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

PRESENT: MARCY S. FRIEDMAN
Justice

PART 60

BASIS YIELD ALPHA FUND (MASTER),

INDEX NO. 654424/2012

Plaintiff,

-against-

MORGAN STANLEY, MORGAN STANLEY & CO. LLC (f/k/a MORGAN STANLEY & CO. INC.), MORGAN STANLEY & CO. INTERNATIONAL PLC (f/k/a MORGAN STANLEY & CO. INTERNATIONAL LIMITED), and JOHN DOES 1-50,

Defendants.

MOTION SEQ. NO. 002

The following papers, numbered 1 to ____ were read on this motion to dismiss.

Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	No (s).
Answering Affidavits — Exhibits	No (s).
Replying Affidavits	No (s).

Cross-Motion: ☐ Yes ☐ No

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Upon the foregoing papers, it is ORDERED that defendants' motion to dismiss is denied in accordance with the attached decision/order, dated April 16, 2015.

Dated: April 16, 2015 Marcy Friedman, J.S.C.
MARCY S. FRIEDMAN, J.S.C.

1. Check one: ☐ CASE DISPOSED ☒ NON-FINAL DISPOSITION
2. Check as appropriate: Motion is: ☐ GRANTED ☒ DENIED ☐ GRANTED IN PART ☐ OTHER
3. Check if appropriate: ☐ SETTLE ORDER ☐ SUBMIT ORDER
☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK – PART 60

PRESENT: Hon. Marcy Friedman, J.S.C.

---x

BASIS YIELD ALPHA FUND (MASTER),

Plaintiff,

-against-

MORGAN STANLEY, MORGAN STANLEY & CO. LLC (f/k/a MORGAN STANLEY & CO. INC.), MORGAN STANLEY & CO. INTERNATIONAL PLC (f/k/a MORGAN STANLEY & CO. INTERNATIONAL LIMITED), and JOHN DOES 1-50,

Defendants.

---x

DECISION/ORDER

Index No. 654424/2012

Motion Seq. 002

In this action, plaintiff Basis Yield Alpha Fund (Master) (the Fund) seeks to recover its losses on subordinated notes (Subordinated Notes) in a collateralized debt obligation (CDO) purchased from defendants Morgan Stanley, Morgan Stanley & Co. LLC (formerly Morgan Stanley & Co. Inc.), and Morgan Stanley & Co. International PLC (formerly Morgan Stanley & Co. International Limited) (collectively, Morgan Stanley). Morgan Stanley moves to dismiss for failure to state a claim and upon documentary evidence pursuant to CPLR 3211(a) (1) and (7), or, in the alternative, to strike plaintiff's demand for a jury trial.

Background

The relevant facts, as alleged in the complaint, are as follows: In late 2006 and early 2007, Morgan Stanley arranged, structured and marketed a $900 million hybrid cash/synthetic mezzanine asset-backed security CDO called STACK 2006-2 (STACK-2). (Complaint, ¶¶ 2-3.) STACK-2 was composed of asset-backed securities, primarily residential mortgage-backed securities (RMBS), and consisted of classes of notes or "tranches" "with different risk allocations, rates of return, and ratings." (Id., ¶¶ 2, 40, 42.) Less than four percent of the structure was comprised of the lowest tranche, unrated Subordinated Notes. (Id., ¶ 43.) These Subordinated Notes "were the most junior layer of the structure" and, only "once the more senior tranches" were paid, would the "remaining cash flow (subject to certain stated limitations) [] be paid to the Subordinated Notes." (Id., ¶ 45.) "STACK-2 was structured and the Subordinated Notes were priced based on the expectation of significant cash flow payments to the Subordinated Notes investors from the very beginning." (Id.)

In January 2007, the Fund finalized a purchase of $20 million of STACK-2 Subordinated Notes for $17.55 million. (Complaint, ¶ 4.) STACK-2's overall structure was particularly important to the Fund's decision to invest in the Subordinated Notes, because "the small size of the [Subordinated Notes] relative to the very large size of the most highly rated tranches . . . spoke to the need for very little credit enhancement, which in turn spoke to the quality of the Collateral Assets, the low expected default correlation of the Collateral Assets, the low expected default rate of the Collateral Assets, and the overall risk/reward involved in the trade." (Id., ¶¶ 50, 54.) Morgan Stanley made the securing of investment-grade ratings for the other tranches a condition of closing and used "[t]he structure and size of the tranches, the ratings of each tranche, and the payment obligations and schedules to each tranche" to induce the Fund and others to invest. (Id., ¶¶ 48-49.)

Before investing, the Fund was provided with offering materials. In addition, the Fund had numerous email and verbal communications with Morgan Stanley concerning the risk of STACK-2, the proper rate of return for the Subordinated Notes, and the key assumptions and variables, including RMBS default rates. (Id., ¶ 168.) For example, Morgan Stanley represented that the constant annual default rate was 0.25% even though it knew "that the mortgages underlying STACK-2 were defective and posed significant default risks that would result in a [constant annual default rate] much higher than 0.25%." (Id., ¶¶ 112, 115.) With respect to another statistic used to market the CDO, Morgan Stanley represented that the default correlation was between 20.77% and 22.50% even though it knew that the actual default correlation was much higher. (Id., ¶¶ 149, 160.)

Morgan Stanley was one of the largest securitizers and underwriters of RMBS in the marketplace and "operated at every level of the securitization process." (Complaint, ¶¶ 58-59.) Through its relationships with numerous subprime mortgage originators, Morgan Stanley had access to material nonpublic information about their underwriting practices, including their systemic deviation from, and abandonment of, their stated underwriting guidelines and criteria. At the time Morgan Stanley sold STACK-2 to the Fund, Morgan Stanley knew that it included RMBS collaterialized with mortgages that did not meet underwriting guidelines. (Id., ¶¶ 58, 65-69, 71, 78.) In addition, Morgan Stanley provided lines of credit to several large originators, and Morgan Stanley would subsequently purchase and securitize those loans. (Id., ¶ 82.) As a lender, "Morgan Stanley became intimately familiar with the lending practices of these originators through extensive due diligence on their business operations." (Id.; see also id., ¶¶ 93-94.) Morgan Stanley "approved for inclusion in STACK-2 over $106 million of its own, Morgan Stanley-securitized, toxic RMBS collateral that was created from these defective loan pools," knowing "that the failure of these RMBS alone would be sufficient to wipe out–many times over–[t]he Fund's entire investment." (Id., ¶ 79.) Morgan Stanley also accepted for STACK-2 an additional $137 million of RMBS backed by loans made by mortgage originators for which Morgan Stanley served as a warehouse facility lender, and which Morgan Stanley knew had abandoned their underwriting guidelines. (Id., ¶¶ 13, 47.) Morgan Stanley "had actual knowledge that a significant portion of the mortgages underlying the RMBS in STACK-2 were much riskier than represented because of Morgan Stanley's peculiar knowledge of the originators' systemic failure to abide by underwriting guidelines." (Id., ¶ 100; see also id., ¶ 101.) Moreover, Morgan Stanley exercised veto power over any asset selected by the collateral manager, non-party TCW Asset Management Company (TCW), for inclusion in STACK-2. (Id., ¶ 51.)

To be eligible for inclusion in STACK-2, the RMBS had to receive certain minimum rating from a rating agency. (Complaint, ¶¶ 102-103.) To procure those ratings, Morgan Stanley provided the rating agencies with inaccurate information regarding the underlying mortgages, including loan-to-value, owner-occupancy, and debt-to-income ratios, and failed to disclose its knowledge regarding "the defective and toxic nature of the loans that made up those RMBS." (Id., ¶ 106.) Morgan Stanley also made misrepresentations to the Fund concerning the credit quality of the underlying mortgages, including that various RMBS deserved investment grade ratings. (Id., ¶¶ 107, 110, 120, 124.)

However, while Morgan Stanley was selling STACK-2, it shorted low rated RMBS tranches for more than $1 billion, demonstrating that it "did not believe in the quality or stability" of the RMBS underlying STACK-2. (Complaint, ¶¶ 162-163.) It also offloaded a major portion of its exposure from another CDO, STACK-1, which was backed by much of the same collateral as STACK-2. (Id., ¶¶ 152-161.) Had Morgan Stanley not been able to remove toxic RMBS collateral carried on it books by selling it through a CDO like STACK-2, it risked significant losses. (Id., ¶ 52.)

According to the complaint, the information about the nature of the underlying RMBS and their ratings was peculiarly within Morgan Stanley's knowledge, unknown to the Fund, and "undiscoverable to even the most sophisticated investor through ordinary due diligence." (Complaint, ¶¶ 2 , 5,-6, 8, 12-13, 46-47, 56, 93-94, 100, 109, 111, 171.) Morgan Stanley "concealed" that information although it had a "duty to disclose" it to the Fund. (Id., 178-179.) The Fund alleges that if it had known about the toxic underlying RMBS and the inflated ratings, it would not have invested in STACK-2. (Id., ¶¶ 21, 149, 171.)

Based on these allegations, the Fund asserts two causes of action, common law fraud (first cause of action) and fraudulent concealment (second cause of action). The Fund seeks compensatory damages in the amount of $17.2 million and punitive damages.

Discussion

It is well settled that on a motion to dismiss addressed to the face of the pleading, "the pleading is to be afforded a liberal construction (see, CPLR 3026). [The court must] accept the facts as alleged in the complaint as true, accord plaintiffs the benefit of every possible favorable inference, and determine only whether the facts as alleged fit within any cognizable legal theory." (Leon v Martinez, 84 NY2d 83, 87-88 [1994]; see also 511 W. 232nd Owners Corp. v Jennifer Realty Co., 98 NY2d 144 [2002].) However, "the court is not required to accept factual allegations that are plainly contradicted by the documentary evidence or legal conclusions that are unsupportable based upon the undisputed facts." (Robinson v Robinson, 303 AD2d 234, 235 [1st Dept 2003]; see also Water St. Leasehold LLC v Deloitte & Touche LLP, 19 AD3d 183 [1st

Dept 2005], lv denied 6 NY3d 706 [2006].) When documentary evidence under CPLR 3211 (a) (1) is considered, "a dismissal is warranted only if the documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law." (Leon, 84 NY2d at 88.)

To state a cause of action for fraud, the Fund must "prove a misrepresentation or a material omission of fact which was false and known to be false by defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the misrepresentation or material omission, and injury." (Lama Holding Co. v Smith Barney, 88 NY2d 413, 421 [1996].) A fraud claim must be pleaded with particularity pursuant to CPLR 3016 (b). (Eurycleia Partners, LP v Seward & Kissel, LLP, 12 NY3d 553, 559 [2009].) However, this statute "should not be so strictly interpreted as to prevent an otherwise valid cause of action in situations where it may be impossible to state in detail the circumstances constituting a fraud." (Id., quoting Pludeman v Northern Leasing Sys., Inc., 10 NY3d 486, 491 [2008].) "Thus, where concrete facts are peculiarly within the knowledge of the party charged with the fraud, it would work a potentially unnecessary injustice to dismiss a case at an early stage where any pleading deficiency might be cured later in the proceedings." (Pludeman, 10 NY3d at 491-492 [internal quotation marks and citations omitted].) CPLR 3016 (b) is satisfied when the alleged "facts are sufficient to permit a reasonable inference of the alleged conduct." (Id. at 492.)

On this motion, Morgan Stanley's primary challenge is to the element of justifiable reliance. Morgan Stanley contends that any claim of reliance is untenable in view of the disclosures and disclaimers made in the offering materials, as well as the Fund's failure to conduct due diligence. (Ds.' Memo. Of Law In Supp. at 11-22.) In support of its motion to dismiss, Morgan Stanley relies on documentary evidence, including the STACK-2 Offering Memorandum (OM) (Rouhandeh Aff., Exh. B) and the STACK-2 Investor Presentation (IP) (Rouhandeh Aff., Exh. C).[1] As to risk, these offering materials cautioned prospective investors that the Subordinated Notes were highly leveraged and volatile (OM at 32; IP at 85) and bore thegreatest risk of loss (OM at 31); that they were subject to "disproportionately large changes in value" and were not guaranteed (OM at 202); that they were extremely sensitive to delinquencies and loss performance in the underlying assets (IP at 82; OM at 38-39); and that might lose all their value. (OM at 32.) The documents also warned that there were no reliable sources of statistical information for the default rate on the type of securities represented by the assets (IP at 82; OM at 48-49) and that, although Morgan Stanley was providing speculative, hypothetical illustrations, forecasts and estimates of the rates, it was making no representations regarding them (IP at 3; OM at 34) or regarding whether the assumptions that were employed were reasonable. (OM at 43; IP at 3.) As to conflict of interest, the offering materials disclosed that Morgan Stanley would be "act[ing] in its own commercial interest . . . without regard to whether its interests conflict with those of the Noteholders [including plaintiff] or any other party." (OM at 57.) In addition, these materials advised that "[n]umerous class action lawsuits have been filed in multiple states alleging violations of [federal, state and local consumer protection laws, including, among others, the federal Truth-in-Lending Act, the Fair Credit Billing Act, the Fair Credit Reporting Act and related statutes] and seeking damages, rescission and other remedies" with respect to related asset-backed securities. The materials also stated that the issuer and some of the loan originators were among the defendants. (OM at 37-38.)

[1]The Fund neither contests the veracity of these documents nor objects to the court's consideration of them.

Morgan Stanley also relies on two letter agreements executed by the Fund in connection with its purchase of the Subordinated Notes: a Master Purchaser Letter dated March 1, 2006 (MPL) (Rouhandeh Aff., Exh. J) and an Investor Representation Letter (IRL) dated February 13, 2007 (Rouhandeh Aff., Exh. G). In these letters, the Fund represented that it had made its investment decision based solely on its own judgment, without reliance on representations from Morgan Stanley (MPL at 2) and that Morgan Stanley was not acting as a fiduciary or an advisor (IPL at 1.) The Fund also represented that it was capable of evaluating the risks of its investment in STACK-2; that it had access to the necessary information about the investment; that it had consulted the appropriate legal, financial and accounting advisors as needed; and that none of the parties to the deal had given it any guarantees regarding the performance of the Subordinated Notes. (MPL at 2; IRL at 1.)

The First Department has recently considered and rejected most of the contentions advanced by Morgan Stanley in CDO transactions involving factually similar allegations of fraud. (See Loreley Financing (Jersey) No. 3 Ltd. v Citigroup Global Markets Inc., 119 AD3d 136 [1st Dept 2014] [Loreley[Citigroup]]; Loreley Financing (Jersey) No. 28, Ltd. v Merrill Lynch, Pierce, Fenner & Smith Inc., 117 AD3d 463 [1st Dept 2014] [Loreley [Merrill Lynch]]; Basis Yield Alpha Fund (Master) v Goldman Sachs Group, Inc., 115 AD3d 128 [1st Dept 2014] [Basis Yield [Goldman]]; China Dev. Indus. Bank v Morgan Stanley, 86 AD3d 435 [1st Dept 2011].)

Disclaimers and Disclosures

In Basis Yield [Goldman Sachs], the same Fund that is the plaintiff here alleged that defendant Goldman perpetrated a fraudulent scheme by constructing CDO offerings and selecting securities, in part from its own inventory, to offload poor quality securities to its clients while at the same time shorting the market in order to profit at its clients' expense. (Id. at 136.) As the Fund further alleged, "based upon Goldman's internal valuation of the securities and its involvement in the underlying asset selection process," Goldman had nonpublic knowledge, which it failed to disclose, "that it was selling toxic assets." (Id. at 138-139.) Like Morgan Stanley here, Goldman relied on disclaimers and disclosures in the offering circulars in support of its contention that the plaintiff could not establish justifiable reliance. (Id. at 137.) The First Department held that New York law is "abundantly clear" that "a buyer's disclaimer of reliance cannot preclude a claim of justifiable reliance on the seller's misrepresentations or omissions unless (1) the disclaimer is made sufficiently specific to the particular type of fact misrepresented or undisclosed; and (2) the alleged misrepresentations or omissions did not concern facts peculiarly within the seller's knowledge." (Id. at 137.) The First Department rejected Goldman's reliance on the following disclaimers and disclosures:

> "First, Goldman points out that the offering circulars required the purchaser to disclaim reliance on 'any advice, counsel or representation whether oral or written of [the sellers] . . . other than in this offering circular' and concomitantly advised the purchaser to 'consider and assess for themselves the likely rate of default of the references obligations.' Secondly, Goldman points out that the offering circulars disclose that '[a]ccording to recent reports, the residential mortgage in the United States has experienced a variety of difficulties and change in economic conditions that may adversely affect the performance and Market of RMBS.' Thirdly, Goldman points out that the offering circulars disclosed that an affiliate 'will act as the sole Synthetic Security counterparty,' which would 'create a conflict of interest,' and that it would be purchasing credit protection from the CDOs."

(Id. at 137-138.) The First Department held that these disclosures were "boilerplate statements regarding the speculative and risky nature of investing in mortgaged-backed CDOs and the possibility of market turns" (id. at 138), and did not put the plaintiff on notice "that Goldman not only structured, marketed and sold [the] CDOs, but that it did so with the intent to rid itself of long term exposure to subprime mortgages, and to profit by selling them to its clients and betting against its own long term position." (Id. at 139.)

Subsequently, in Loreley [Citigroup], the First Department reviewed similar allegations of fraudulent misrepresentations and omissions, which it described as "indistinguishable from those alleged in Basis Yield." (119 AD3d at 144.) As quoted by the Court, the complaint alleged that "'[a]s a result of its insider's knowledge, Citigroup knew that the RMBS it and other major banks were packaging into CDOs included a significant percentage of subprime mortgages that violated basic underwriting standards and were likely to default. . . . Rather than disclosing these material facts to investors . . . , Citigroup concealed them so that it could offload some of the massive exposure to subprime RMBS that Citigroup carried on its own balance sheet to unsuspecting investors. . . .'" (Id. at 140.) Citigroup also used the CDOs to benefit preferred clients who wanted to "short" the housing market. (Id.) The Court rejected the disclaimers, which it also found "strikingly similar" to those in Basis Yield, holding that those "disclaimers and disclosures d[id] not preclude, as a matter of law, a claim of justifiable reliance on the seller's misrepresentations or omissions."[2] (Id. at 146.)

[2]The Court summarized the disclaimers as follows:

> "First, Citigroup points out that the offering circulars required the purchasers to disclaim reliance on 'the advice or recommendations of or any information, representation . . . provided by [Citigroup] or any of its affiliates' and concomitantly acknowledge that they have 'determined (independently and without relying on [Citigroup] or any of its affiliates) . . . that [they are] financially able to bear such risks that [the] investment' entails. Secondly,

Similarly, in Loreley [Merrill Lynch] (117 AD3d at 467), where the offering circular represented that collateral debt securities were selected by an independent collateral manager, but it was alleged that a hedge fund was secretly placing a large short bet against the CDO and was, in fact, selecting collateral riddled with high percentages of nonconforming loans, the Court held: "[I]t cannot be said that the disclaimers and disclosures in the offering circulars preclude a claim of fraud on the ground of a prior misrepresentation as to the specific matter, namely that the CDO's collateral had been carefully selected by an independent collateral manager, in the interests of the success of the deal and for the benefit of [the issuer's] long investors." (See also Basis Yield Alpha Fund Master v Morgan Stanley, 2013 WL 942359, *3 [Sup Ct, NY County, Feb. 28, 2013, Index No. 652129/2012] [holding that facts about Morgan Stanley's specific knowledge of particular securities in the STACK-1 asset pool, based on its "own underwriting and internal due diligence procedures [,] were peculiarly within the knowledge of Morgan Stanley at the time that Basis Yield purchased the Subordinated Notes," and that the plaintiff's disclaimers of reliance were therefore ineffective to preclude it from pleading justifiable reliance].)

As in the above cases, Morgan Stanley's disclaimers and disclosures were general in nature and went largely to the risk of investing in the CDOs – in particular, the risk of the

---

Citigroup points out that the offering circulars disclosed that the collateral will be subject to various types of risks associated with RMBS, 'including, among others, credit risks, liquidity risks and interest rate' risks. Thirdly, Citigroup points out that the offering circulars disclosed that Citigroup and its affiliates 'may be acting in a number of capacities,' that the 'roles played by [Citigroup and its] affiliates may, at times, conflict with the interest' of the purchaser, and that 'the decisions made by such entities may prejudice (possibly materially) the interests of . . . the Noteholders.'" (119 AD3d at 143-144 [brackets in original].)

Subordinated Notes as the last tranche in the structure, the risk of the RMBS market generally, and the risk that results could not be predicted or guaranteed. (See supra at 6-7.) The disclosures relied on by Morgan Stanley did not put the Fund on notice of the facts forming the core of the alleged fraud – namely, that Morgan Stanley not only knowingly placed into the CDO "toxic" RMBS backed by mortgages that deviated from underwriting guidelines, but also that Morgan Stanley intended to profit by offloading toxic RMBS that it carried on its books. The disclosures thus did not apprise investors that Morgan Stanley had deliberately sabotaged assets in the CDO to profit from its short positions. (See e.g. Basis Yield [Goldman],115 AD3d at 138-139 [rejecting similar disclosures based on substantially similar allegations of fraud]; Loreley [Citigroup], 119 AD3d at 145 [holding that similar disclosures "did not reveal that seller had deliberately sabotaged the bond issuance so as to profit from the credit default swaps"].)

The disclosure that Morgan Stanley would be acting in "its own commercial interest" (see supra at 7), was similarly insufficient to put the Fund on notice of Morgan Stanley's intent to offload low-rated RMBS from its books. (See Basis Yield [Goldman], 115 AD3d at 138-139 [holding that even disclosure that Goldman was taking a short position was insufficient to preclude fraud claim based on Goldman's alleged structuring of CDO's "with intent to rid itself of long term exposure to subprime mortgages, and to profit by selling them to its clients and betting against its own long term position"].)

The disclosure of litigation against Morgan Stanley for alleged violations of consumer protection laws also does not mandate dismissal of plaintiff's claim of justifiable reliance. Morgan Stanley argues that this disclosure alerted the Fund to the need to question it or others about underwriting standards. (Ds.' Memo. Of Law In Supp. at 16.) On this record, the court cannot find as a matter of law that the disclosure, without more, put the Fund on notice that underwriting guidelines had been systematically abandoned with respect to the mortgages underlying STACK-2, and that ratings for the higher tranches had been falsely procured. The extent to which the scope and cause of problems in the subprime mortgage industry was understood in 2007 and 2008 has been the subject of considerable dispute. (See HSH Nordbank AG v Barclays Bank PLC, 2014 WL 841289,*6-7 [Sup Ct, NY County, March 3, 2014, Index No. 652678/2011] [discussing numerous decisions in RMBS investor fraud cases holding that motions to dismiss based on the statute of limitations could not be determined as a matter of law, where sponsors similarly argued that investors' duty of inquiry was triggered by information publicly available in 2007 and as late as mid-2008, such as media reports and filing of lawsuits against originators, regarding loosening of underwriting standards and unsatisfactory lending practices].)

"Peculiar Knowledge"

Under the First Department cases discussed above, even if this court were to find the disclaimers and disclosures sufficiently specific, the Fund adequately alleges that Morgan Stanley possessed nonpublic "peculiar knowledge" of the deficiencies in the collateral by virtue of its role in underwriting, securitizing and warehousing RMBS included in STACK-2. In Basis Yield [Goldman], the First Department relied on well settled law that "a purchaser may not be precluded from claiming reliance on misrepresentations of facts peculiarly within the seller's knowledge." (115 AD3d at 139 [internal quotation marks and citation omitted].) There, the plaintiff alleged that "because of what Goldman knew from its role as an underwriter and because of what the mortgage investigations conducted on its behalf (Clayton report) revealed, Goldman had access to nonpublic information regarding the deteriorating credit quality of subprime mortgages." (Id.) The Court held that these allegations were "more than adequate to allege the peculiar knowledge exception to the disclaimer bar." (Id.; see also Loreley [Citigroup], 119 AD3d at 145-146 [same]; China Dev. Indus. Bank, 86 AD3d at 436 [holding that plaintiff's allegations that Morgan Stanley "falsely promoted" CDOs with credit ratings it "knew to be overstated and misleading" sufficed to allege that Morgan Stanley "possessed peculiar knowledge of the facts underlying the fraud"].) The Fund makes substantially the same factual allegations here (see supra at 3-5), which are therefore also sufficient to withstand the motion to dismiss.

Morgan Stanley urges this court to read First Department precedent as requiring the Fund to plead facts demonstrating that only Morgan Stanley had knowledge of the damaging information. (Ds.' Reply Memo. Of Law at 10-13, citing MBIA Ins. Corp. v Merrill Lynch, 81 AD3d 419, 419 [1st Dept 2011] ["Given their level of sophistication and the undisputed fact that the information was not exclusively in defendants' possession, plaintiffs' contention that it would have been impractical to conduct the investigation necessary to discern the truth of defendants' allegedly fraudulent representations does not satisfy the requirements of the peculiar knowledge exception"]; and Plaza PH2001, LLC v Plaza Residential Owners LP, 79 AD3d 587, 587 [1st Dept 2010] [holding that the peculiar facts "exception applies only where the defendant was in exclusive possession of facts demonstrating that a disclaimed representation was false at the time the time [sic] the disclaimer was made"].)

The cases on which Morgan Stanley relies thus refer to a seller's "exclusive" knowledge in articulating the peculiar knowledge exception to the effectiveness of a seller's disclaimers or disclosures. However, the recent First Department CDO cases which are discussed at length in this decision did not by their terms impose an exclusive knowledge requirement. Rather, both Basis Yield [Goldman] (115 AD3d at 139-140) and Loreley [Citigroup] (119 AD3d at 147-148) held that the peculiar knowledge exception was adequately pleaded based on allegations that the defendants had nonpublic knowledge of the nature also alleged here. Morgan Stanley's contention that other securitizers and underwriters "must have had equal or better access than Morgan Stanley" to abandonment of underwriting guidelines (Ds.' Memo. Of Law In Supp. at 20) is therefore not a bar to maintenance of plaintiff's claim.

Finally, Morgan Stanley contends that the Fund cannot rely on the peculiar knowledge exception as the Fund, a sophisticated investor, did not conduct due diligence. (Ds.' Memo. Of Law In Supp. at 15-16.) It is well settled that where a party could have discovered the facts through the exercise of "ordinary intelligence," but failed to do so, it may not complain that it was induced to enter into the transaction by fraud. (See Abrahami v UPC Constr. Co., 224 AD2d 231, 234 [1st Dept 1996], quoting Schumaker v Mather, 133 NY 590, 596 [1892]; accord HSH Nordbank AG v UBS AG, 95 AD3d 185, 195 [1st Dept 2012] ["[S]ophisticated parties have a duty to exercise ordinary diligence and conduct an independent appraisal of the risk they are assuming" particularly where "the true nature of the risk being assumed could have been ascertained from reviewing market data or other publicly available information" [internal quotation marks, citations, and brackets omitted].)

Here, the Fund pleads that, before investing, it did inquire directly of Morgan Stanley regarding the risk of STACK-2, the proper rate of return for the Subordinated Notes, and the key assumptions and variables, including RMBS default rates, and that Morgan Stanley deliberately withheld the information relating to the underlying collateral and the bases for the ratings of the higher tranches. (See supra at 3-5.) The Fund "has sufficiently alleged that Morgan [Stanley] possessed peculiar knowledge of the facts underlying the fraud, and the circumstances present would preclude any investigation [the Fund] conducted with due diligence." (China Dev. Indus. Bank, 86 AD3d at 436.) As the First Department held in Basis Yield [Goldman], "[w]hile evidence may ultimately demonstrate that Goldman did not have special knowledge upon which it relied or which plaintiff could have ascertained by exercising reasonable diligence, these are issues which are inappropriate to determine, as a matter of law, based solely on the allegations of the complaint." (115 AD3d at 139 [internal quotation marks and brackets omitted].)

In so holding, the court rejects Morgan Stanley's claim that other First Department cases, HSH Nordbank AG v UBS AG (95 AD3d 185, supra), Yang v Morgan Stanley Dean Witter (282 AD2d 271 [1st Dept 2001]), and ACA Financial Guaranty Corporation v Goldman, Sachs & Co. (106 AD3d 494 [1st Dept 2013], appeal dismissed 22 NY3d 909, lv granted 1st Dept, May 1, 2014, Index No. 650027/2011), require a different result. The First Department itself distinguished HSH Nordbank on two grounds which are equally applicable here. First, as the Basis Yield [Goldman] Court noted, the disclaimers and disclosures in HSH Nordbank were "sufficiently specific to the particular type of information allegedly misrepresented. . . . [T]he core subject of the complained-of representations was the reliability of the credit ratings" for the securities in the underlying pool. "Yet, the disclaimers and disclosures 'relate[d] directly or indirectly to the reliability of credit ratings in the relevant market.'" (115 AD3d at 140, quoting HSH Nordbank, 95 AD3d at 199.) Second, in HSH Nordbank, "the alleged misrepresentation did not concern facts peculiarly within the seller's knowledge. On the contrary, the reliability of the credit ratings could have been ascertained from reviewing market data or other publicly available information." (Basis Yield [Goldman],115 AD3d at 140.) Thus, HSH could have uncovered any misrepresentation by exercising due diligence. (Id.)

In Yang (282 AD2d at 271), similarly, the disclosures were specifically related to the alleged misrepresentations. The defendants there purportedly affirmatively misrepresented that certain futures and options contracts were suitable for "conservative investors" – a claim the Court found was contradicted by disclosures that the investment was in fact speculative and risky. There was also no allegation that the defendants possessed special, nonpublic information. In ACA, which was distinguished by the Court in Loreley [Citigroup], the defendants represented that a hedge fund would be an equity sponsor (i.e., would purchase the first loss tranche) of a CDO, whereas the fund in fact had a short position on the CDO. As noted in Loreley [Citigroup], the plaintiff's reliance on this alleged representation was not reasonable because the offering circular specifically disclosed that no one was investing in the first loss tranche. Rather, this disclosure triggered the plaintiff's duty of inquiry. (Loreley [Citigroup], 119 AD3d at 146, citing ACA, 106 AD3d at 496-497.) Moreover, "the hedge fund's intentions with regard to th[e] investment were not peculiarly within defendant's knowledge" and the plaintiff failed to inquire of the hedge fund with which it was in direct contact. (ACA, 106 AD3d at 497.)

Here, in contrast, as held above, the court does not find as a matter of law that the disclosures and disclaimers were made with the specificity that would bar any claim of justifiable reliance by the Fund on Morgan Stanley's alleged misrepresentations or omissions. Nor does the court find as a matter of law that the Fund could have discovered the facts by the exercise of due diligence or that the facts were not peculiarly within Morgan Stanley's knowledge.

Misrepresentations

In contending that the Fund has failed to identify actionable misrepresentations, Morgan Stanley characterizes its representations concerning risk assumptions and ratings as mere opinion or predictions, and again points to various disclaimers and disclosures. (Ds.' Memo. Of Law In Supp. at 22-25.) As held above, the disclaimers and disclosures do not shield Morgan Stanley at the pleading stage. (See China Dev. Indus. Bank, 86 AD3d at 436 [affirming denial of dismissal of fraudulent concealment claim where complaint alleged that "Morgan [Stanley] falsely promoted collateral debt obligations as having specified credit ratings, which Morgan [Stanley] knew to be overstated and misleading"]; MBIA Ins. Corp. v Countrywide Home Loans, Inc., 87 AD3d 287, 291-292 [1st Dept 2011] [affirming denial of dismissal of fraud claim based on representations "that the loans were made in strict compliance with its underwriting standards and guidelines, as well as industry standards" and allegations that "Countrywide abandoned those guidelines by knowingly lending to borrowers who could not afford to repay the loans, or who committed fraud in loan applications or whose applications could not satisfy basic criteria for responsible lending"]; see also M&T Bank Corp. v McGraw Hill Co., Inc., 126 AD3d 1414, 2015 WL 1282336, *1 [4th Dept 2015] [affirming denial of dismissal of fraud claim against rating agency where "plaintiff adequately pleaded that defendant did not believe its opinions when it issued the ratings" and that "defendant was aware that the ratings were inflated . . . [and] failed to follow its own policies and procedures in determining the ratings"].)

Moreover, as in Basis Yield [Goldman], plaintiff's "theory of fraud does not rest upon a single decisive event which manifestly demonstrates [defendants'] wrongdoing, but on a series of interrelated events which, viewed as whole, portray the alleged fraudulent scheme" to compromise the CDO and profit upon its collapse. (115 AD3d at 135-36; see also Loreley [Citigroup], 119 AD3d at 142 ["the gravamen of the complaint is essentially that Citigroup secretly selected its riskiest mortgages for sale to its investors as CDOs and purchased credit default swaps to short the issuance"].)

Loss Causation

Morgan Stanley contends that the Fund cannot state a claim because the complaint fails to plead loss causation. In particular, Morgan Stanley argues that because the Fund purchased the most junior tranche, it cannot prove that its investment would have performed differently during the nationwide housing market collapse. (Ds.' Memo Of Law In Supp. at 25.) To demonstrate loss causation, the complaint must show that "the misrepresentations directly caused the loss about which [the] plaintiff complains." (Laub v Faessel, 297 A2d 28, 31 [1st Dept 2002].) It is sufficient to plead facts showing that the losses were the foreseeable consequence of the plaintiff's reliance on the challenged statements. (MBIA [Countrywide], 87 AD3d at 296; Silver Oak Capital LLC v UBS AG, 82 AD3d 666, 667 [1st Dept 2011].) The fact that the losses may have coincided with an economic downturn does not automatically absolve Morgan Stanley of the alleged wrongdoing. "While the plaintiff must plead some facts supporting its theory that defendants' conduct was responsible for its losses, it is not . . . necessary to allege that the entirety of the loss was caused by the alleged misstatements and none was caused by the more general market decline." (Allstate Ins. Co. v Morgan Stanley, 2013 WL 2369953 [Sup Ct, NY Co 2013], affd 117 AD3d 546 [1st Dept 2014].) The First Department has repeatedly held that "the argument that the general collapse of the residential mortgage-backed securities market bars [a plaintiff] from proving loss causation is not ripe for determination at the pleading stage."

(Allstate Ins. Co. [Morgan Stanley], 117 AD3d at 546; see also MBIA [Countrywide], 87 AD3d at 295-96.) The Fund has sufficiently pleaded that its losses were the direct result of Morgan Stanley's fraud concerning, among other things, the creditworthiness of the underlying collateral, the default rate, and the structure of the CDO.

Jury Demand

Finally, Morgan Stanley relies on a jury waiver in the Investor Representation Letter to support that branch of its motion to strike the Fund's jury demand.[3] As the Fund has stated a claim that it was fraudulently induced to invest, the contractual jury waiver provision does not bar a jury demand. (See J.P. Morgan Secs. Inc. v Ader, __ AD3d __, 2015 WL 1636915 [1st Dept 2015]; China Dev. Indus. Bank, 86 AD3d at 436-37; Ambac Assurance Corp. v DLJ Mtge. Capital, Inc., 102 AD3d 487, 487 [1st Dept 2013]; MBIA Ins. Corp. v Credit Suisse Secs. (USA), LLC, 102 AD3d 488, 488 [1st Dept 2013].)

It is accordingly hereby ORDERED that Morgan Stanley's motion to dismiss and to strike plaintiff's jury demand is denied in its entirety; and it is further

ORDERED that the parties shall appear for a preliminary conference in Part 60, Room 248, 60 Centre Street, New York, New York on May 28, 2015 at 2:30 p.m.

This constitutes the decision and order of the court.

Dated: New York, New York
April 16, 2015

Marcy Friedman

MARCY FRIEDMAN, J.S.C.

---

[3]The Investor Representation Letter provides, in relevant part, as follows: "The undersigned . . . waives any rights it may have to a trial by jury in any action or proceeding arising out of or relating to the matters discussed herein." (Rouhandeh Aff., Ex. G.)