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

MBIA INSURANCE CORPORATION and LACROSSE FINANCIAL PRODUCTS, LLC,

Plaintiffs,

–against–

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED and MERRILL LYNCH INTERNATIONAL,

Defendants.

Index No.: 601324/2009 (Fried, J.)

MEMORANDUM OF LAW OF PLAINTIFFS MBIA INSURANCE CORPORATION AND LACROSSE FINANCIAL PRODUCTS, LLC IN SUPPORT OF THEIR MOTION FOR LEAVE TO AMEND AND TO FILE A SECOND AMENDED COMPLAINT

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Page

Cases

Rules / Statutes

PRELIMINARY STATEMENT

Plaintiffs MBIA Insurance Corporation ("MBIA") and LaCrosse Financial Products, LLC ("LaCrosse," and together with MBIA, "Plaintiffs") seek leave to amend and to file a Second Amended Complaint (the "Proposed Amended Complaint").[1] It is well settled that "[m]otions for leave to amend pleadings should be freely granted (CPLR 3025[b]), absent prejudice or surprise resulting therefrom, unless the proposed amendment is palpably insufficient or patently devoid of merit." *MBIA Ins. Co. v. Greystone & Co.*, 74 A.D.3d 499, 499 (1st Dep't 2010) (citation omitted). The Proposed Amended Complaint is far from devoid of merit – it includes precisely the allegations that the First Department indicated would be sufficient to state a viable cause of action in its decision and order directing dismissal of Plaintiffs' First Amended Complaint (the "Decision and Order") (Ex C.). The Proposed Amended Complaint describes actionable claims against Defendants Merrill Lynch, Pierce, Fenner and Smith Inc. and Merrill Lynch International (collectively, "Merrill Lynch," "Merrill" or the "Defendants"), and Plaintiffs should be permitted to proceed with this action.

In dismissing Plaintiffs' claims for fraud, the First Department in *MBIA Insurance Corp. v. Merrill Lynch*, 81 A.D.3d 419 (1st Dep't 2011) (Ex. C), did not hold that Defendants' alleged misstatements concerning the disputed collateralized debt obligations (the "ML-series CDOs" or the "Merrill Lynch CDOs"), as set forth in the First Amended Complaint, were inadequate to support such a claim. Rather, the Court held that Plaintiffs' claims were barred by a series of disclaimers in the transaction documents. *Id.* at 419. In reaching this holding, the Court

[1] References to "Exhibit __" or "Ex. __" are to the Exhibits to the accompanying affirmation of Adam M. Abensohn. The Proposed Amended Complaint is submitted as Exhibit A, and a form of the Proposed Amended Complaint indicating in what respect it differs from the First Amended Complaint is submitted as Exhibit B.

recognized that the "peculiar knowledge" doctrine permits fraud claims even in the face of otherwise binding disclaimers, but held that this doctrine was unavailable only because, in the Court's view, there was no allegation that Defendants possessed "exclusive," as opposed to merely "superior," knowledge of the defects in the collateral underlying the Merrill Lynch CDOs. *Id.* The Proposed Amended Complaint includes precisely such allegations, with persuasive factual support.[2]

The Proposed Amended Complaint, a draft of which is provided as an exhibit to this Motion, includes numerous detailed allegations making clear that Merrill possessed exclusive and unique knowledge of the defects in the collateral underlying the complex financial instruments that Defendants touted to investors and insurers, such as Plaintiffs. These allegations reflect information that has come to light only since Plaintiffs filed their First Amended Complaint, and in some instances within the last few weeks or months, including through the report of the Financial Crisis Inquiry Commission (the "FCIC Report"), released in January 2011, and the report of the U.S. Senate Permanent Subcommittee on Investigations (the "PSI Report"), released on April 13, 2011.[3] Among other things, this new information, as set

[2] MBIA intends to file with the Court of Appeals a motion for leave to appeal, and will argue, *inter alia*, that the First Department erred when it concluded that "exclusive" rather than "superior" knowledge is required to vitiate a disclaimer. *See*, *e.g.*, *Steinhardt Grp., Inc. v. Citicorp*, 272 A.D.2d 255, 257 (1st Dep't 2000) (holding that plaintiffs were entitled to proceed with a claim concerning the valuation of residential mortgages, in part, because there were "factual issues as to whether defendants acted with *superior knowledge*" of correct pricing methodology) (emphasis added). As demonstrated above in text, however, the Proposed Amended Complaint states actionable tort claims even under the standard applied by the First Department in its February 2011 ruling.

[3] The Financial Crisis Inquiry Commission was created by the Fraud Enforcement and Recovery Act of 2009, and was established to examine the causes, domestic and global, of the current financial and economic crisis in the United States. Likewise, the PSI recently conducted a two-year investigation into the causes of the 2008 financial crisis, in the course of which the PSI held public hearings, issued subpoenas, conducted over 150 interviews and depositions, and reviewed tens of millions of pages of documents.

forth in the allegations of the Proposed Amended Complaint, confirms that Merrill pursued its "de-risking" strategy by constructing multi-billion dollar CDOs from toxic collateral while concealing this scheme – and the information contained in its individual mortgage loan files and the findings of its own due diligence firms – from prospective investors and insurers. Furthermore, the FCIC Report reveals, through testimony and documentary evidence, that Merrill, contrary to its representations that the collateral underlying the ML-series CDOs would be selected by an independent collateral manager, retained final authority over collateral selection – which Plaintiffs did not know, and could not know – and used that authority to ensure that the CDOs would be constructed from toxic assets off of its own balance sheet. In addition, the Proposed Amended Complaint includes allegations, based in part on testimony and documents appended to the PSI Report, that Merrill, again unbeknownst to Plaintiffs, exerted undue influence over purportedly independent rating agencies to secure inflated ratings for the ML-series CDOs.

These new allegations of "exclusive" knowledge meet the precise pleading standard that the First Department described in its Decision and Order. Plaintiffs have thus cured the purported deficiencies of their First Amended Complaint, and there is no reason that Defendants should be shielded from viable fraud claims addressed to their misstatements in connection with the creation and marketing of multi-billion dollar financial instruments that have left investors and insurers alike with massive and continuing losses. Further, the Proposed Amended Complaint cures purported deficiencies in the claim for breach of the implied covenant of good faith and fair dealing by alleging with persuasive factual support that the implied covenant claim is not duplicative of a breach of contract claim (a claim not even pled in the Proposed Amended Complaint).

BACKGROUND

A. Procedural Background

On April 30, 2009, Plaintiffs filed a Complaint asserting tort and contract claims against Defendants arising out of the Merrill Lynch CDOs and a series of related credit default swap agreements (the "CDS Contracts"). Dkt. 1. On May 15, 2009, Plaintiffs filed their First Amended Complaint, which pursued substantially the same tort and contract claims. Dkt. 2. As set forth in the First Amended Complaint, Merrill Lynch assembled the Merrill Lynch CDOs from toxic assets that it knew were rapidly declining in value, and engaged in a series of misrepresentations and omissions directed to investors and insurers, such as Plaintiffs, concerning the credit quality and structure of the Merrill Lynch CDOs.

On July 1, 2009, Merrill Lynch moved to dismiss the Amended Complaint in its entirety, and on April 9, 2010, this Court granted that motion in part. *MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 601324/09, 27 Misc. 3d 1233(A) (TABLE), 2010 WL 2347014 (N.Y. Sup. Ct. New York County Apr. 9, 2010) (Ex. D). Specifically, the Court dismissed Plaintiffs' tort claims, but denied Merrill Lynch's motion to dismiss the portion of Plaintiffs' breach of contract claim premised on the allegation that the collateral underlying the Merrill Lynch CDOs was not worthy of AAA-ratings as represented by Merrill Lynch. *Id.* at *6-8.

Both sets of parties appealed the Court's order, and, on February 1, 2011, the Appellate Division affirmed this Court's decision to the extent that it had dismissed Plaintiffs' tort claims but reversed this Court's order permitting Plaintiffs to proceed with their contract claim. 81 A.D.3d at 419. In affirming dismissal of the tort claims, the Appellate Division relied on unspecified disclaimers and the supposed absence of any allegation by Plaintiffs that Merrill

Lynch possessed exclusive knowledge, as opposed to superior knowledge, of the defects in the collateral underlying the Merrill Lynch CDOs. *Id.* As to the contract claim, the Appellate Division held that there was no breach because the disputed collateral, regardless of its actual credit quality, possessed nominal AAA ratings. *Id.* at 420. The Appellate Division also dismissed the cause of action for breach of the implied covenant of good faith and fair dealing because it was purportedly premised on the same conduct underlying the breach of contract claim. *Id.* at 419-20. On these grounds, the Appellate Division directed the Clerk "to enter judgment dismissing the complaint in its entirety." *Id.* at 419.

Notwithstanding that the Appellate Division's Decision and Order made no reference to Plaintiffs' claims being dismissed "with prejudice" to Plaintiffs' ability to amend their complaint, the Clerk of Court, at Merrill's request and over Plaintiffs' repeated objections, entered a Judgment on February 4, 2011 "with prejudice." *See* Dkt. 94, 96–107. On February 8, 2011, Plaintiffs filed an Order to Show Cause to correct the Judgment by striking the designation of the dismissal as being "with prejudice," in order to conform it to the Decision and Order of the Appellate Division. Dkt. 108–20. Following briefing and argument, this Court on April 6, 2011, issued a Decision and Order granting Plaintiffs' Order to Show Cause and ordering the words "with prejudice" to be removed from the Judgment in order to conform it with the Decision and Order of the Appellate Division. Dkt. 137. As this Court explained, "[i]t remains to be determined, when the issue is properly raised, whether the Appellate Division's Decision and Order was with or without prejudice." *Id.* at 2. That question is now presented.

B. The Proposed Amended Complaint

The Proposed Amended Complaint directly responds to and cures the purported pleading deficiencies identified by the Appellate Division in Plaintiffs' First Amended Complaint. The new complaint contains numerous allegations that Merrill Lynch in fact possessed *exclusive*

knowledge of the defects in the Merrill Lynch CDOs. Moreover, these new allegations make clear that Plaintiffs' claimed breach of the implied covenant of good faith and fair dealing is not merely duplicative of a breach of contract claim, which was the basis for the Appellate Division's dismissal of that claim. *See* 81 A.D.3d at 419-20.

Plaintiffs have based these allegations on information that was unavailable to them at the time they filed the First Amended Complaint, including evidence set forth in the recent FCIC and PSI Reports. These new factual allegations include the following:

- Internal Merrill Lynch emails and presentations, which were previously unavailable to Plaintiffs and were only recently disclosed through discovery in this action, confirm that Merrill Lynch was acutely aware of the risks posed by residential mortgage-backed securities ("RMBS") and CDOs – risks which were not disclosed to Plaintiffs at the time Plaintiffs entered into the CDS Contracts.

- Merrill Lynch, through its loan origination subsidiaries, was aware of and involved in rampant underwriting failures in its own mortgage lending portfolio, and thereby knew, well ahead of the market (and ahead of Plaintiffs), that significant defaults on the mortgage collateral underlying the CDOs were likely imminent.

- Merrill Lynch employed several due-diligence firms, including Clayton Holdings ("Clayton"), to review mortgage loans that Merrill Lynch was pooling in its RMBS and, ultimately, in its RMBS CDOs. As disclosed through testimony to the FCIC, Clayton advised Merrill Lynch that 23 percent of the loans that it reviewed for Merrill failed to meet underwriting guidelines, yet Merrill included 32 percent of those same loans in its securitizations. This information was not available to, and was not disclosed to, Plaintiffs at the time the CDS Contracts closed.

- Merrill Lynch represented that the collateral underlying the Merrill Lynch CDOs had been selected by independent collateral managers, when, in fact (and again unbeknownst to Plaintiffs), Merrill Lynch retained ultimate authority over collateral selection and purposely used that authority to ensure that the CDOs would be constructed from toxic collateral off of its own balance sheet.

As set forth below, these allegations are more than sufficient to cure any perceived pleading deficiencies in the First Amended Complaint, and Plaintiffs' motion for leave to amend should therefore be granted under the permissive standard governing such applications.

ARGUMENT

I. THE PROPOSED AMENDED COMPLAINT CURES THE PURPORTED PLEADING DEFICIENCIES IDENTIFIED IN THE APPELLATE DIVISION'S DECISION AND ORDER.

Under settled First Department precedent, "[m]otions for leave to amend pleadings should be freely granted (CPLR 3025[b]), absent prejudice or surprise resulting therefrom, unless the proposed amendment is palpably insufficient or patently devoid of merit." *MBIA Ins. Co.*, 74 A.D.3d at 499 (citation omitted); *accord Pier 59 Studios, L.P. v. Chelsea Piers, L.P.*, 40 A.D.3d 363, 365-66 (1st Dep't 2007). As set forth below, the Proposed Amended Complaint is not "patently devoid of merit"; rather, it directly addresses and cures the purported pleading deficiencies identified by the First Department in its Decision and Order. Moreover, the First Department's Decision and Order is not *res judicata* on this matter such that Plaintiffs are precluded from asserting their amended claims. Finally, Plaintiffs have promptly moved to amend their complaint following the First Department's Decision and Order (and following this Court's Order directing that the Judgment be corrected), and much of the material that forms the basis for the proposed amendment, which was previously unavailable to Plaintiffs, comes directly from the public record and from Merrill's own files. Under these circumstances, Merrill cannot plausibly assert that permitting this amendment would result in any undue prejudice or surprise. Accordingly, leave to amend should be granted.

A. The Proposed Amended Complaint More Than Adequately Pleads Fraud Under The Standards Applied By The First Department

The Appellate Division recognized that, under the "peculiar knowledge exception," even specific disclaimers will not defeat a claim of reasonable reliance on a fraudulent representation where the facts underlying that misrepresentation were within the "exclusive" or "peculiar" knowledge of the defendant. 81 A.D.3d at 419. The Court held that this doctrine did not apply

as to the First Amended Complaint, however, because, according to the Court, Plaintiffs had alleged that Merrill Lynch had "superior," rather than "exclusive," knowledge of the true state of the collateral underlying the Merrill Lynch CDOs. *Id*.; *see also Steinhardt Grp.*, 272 A.D.2d at 257 ("[A] purchaser may not be precluded from claiming reliance on misrepresentations of facts peculiarly within the seller's knowledge, notwithstanding the execution of a specific disclaimer."); *Tahini Inv., Ltd. v. Bobrowsky*, 99 A.D.2d 489, 490 (2d Dep't 1984) ("[E]ven where the parties have executed a specific disclaimer of reliance on a seller's representations, a purchaser may not be precluded from claiming reliance on any oral misrepresentations if the facts allegedly misrepresented are peculiarly within the seller's knowledge").[4]

This purported pleading deficiency has been cured in the Proposed Amended Complaint. Plaintiffs now specifically allege that Merrill had *exclusive* knowledge of the credit quality of the Merrill Lynch CDOs based on its role as the arranger, broker-dealer, and warehouse provider for each of the Merrill Lynch CDOs, as well as by virtue of its role as operator of its own mortgage origination and servicing business. *See* Ex. A ¶¶ 94-97. As detailed in the Proposed Amended Complaint, Merrill, among other things, concealed the findings of its due diligence firms, including Clayton, which identified rampant defects in the mortgage loans ultimately backing the ML-series CDOs. *Id.* ¶¶ 100-103. In addition, due to its involvement in originating many of the individual mortgage loans underlying these complex CDOs, Merrill knew that there had been pervasive failures to adhere to the loan underwriting standards for those loans, and that they would likely default in large numbers. *See id.* ¶¶ 94-97, 103. None of this information was

[4] As discussed in note 2, *supra*, the peculiar knowledge doctrine is in fact satisfied where it is alleged that a defendant possessed "superior knowledge" of the facts underlying an alleged misrepresentation. Even under the "exclusive knowledge" standard that the First Department applied here, however, the allegations of the Proposed Amended Complaint are sufficient to state a viable cause of action.

available to Plaintiffs. Furthermore, contrary to its representations that the collateral underlying the ML-series CDOs would be selected by an independent collateral manager, Merrill retained final authority over collateral selection – which Plaintiffs did not know, and could not know – and used that authority to ensure that the CDOs would be constructed from toxic assets off of its own balance sheet. *See id.* ¶¶ 53-59, 129.

In sum, the Proposed Amended Complaint includes exactly the sort of "exclusive knowledge" allegations that the First Department indicated would be sufficient to support a claim of fraud, even in the face of otherwise binding disclaimers.

B. The Proposed Amended Complaint More Than Adequately Pleads Breach of the Implied Covenant of Good Faith and Fair Dealing

The Appellate Division dismissed Plaintiffs' cause of action for breach of the implied covenant of good faith and fair dealing on the grounds that it was duplicative of the breach of contract claim. *See* 81 A.D.3d at 419-20 ("The cause of action for breach of the implied covenant of good faith and fair dealing cannot be maintained because it is premised on the same conduct that underlies the breach of contract cause of action and is intrinsically tied to the damages allegedly resulting from a breach of the contract.") (citation and internal quotation marks omitted). The Proposed Amended Complaint cures this purported defect by alleging a breach of the implied covenant of good faith and fair dealing that is distinct from any alleged breach of contract.[5]

A cause of action for breach of the implied covenant does not duplicate a cause of action for breach of contract, even if it arises from the same underlying transactions and occurrences as the contract claim, so long as it alleges that the defendant acted to deprive the plaintiff of the

[5] The Proposed Amended Complaint no longer includes a claim for breach of contract. Thus, the claim for breach of the implied covenant of good faith and fair dealing is not "premised on the same conduct that underlies the breach of contract cause of action." 81 A.D.3d at 420.

benefits of the contract. *See, e.g.*, *Richmond Shop Smart, Inc. v. Kenbar Dev. Ctr., LLC*, 32 A.D.3d 423, 424 (2d Dep't 2006) (finding that allegations and supporting evidence stated claims for breach of contract and breach of the implied covenant of good faith and fair dealing where defendant's actions "frustrated the rights and reasonable expectations of the plaintiff under the lease termination agreement"). The implied covenant of good faith and fair dealing "embraces a pledge that 'neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.'" 5*11 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 98 N.Y.2d 144, 153 (2002) (quoting *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389 (1995)). The implied covenant exists to relieve parties of the burden of explicitly addressing in advance every difficult-to-foresee contingency that might arise during the life of the contract. *See, e.g.*, *Bank of China v. Chan*, 937 F.2d 780, 789 (2d Cir. 1991) ("A party's actions may implicate the implied covenant of good faith when it acts so directly to impair the value of the contract for another party that it may be assumed that they are inconsistent with the intent of the parties.").

In the Merrill Lynch CDOs, Plaintiffs contracted to sell credit protection to Merrill Lynch with respect to collateralized debt obligations with AAA ratings and specified levels of subordination. Plaintiffs charged extremely low premium rates reflecting their understanding that the CDOs represented safe investments with a very low risk of default. Even assuming that the nominal AAA ratings on that collateral were adequate to preclude a claim for breach of contract as a technical matter (as the First Department held), Merrill Lynch plainly understood – and the Proposed Amended Complaint alleges that Merrill understood, *see* Ex. A. ¶¶ 77, 89, 167 – that Plaintiffs reasonably expected that the collateral underlying the Merrill Lynch CDOs was of a quality that investors associate with high-grade securities generally. Merrill Lynch also

understood—and the Proposed Amended Complaint again alleges this understanding, *see, e.g.*, *id.* ¶¶ 94-103, 110—that the collateral underlying the Merrill Lynch CDOs was in fact rapidly deteriorating and unlikely to perform at a level typically associated with high-grade securities. By nevertheless constructing the ML-series CDOs from toxic assets and entering into the CDS Contracts, recognizing that Plaintiffs reasonably understood that they were insuring CDOs that were unlikely to default, Merrill Lynch acted to deprive Plaintiffs of the benefit of the credit default swap contracts, regardless of whether Merrill Lynch otherwise adhered to the strict requirements of the transaction documents.

The Proposed Amended Complaint further alleges that Merrill Lynch breached the implied covenant of good faith and fair dealing by failing to deliver true subordination protection. *Id.* ¶ 89, 167. Here, again, even accepting *arguendo* that a breach of contract claim is precluded on grounds that Merrill delivered nominal subordination protection, insofar as there were investor classes below those classes that Plaintiffs insured, the Proposed Amended Complaint makes clear that Merrill Lynch understood that Plaintiffs reasonably expected that such protection was to be not merely nominal, but that, as of the closing date of the Merrill Lynch CDOs, Plaintiffs would have a specified level of subordination protection still intact. In fact, however, that protection from junior tranches of the CDO had already evaporated by the closing date as a result of the undisclosed degradation of the underlying collateral. *See id.* ¶ 17. Merrill Lynch thus breached the implied covenant of good faith and fair dealing just as surely as if it had sold MBIA a so-called "penthouse apartment" in a planned 21-story building without revealing that the lower 20 floors would be constructed underground.

In sum, Plaintiffs' claim for breach of the implied covenant of good faith and fair dealing does not rely on the express terms of its contracts with Merrill Lynch, but rather on Plaintiffs'

implicit right to receive "the fruits of the contract." *Dalton*, 87 N.Y.2d at 389. Merrill Lynch understood that Plaintiffs reasonably expected more than nominal AAA ratings, and more than nominal subordination, and yet Merrill Lynch entered into the transactions recognizing that these basic protections were non-existent. Accepting these facts as true and drawing all reasonable inferences in favor of the non-moving party – as the Court would in deciding a motion to dismiss, *see Leon v. Martinez*, 84 N.Y.2d 83, 87–88 (1994) – Plaintiffs have more than adequately pled that Merrill Lynch "destroy[ed] or injur[ed] the right of [Plaintiffs] to receive the fruits of the contract." *Dalton*, 87 N.Y.2d at 389. Accordingly, the Appellate Division's rationale for dismissing the claim for breach of the implied covenant of good faith and fair dealing in the First Amended Complaint does not apply to the allegations in the Proposed Amended Complaint.

II. THE PROPOSED AMENDED COMPLAINT IS NOT BARRED BY THE CORRECTED JUDGMENT OR BY THE APPELLATE DIVISION'S FEBRUARY 1, 2011 DECISION AND ORDER

There is nothing in the corrected judgment or the Appellate Division's February 1, 2011 Decision and Order that precludes Plaintiffs from pursuing their amended claims. Indeed, in directing that the Complaint be dismissed "in its entirety," 81 A.D.3d at 419, the Appellate Division gave no direction that such dismissal would be on the merits. Settled New York law dictates that the dismissal was therefore without prejudice, and Plaintiffs are entitled to amend the Complaint to assert claims for fraud and breach of the implied covenant of good faith and fair dealing.

A. It Is Well Settled That A Judgment Or Decision That Is Silent As To Prejudice Is Not On The Merits And Does Not Bar The Filing Of An Amended Complaint

It is settled by Rule that "[a] judgment dismissing a cause of action before the close of the proponent's evidence is not a dismissal on the merits unless it specifies otherwise . . . ." CPLR

5013. The First Department has therefore specifically held that, where a decision is rendered prior to the close of evidence and does not direct otherwise, *the judgment is not on the merits and does not preclude the filing of an amended claim*. *See 420 E. Assocs. v. Estate of Lennon*, 225 A.D.2d 326, 326 (1st Dep't 1996) ("Since the judgment is silent as to 'prejudice', it is deemed to be not on the merits (CPLR 5013), and it is without prejudice to the filing of a new action . . . ."); *see also Maitland v. Trojan Elec. & Mach. Co., Inc.*, 65 N.Y.2d 614, 615 (1985) ("Where, as here, a dismissal of a cause of action occurs prior to the close of proponent's evidence, the dismissal will not be deemed on the merits so as to preclude the commencement of a second action. (CPLR 5013.)"); *Avins v. Fed'n Emp't & Guidance Serv., Inc.*, 67 A.D.3d 505, 506 (1st Dep't 2009) ("Since the prior complaint was dismissed for failure to state a cause of action without any indication that the dismissal was intended to be with prejudice or on the merits, the doctrine of *res judicata* does not bar the timely commencement of this action purporting to correct the identified pleading deficiency."); *A.B. Med. Servs., PLLC v. N.Y. Cent. Mut. Fire Ins. Co.*, No. 2009-556 N C, 27 Misc. 3d 132(A) (TABLE), 2010 WL 1629939, at *1-2 (N.Y. App. Term Nassau County Apr. 13, 2010) ("[T]he dismissal order did not state that the dismissal was with prejudice, nor does a review of the record reveal the existence of a preclusion order. Consequently, plaintiffs were not barred from commencing a second action."). That settled rule is dispositive here.

The judgment in this case, which has been corrected pursuant to this Court's order dated April 6, 2011, does not direct dismissal on the merits or with prejudice. Dkt. 137. As this Court ruled in its April 6 Order, the judgment is now properly silent on the question of prejudice since the Appellate Division's Decision and Order, as well as this Court's Decision and Order that was

on appeal, were themselves silent on the question of prejudice.[6] *See, e.g.*, *Di Prospero v. Ford Motor Co.*, 105 A.D.2d 479, 480 (3d Dep't 1984) ("It is, of course, beyond dispute that a written order [or judgment] must conform strictly to the court's decision . . . ."); *see also* CPLR 5016(c) ("Judgment upon the decision of a court . . . shall be entered by the clerk *as directed therein*.") (emphasis added). Thus, under CPLR 5013 and the settled precedent of this jurisdiction, the judgment dismissing Plaintiffs' Complaint, which occurred before the close of evidence, was not on the merits and therefore does not preclude Plaintiffs from filing their Proposed Amended Complaint. CPLR 5013; *420 E. Assocs.*, 225 A.D.2d at 326; *see also Ross Sys., Inc. v. Now Solutions, LLC*, No. 600679/04, 2004 WL 5831267 (N.Y. Sup. Ct. New York County Oct. 7, 2004) ("[T]he claims against [plaintiff] in the derivative action were ultimately dismissed for failure to state a cause of action, which constitutes a dismissal on the pleadings only, and does not bar a second pleading for the same cause which is materially different from the first.").

B. Plaintiffs Are Not Barred By Principles of *Res Judicata* From Amending the Complaint

Further, the decision of the Appellate Division does not preclude Plaintiffs from amending their claims under the doctrine of *res judicata*. It is well established that "[w]here a dismissal does not involve a determination on the merits, the doctrine of *res judicata* does not apply." *Pereira v. St. Joseph's Cemetery*, 78 A.D.3d 1141, 1142 (2d Dep't 2010). Here, when the Appellate Division directed the Clerk "to enter judgment dismissing the complaint in its entirety," 81 A.D.3d at 419, it did not determine the merits of either the cause of action for fraud

[6] Nowhere in the Appellate Division's Decision and Order, and nowhere in the portions of this Court's Decision and Order that were affirmed, is there any direction that the dismissal of Plaintiffs' claims was to be with prejudice. The Appellate Division stated only that "[t]he Clerk is directed to enter judgment dismissing the complaint in its entirety." 81 A.D.3d at 419. And this Court, in its April 9, 2010 Decision and Order, directed only that Merrill's motion was "granted solely as to the dismissal of the first, second, third, fifth, and sixth causes of action, and is otherwise denied . . . ." 2010 WL 2347014, at *7.

or the cause of action for breach of the implied covenant of good faith and fair dealing, but instead only held that Plaintiffs failed to plead those causes of action.

As to the cause of action for fraud, the Appellate Division stated that the Complaint "failed to state a cause of action" in light of disclaimers in the transaction documents. *Id*. The court recognized, however, that an allegation of exclusive knowledge would be sufficient to defeat otherwise binding disclaimers, and declined to apply that doctrine, not on the basis of any documentary evidence, but based instead on "the undisputed fact that the information was not exclusively in defendant's possession . . . ." *Id*. Thus, the court did not decide, based on its consideration of any outside evidence, that the cause of action for fraud was not viable on the merits; rather, the court decided, based on its reading of the "four corners of the complaint," that Plaintiffs had failed to make the allegations necessary to trigger application of the peculiar knowledge exception. *See Scott v. Bell Atl. Corp.*, 282 A.D.2d 180, 183 (1st Dep't 2001) ("The applicable standard for determining a CPLR 3211(a)(7) motion is whether, within the four corners of the complaint, any cognizable cause of action has been stated.") (citations omitted).

Similarly, the dismissal of the implied covenant of good faith and fair dealing claim was "premised on the same conduct that underlies the breach of contract cause of action and is intrinsically tied to the damages allegedly resulting from a breach of the contract." 81 A.D.3d at 419-20 (citation and internal quotation marks omitted). Thus, it too was based on the "four corners of the complaint"—i.e. the supposed overlap between the allegations underlying the contract and implied covenant claims—and not on any documentary evidence.

Accordingly, both dismissals fall well within the line of cases recognizing that dismissals for failure to state of cause of action do not have *res judicata* effect. *See, e.g.*, *Pereira*, 78 A.D.3d at 1142 (holding that prior dismissal under CPLR 3211(a)(7) was not on the merits and

thus *res judicata* did not bar plaintiff's second action); *Avins*, 67 A.D.3d at 506; *Amsterdam Savings Bank, FSB v. Marine Midland Bank, N.A.*, 140 A.D.2d 781, 782 (3d Dep't 1988) ("The dismissal of a prior complaint for failure to state facts sufficient to constitute a cause of action is not on the merits and does not bar a second complaint on the same cause of action which corrects the defects or omissions adjudged to exist in the original complaint.") (citation omitted); *Plattsburgh Quarries, Inc. v. Palcon Indus., Inc.*, 129 A.D.2d 844, 845-46 (3d Dep't 1987) (prior dismissal under CPLR 3211(a)(7) "was not sufficiently close to the merits for claim preclusion purposes to bar a second action"); *Furia v. Furia*, 116 A.D.2d 694, 695 (3d Dep't 1986) ("The prior District Court judgments dismissing the previous complaints were not expressly made on the merits and therefore, do not act as a bar to the instant action. Moreover, a review of the present complaint reveals that plaintiffs corrected the relevant defects in the prior pleadings …."); *A.B. Med. Servs.*, 2010 WL 1629939, at *1-2; *see also Pretzel Time, Inc. v. Pretzel Int'l, Inc.*, No. 98 CIV 1544 (RWS), 1998 WL 474075, at *4 (S.D.N.Y. Aug. 10, 1998) (ruling that, unlike dismissals under CPLR 3211(a)(1), dismissals under CPLR 3211(a)(7) prior to the close of evidence do *not* have preclusive effect, absent an express statement from the court that the dismissal is on the merits).[7]

[7] There is nothing incongruous about the Appellate Division dismissing Plaintiffs' action "in its entirety," yet not on the merits and therefore without prejudice to Plaintiffs' ability to cure the alleged deficiencies identified by the Appellate Division's opinion. In fact, numerous decisions demonstrate that it is routine for an action to be dismissed "in its entirety" yet "without prejudice." *See, e.g.*, *Lex 33 Assoc. v. Grasso*, 724 N.Y.S.2d 841, 841 (1st Dep't 2001) (denying motion "in its entirety, without prejudice to renewal of [a] portion of the motion"); *Charney v. Sullivan & Cromwell LLP*, No. 100625/07, 15 Misc. 3d 1128(A) (TABLE), 2007 WL 1240422, at *4 (N.Y. Sup. Ct. New York County Apr. 30, 2007) (ordering plaintiff's complaint "dismissed in its entirety without prejudice"); *see also Harrington v. Palmer Mobile Homes, Inc.*, 71 A.D.3d 1274, 1274–75 (3d Dep't 2010) (affirming trial court's order "den[ying] the motion in its entirety, without prejudice"); *Grunberger v. S & Z Serv. Station Inc.*, No. 18096/08, 28 Misc. 3d 1206(A) (TABLE), 2010 WL 2679887, at *5 (N.Y. Sup. Ct. Kings County July 1, 2010) (dismissing motion "in its entirety" and stating that the disposition was "without prejudice");

III. PERMITTING PLAINTIFFS TO AMEND THEIR COMPLAINT WOULD NOT RESULT IN ANY UNDUE PREJUDICE OR SURPRISE TO DEFENDANTS

As established above, the proposed amendments to the First Amended Complaint directly respond to the Appellate Division's Decision and Order and cure any purported deficiencies identified by that Court. Thus, the Proposed Amended Complaint is not "patently devoid of merit" and leave to amend should be "freely granted," unless such a ruling would result in unreasonable "prejudice or surprise." *MBIA Ins. Co.*, 74 A.D.3d at 499 (citation omitted); *see also Krichmar v. Krichmar*, 42 N.Y.2d 858, 860 (1977) (holding that the decision whether to grant such leave lies within the sound discretion of the Court). There would be no such prejudice or surprise here.

In order to establish "prejudice," it is not enough for a defendant merely to be exposed to greater liability. *See Loomis v. Civetta Corinno Constr. Corp.*, 54 N.Y.2d 18, 23 (1981). Rather, "prejudice occurs when the party opposing amendment has been hindered in the preparation of his case or has been prevented from taking some measure in support of his position." *Jacobson v. McNeil Consumer & Specialty Pharm.*, 68 A.D.3d 652, 654-55 (1st Dep't 2009) (citations and internal quotation marks omitted). Mere delay in seeking to amend a complaint – absent prejudice – is not ground for denying an amendment. *See id.* at 655 ("In the absence of prejudice, plaintiffs' delay in seeking to amend a second time is not a sufficient reason to deny the amendment.") (citations omitted). Plaintiffs have moved promptly to amend their complaint following the Appellate Division's Decision and Order, allowing for the time necessary to petition this Court to correct the judgment that Merrill presented to the Clerk improperly directing dismissal with prejudice.

Day Op of N. Nassau, Inc. v. Viola, No. 005018/07, 16 Misc. 3d 1122(A) (TABLE), 2007 WL 2305035, at *8 (N.Y. Sup. Ct. Nassau County Aug. 1, 2007) ("Plaintiff's complaint is dismissed in its entirety without prejudice.").

Moreover, a substantial portion of the additional allegations in the Proposed Amended Complaint derives from evidence that was unavailable to Plaintiffs at the time either the Complaint or the First Amended Complaint was pled. Indeed, as set forth in the Proposed Amended Complaint, the FCIC Report, issued on January 2011, reveals through testimony and documentary evidence that Merrill, *inter alia*, ignored the findings of its own diligence firms, based on their review of loan files available to Merrill but not to Plaintiffs, by including defective mortgages as RMBS and RMBS CDO collateral. *E.g.*, Ex. A ¶¶ 98-103. In addition, the Proposed Amended Complaint includes allegations, based in part on testimony and documents appended to the PSI Report issued on April 13, 2011, that Merrill, unbeknownst to Plaintiffs, exerted undue influence over the rating agencies to secure inflated ratings for the ML-series CDOs. The Proposed Amended Complaint also relies on evidence that was known to Merrill Lynch and indeed derived from document discovery in this case, thereby eliminating any suggestion of "surprise." *See Tinajero v. Bd. of Educ. of City of N.Y.*, 294 A.D.2d 564, 565 (2d Dep't 2002) (party opposing amendment of pleading could not claim "surprise" where a new cause of action "arises from the same facts as those underlying" the cause of action originally pled); *Norwood v. City of N.Y.*, 203 A.D.2d 147, 149 (1st Dep't 1994) (party opposing amendment of pleading could not credibly claim "surprise" where the facts and circumstances supporting the amendment "were fully explored during discovery").

There is also nothing about Plaintiffs' proposed amendments that would in any way "hinder[ ] [Merrill Lynch] in the preparation of [its] case . . . ." *Jacobson*, 68 A.D.3d at 655 (quoting *Loomis*, 54 N.Y.2d at 23) (internal quotation marks omitted). To the contrary, these amendments would not significantly change the scope of document discovery (which has already been largely completed); and would not significantly alter the selection of deponents (most of

whom have already been identified). Instead, these amendments preserve causes of action that were already pending while directly addressing the discreet purported pleading deficiencies identified by the First Department in its Decision and Order. Accordingly, this action can and should proceed without delay.

CONCLUSION

For the foregoing reasons, Plaintiffs respectfully request that the Court grant Plaintiffs' Motion for Leave to Amend and to File a Second Amended Complaint.

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