relate to the Court's Order entered April 7, 2010.

4 *See* First Amended Complaint at ¶ 15, *MBIA Insurance Corp. v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, No. 09-601324 (N.Y. Sup. Ct. May 15, 2009), available at http://www.mbia.com/investor/legal_proceedings.html.

5 First Amended Complaint at ¶ 14.

offering materials. First, in each Financial Guaranty Insurance Policy (collectively, the "Guaranty"), MBIA waived all defenses to payment and also represented that it unconditionally and irrevocably guaranteed to Protection Buyer the full payment on behalf of LaCrosse Financial of any insured amount "without the assertion of any defenses to payment, including fraud in the inducement or fact." Paragraph 12 of the Guaranty also contained a "sweeping disclaimer of reliance on, among other things, any assertion that MBIA (A) was not acting for its own account, (B) was not capable of assessing or understanding (on its own behalf or through independent professional advice) and accepting the terms, conditions and risks of issuing the Policy, (C) was not capable of assuming the risks of the Policy."

LaCrosse Financial likewise specifically disclaimed reliance on Merrill Lynch and represented that it was capable of assessing and evaluating the transaction. For instance, the Schedule to the ISDA Master under which the swap confirmations between LaCrosse Financial and Merrill Lynch were executed specifically provided that LaCrosse Financial was "not relying on any advice, statements or recommendations (whether written or oral) of the other party regarding the Transaction, other than the written representations expressly made by that other party in this Agreement and in the Confirmation," and that LaCrosse Financial had "the capacity to evaluate (internally or through independent professional advice) the Transaction (including decisions regarding the appropriateness or suitability of the Transaction) and has made its own decision to enter into the Transaction [.]" LaCrosse Financial further represented that it "acknowledges and agrees that [Merrill Lynch] is not acting as a fiduciary or advisor to it in connection with the Transaction."

Notwithstanding the various disclaimers in their agreements and offering materials, plaintiffs argued that their reliance on Merrill Lynch was justified and reasonable because "it was not customary, and would have been very unusual, for any buyer or any credit protection provider at the super-senior level to value complex CDOs by assessing the thousands of underlying securities and the tens or hundreds of thousands of underlying loans, in order to verify whether the arranger's representations of credit quality were truthful."[6] Plaintiffs further alleged that the "buyside industry standard approach to evaluating senior debt tranches of complex and illiquid CDOs . . . was (1) due diligence of the expertise and integrity of the arranger and collateral manager..."[7]

The court rejected plaintiffs' reliance arguments based on long-standing precedent,[8] holding that to allow MBIA and LaCrosse Financial "to now disavow their express and specific promise not to raise the affirmative defense of fraud would be to allow them to condone [their] own fraud in deliberately misrepresenting their true intention when putting their signatures to their "absolute and unconditional" guarantee." In addition, the court cited precedent[9] which held that a specific disclaimer in a guarantee bars the guarantor's claim for fraud in the inducement where the guarantor specifically disclaims reliance on the information it claims caused it to be misled. The court also stressed that clauses that declare an agreement unconditional and absolute and waive affirmative defenses (such as those in the Guaranty) "reinforc[e] the specificity of the disclaimer." The court found the disclaimers in the Guaranty sufficiently specific to withstand challenge, especially in light of the fact that the disclaimers "were the product of intensive negotiations among the parties, whose sophistication and business acumen and experience cannot be overstated." Ultimately, the court dismissed plaintiffs' claims for fraud in the inducement, fraud by omission and negligent misrepresentation, "all of which require a claim of reasonable reliance on representations plaintiffs expressly stated they were not relying on."

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6 First Amended Complaint at ¶ 10.

7 First Amended Complaint at ¶¶ 10, 62.

8 Danann Realty Corp. v. Harris, 5 N.Y.2d 317, 323 (1959).

9 Citibank, N.A. v. Paplinger, 66 N.Y.2d 90, 94-5 (1985).

"UNDERSERVED" AAA RATINGS

One important aspect of MBIA's complaint remains viable. MBIA claimed that Merrill, through its subsidiary Merrill Lynch International ("MLI"), breached promises in the CDS contracts to deliver securities that were AAA rated with senior or super senior subordination characteristics. Specifically, plaintiffs alleged that although the securities were rated AAA, the credit-quality of the collateral underlying the securities "did not warrant their AAA-ratings and did not have the levels of subordination represented by Defendant MLI."[10] The court held that plaintiffs stated a claim for breach of contract on the "bogus" credit ratings because" plaintiffs had a right to expect that the AAA ratings were backed by intelligence which could verify that the notes were actually of the "credit quality" an AAA rating implied."

As far as we know, this is the first time a court has held that a defendant faces potential liability for stating that securities were AAA rated when they were in fact AAA rated but it later turns out that the third-party rating agency should not have rated them AAA.

Finally, the court held that plaintiffs failed to plead breach of contract on the subordination issue because none of the documents that formed the parties' agreements contained an express right to any fixed level of subordination. The court dismissed the remaining causes of action as duplicative, or for failure to state a recognizable cause of action. Plaintiffs are appealing the decision.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or the person listed below.

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10 First Amended Complaint at ¶ 96.