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

FINANCIAL GUARANTY INSURANCE COMPANY, Plaintiff, - against - MORGAN STANLEY ABS CAPITAL I INC. and MORGAN STANLEY MORTGAGE CAPITAL HOLDINGS LLC, as successor to MORGAN STANLEY MORTGAGE CAPITAL INC., Defendants.	Mot. Seq. 001 Index No. 652853/2014 Justice Friedman Part 60 ORAL ARGUMENT REQUESTED

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS PLAINTIFF'S COMPLAINT

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PRELIMINARY STATEMENT

This is a case about insurer's remorse. In 2007, on the eve of the financial crisis, plaintiff Financial Guaranty Insurance Company ("FGIC"), in exchange for sizeable premiums, agreed to irrevocably insure a class of notes backed by various net interest margin ("NIM") securities. NIM securities are highly risky by nature because they are comprised of the riskiest portion of the underlying mortgage-backed securitization (the "residual" portion). In other words, NIM securityholders receive only what is left after all other payments from a mortgage-backed securitization are made. If the underlying securitizations suffer a shortfall, the NIM securityholders absorb the first loss. The notes at issue here were backed by NIM securities from 48 underlying mortgage-backed securitizations, less than half of which were sponsored by Morgan Stanley, which had no involvement whatsoever in the remainder. FGIC, a sophisticated monoline insurer, doubtless appreciated these risks in agreeing to insure the notes. Seven years later, FGIC has brought this breach of contract action seeking to hold Morgan Stanley responsible for the payments FGIC has made under the insurance policy it issued, and even for payments it has not yet made. FGIC's claims fail for a number of independent reasons.

First, FGIC's requests for *future* damages fails under the terms of the governing contract and binding precedent. The plain terms of FGIC's insurance agreement with Morgan Stanley entitle FGIC to recover only for amounts "then due," not amounts that may become due later. In addition, First Department precedent precludes requests for forward-looking rescissory damages, like those sought here, where the insurer has bargained away the right to rescission by agreeing to an unconditional and irrevocable policy. Even if the above were not the case, New York law treats requests for future damages as speculative, and therefore precludes them.

Second, FGIC's breach of contract claim is based on the allegation that the offering materials for the underlying securitizations contained misstatements, but the plain terms of the offering materials belie that claim. FGIC argues that, based on a computer algorithm run by its litigation consultants, the offering documents overstated the percentage of properties that were owner occupied. This claim fails because the offering materials expressly stated that the owner-occupancy statistics being reported were *based on the information provided by borrowers*. FGIC does not allege that the offering materials failed to accurately report the information provided by borrowers. FGIC's other alleged misstatement is that the combined loan-to-value ("CLTV") ratios reported in the offering materials were understated because the underlying appraisals were inflated. Here, too, the claim fails under the plain terms of the offering materials. The offering materials define CLTV as *based on the appraisals themselves—i.e.*, simply as a mathematical formula in which the numerator is the value of the sum of the loan and any senior loans, and the denominator is the appraised value of the property. The offering materials do not make any independent representation as to the value of the underlying properties. There can be no breach of contract based on these allegations and notably FGIC does not, because it cannot, allege fraud.

Third, FGIC has not adequately alleged causation. Under controlling law, FGIC must plead that Morgan Stanley's alleged contractual breaches materially increased FGIC's risk of loss. FGIC fails to include any allegations tying the alleged breaches to FGIC's purported damages, nor could it plausibly do so.

For these reasons, as set forth more fully below, the Court should grant Morgan Stanley's motion to dismiss.

BACKGROUND

A. The Structure of the Transaction

In 2007, FGIC agreed, "unconditional[ly] and irrevocabl[y]," to insure principal and interest payments on a class of Notes issued by Basket of Aggregated Residential NIMS 2007-1 Ltd. ("BARN" or the "Issuer"). (*See* Compl. ¶¶ 1, 54, 59.) The Notes entitle their holders to cash flows from NIM securities from 48 different residential mortgage-backed securitizations (the "Underlying Securitizations"). (*Id.* ¶ 2.) Twenty-two of the Underlying Securitizations were sponsored by Morgan Stanley; Morgan Stanley had no involvement in twenty-six of the Underlying Securitizations. (*See id.* ¶ 47.)

NIM securities are created as part of the mortgage-backed securitization process. A typical residential mortgage-backed securitization is designed to generate cash flows beyond what is distributed to holders of its publicly issued securities. (*See* Compl. ¶ 2 ("The Underlying NIM Securities are . . . supported by other securities that were issued in connection with a private securitization . . . of mortgage loans . . . [and] represent[] a right to receive prepayment charges and/or excess cashflow . . . .").) These excess cash flows offer a layer of protection to the holders of the publicly issued securities, as they must first be depleted before the security-holders experience losses. (*See id.* (explaining that payments on NIM securities are made "after payment of fees and expenses of the issuer and distributions to the related senior classes of certificates").) Rather than retain these extra cash flows, many issuers packaged them, along with certain other possible payments—mortgage-prepayment charges, for instance—as NIM securities, offered through private placement transactions.

NIM securities thus represent the very bottom of the payment structure of a mortgage-backed securitization: The excess cash flows they comprise are the first to suffer losses and the last to be paid out. Accordingly, any losses on the underlying mortgage loans will decrease those cash flows and, in turn, the value of the related NIM security. (*See id.* ("The securities [at issue here], being dependent on . . . charges and excess cashflows, were exposed to the credit risk of the Mortgage Loans.").) Excess cash flows and, correspondingly, NIM securities are thus extremely sensitive to losses on the underlying Mortgage Loans—losses that could be caused by a variety of factors, not least a nationwide downturn in the housing market. Because they are so vulnerable to loss based on even a small percentage of defaults in the loans comprising the Underlying Securitizations, NIMs are inherently risky, and accordingly, so is the insurance of NIMs.

B. The Transaction Documents

The BARN securitization was effected through a series of interlocking contracts: the Underlying NIM Securities Purchase Agreement (the "Purchase Agreement"[1]), which governed the sale of the underlying NIM securities from Morgan Stanley ABS Capital I Inc. ("MSAC") to the Issuer; the Indenture, which established the Trust and transferred to the Indenture Trustee "for the benefit of the Noteholders and [FGIC], all of the Issuer's right, title and interest in and to . . . the Underlying NIM Securities and all payments thereon" (Indenture at 1[2]); the Insurance and Indemnity Agreement (the "I&I"), in which FGIC agrees to issue the Insurance Policy "in

[1] Attached as Exhibit 2 to the accompanying Affirmation of James P. Rouhandeh ("Rouhandeh Aff."). Because these transaction documents form the basis of the Complaint—and hence are undisputed by FGIC—the Court may consider them on this motion. *See Crawford v. Merrill Lynch, Pierce, Fenner & Smith*, 35 N.Y.2d 291, 298 (1974).

[2] Attached as Rouhandeh Aff. Ex. 3.

favor of the Indenture Trustee, for the benefit of the Holders of the Insured Notes" (I&I § 1.01[3]); and finally, the Insurance Policy itself, in which FGIC "unconditionally and irrevocably agree[d] to pay" interest and principal shortfalls to the holders of Class N-1 Notes issued by the Issuer (Insurance Policy at 1[4]). The Notes were offered through a Private Placement Memorandum (the "PPM").[5]

As part of the transaction, Morgan Stanley made certain representations and warranties, including that "Exhibit A[and Exhibit H] to the [PPM] . . . are true, complete and correct in all material respects." (Purchase Agmt. ¶ 3(iv).[6]) Exhibit A consists of the private placement memorandum used to offer each of the underlying NIM securities, while Exhibit H consists of the pooling and servicing agreements ("PSAs"), prospectuses, and prospectus supplements for the publicly offered securities for the Underlying Securitizations for each of the NIMs.[7] (*See* Compl. ¶ 66.) Morgan Stanley "agree[d] to repurchase any Underlying NIM security . . . which is discovered at any time not to be in conformance with the representations and warranties in paragraph 3 [of the Purchase Agreement]." (Purchase Agmt. ¶ 4(a)(iii).) Morgan Stanley further represented that "[n]either the Transaction Documents"—the I&I, the Insurance Policy, the Purchase Agreement, the Indenture, and several other contracts—"nor any other information

[3] Attached as Rouhandeh Aff. Ex. 4.

[4] Attached as Rouhandeh Aff. Ex. 5.

[5] Attached as Rouhandeh Aff. Ex. 6.

[6] Although FGIC is not a party to the Purchase Agreement, the I&I provides, "[e]ach of the representations and warranties made by [Morgan Stanley] in the Transaction Documents (other than this [I&I]) to which it is a party is true and correct in all material respects and it makes each such representation and warranty to, and for the benefit of, [FGIC] as if the same were set forth in full herein." (I&I § 2.02(*l*).)

[7] Exhibits A and H will be referred to collectively as the "Underlying Securitization Documents."

relating to the Transaction Documents, or the Underlying NIM Securities, or any Underlying Securitization or any Underlying Trust Estate . . . and furnished to [FGIC] contain any statement of material fact which was untrue or misleading in any material respect when made." (I&I § 2.01(j).)

If any of Morgan Stanley's representations or warranties made in the I&I or the other Transaction Documents "prove[s] to be untrue or incorrect in any material respect," then an "Event of Default" has occurred (I&I § 5.01(a)), and FGIC is entitled to "take whatever action at law or in equity as may appear necessary or desirable in its judgment to collect the amounts, if any, *then due*" under the I&I or the other Transaction Documents. (*Id.* § 5.02(a)(iii) (emphasis added).)

C. FGIC's Claims Against Morgan Stanley

In September of this year, FGIC sued Morgan Stanley for alleged breaches of its representations and warranties contained in the Transaction Documents. FGIC asserts that Morgan Stanley breached both the Transaction Warranties and its warranties in the Purchase Agreement because the Offering Materials contain incorrect data about the loans comprising the Underlying Securitizations (the "Underlying Loans").

FGIC's allegations stem from an analysis of the Underlying Loans performed by FGIC's "litigation consultants." According to FGIC, the analysis "focused primarily on two loan attributes: (1) the occupancy status of the mortgaged properties and (2) the appraisal value of the mortgaged properties," which is used to determine the combined loan-to-value ratio, or CLTV, for each property. (Compl. ¶ 10.) FGIC bases its claims on an alleged discrepancy between the occupancy and CLTV statistics found in the Offering Materials or loan tapes—which were the *actual* occupancy information provided by borrowers, and the CLTV ratios calculated using the *actual* appraisals received—and those generated through its litigation consultants' backward-looking analysis. (*Id.* ¶ 11.)

Without tying these allegations concerning owner-occupancy and CLTV statistics to any losses experienced by the NIM securityholders, FGIC seeks to unwind its "irrevocabl[e]" agreement to insure the Class N-1 Notes, alleging that Morgan Stanley is liable for "all payments [FGIC has] made to date and all payments required to be made in the future under [the Insurance] Policy, as well as the costs incurred in attempting to minimize its losses." (*Id.* ¶ 242.)

ARGUMENT

Morgan Stanley moves under CPLR 3211(a)(1) and 3211(a)(7). "Generally, on a motion to dismiss made pursuant to CPLR 3211, the court must accept the facts as alleged in the complaint as true. . . ." *Morgenthow & Latham v. Bank of N.Y. Co.*, 305 A.D.2d 74, 78 (1st Dep't 2003) (internal quotation marks omitted). In cases such as this, however, "where the legal conclusions and factual allegations are flatly contradicted by documentary evidence they are not presumed to be true or accorded every favorable inference." *Id.* And the Court must dismiss claims where "documentary evidence conclusively refutes plaintiff's . . . allegations." *AG Capital Funding Partners, L.P. v. State St. Bank & Trust Co.*, 5 N.Y.3d 582, 590-91 (2005) (citing CPLR 3211(a)(1); *Goshen v. Mut. Life Ins. Co. of N.Y.*, 98 N.Y.2d 314, 326 (2002)).

I. FGIC Cannot Recover for Insurance Payments It Has Not Made—and May Never Make

FGIC claims that it is entitled to damages to compensate not only for payments that it has made under the Insurance Policy, but also for all payments that it may make under the Policy in the future. For at least three reasons, FGIC's claim to future damages must be dismissed. First, the plain language of the I&I precludes such recovery. Second, future damages are the sort of forward-looking rescissory damages that the First Department held unavailable to insurers who have committed to provide irrevocable insurance, as FGIC has done here. Finally, future damages are unavailable under New York law because they are speculative.

A. The Plain Language of the I&I Bars Future Damages

Black-letter law instructs that, "[a]s with the construction of contracts generally, unambiguous provisions of an insurance contract must be given their plain and ordinary meaning, and the interpretation of such provisions is a question of law for the court." *Vigilant Ins. Co. v. Bear Stearns Cos.*, 10 N.Y.3d 170, 177 (2008) (internal quotation marks omitted). Here, the I&I, which sets forth FGIC's rights, provides that upon an Event of Default, FGIC may "take whatever action at law or in equity as may appear necessary or desirable in its judgment to collect the amounts, if any, *then due* under this . . . Agreement or any other Transaction Document." (I&I § 5.02(a)(iii) (emphasis added).) By its plain terms, then, the I&I limits FGIC's recovery to the amount "then due." FGIC's damages are thus capped at the amount it has actually paid out under the Insurance Policy so far.[8]

B. In Any Event, FGIC's Request for Future Damages Is No More than a Request for Rescissory Damages, Which Are Precluded Under New York Law

In seeking all payments it has made and will be required to make in the future, FGIC actually seeks a return to its pre-contractual position. In other words, it seeks rescission or rescissory damages. *See Symphony Space, Inc. v. Pergola Props., Inc.*, 214 A.D.2d 66, 80 (1st

[8] Indeed, the proviso "if any" reflects the parties' recognition that FGIC may have suffered no losses at all when an Event of Default occurs. *See Slamow v. Del Col*, 79 N.Y.2d 1016, 1018 (1992) (per curiam) ("The best evidence of what parties to a written agreement intend is what they say in their writing.").

Dep't 1995) ("[The] effect [of rescission] is 'to declare the contract void from its inception and to put or restore the parties to *status quo*.'" (quoting *Schwartz v. Nat'l Computer Corp.*, 42 A.D.2d 123, 125 (1st Dep't 1973))). But as the First Department has held, neither remedy is available here. *See MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, 105 A.D.3d 412, 413 (1st Dep't 2013) ("*Countrywide II*"). In *Countrywide II*, the First Department held that where a monoline insurer promises to irrevocably insure securities, it "voluntarily [gives] up the right to seek rescission—*under any circumstances*." *Id.* The insurer likewise forfeits its right to rescissory damages. *See id.* ("Plaintiff should not be permitted to utilize this very rarely used equitable tool [*i.e.*, rescissory damages] to reclaim a right it voluntarily contracted away . . . ." (citation omitted)).

Countrywide II thus precludes FGIC's claim for future damages. A federal court in New York recently held as much. *See Assured Guar. Mun. Corp. v. RBS Sec. Inc.*, No. 13 Civ. 2019 (JGK), 2014 WL 1855766, at *1-2 (S.D.N.Y. May 8, 2014) (discussing *Countrywide II*). In *RBS*, the court held that plaintiff-insurer improperly sought future damages on its claim for misrepresentations in connection with a monoline insurance contract. As the court observed, awarding plaintiff its requested "'damages in the amount of all payments [it] has made and will make pursuant to the [insurance] [p]olicy' . . . would effectively restore the insurer to the position it would have occupied had it not issued the [p]olicy. Therefore, such damages are in fact the economic equivalent of rescission and are thus clearly rescissory damages." *Id.* at *2 (citation omitted). Like FGIC, the plaintiff in *RBS* sought "damages for payments that plaintiff 'will make' in the future," and thus the court concluded that "the damages sought are indeed forward-looking rescissory damages." *Id.* Based on that conclusion, the *RBS* court dismissed plaintiff's request for future damages.

For the same reasons, Justice Bransten concluded that the monoline insurer plaintiff was not entitled to rescissory damages in *MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, 39 Misc. 3d 1220(A), 2013 WL 1845588, at *7 (Sup. Ct. N.Y. Cnty. Apr. 29, 2013) ("*Countrywide III*"). There, as here, plaintiff sought rescissory damages by requesting "damages equivalent to 100% of [plaintiff]'s payments under the policies (less premiums paid by [defendants])." Countrywide Defendants' Memorandum of Law in Opposition to Plaintiff MBIA's Motion for Summary Judgment, *Countrywide*, No. 602825/08 (Sup. Ct. N.Y. Cnty. Oct. 24, 2012) (NYSCEF Doc. No. 2106). Justice Bransten ruled that "rescissory damages are not 'legally available' because [plaintiff] 'voluntarily gave up the right to seek rescission,'' and thus "[plaintiff]'s request for rescissory damages fails." *Countrywide III*, 2013 WL 1845588, at *7.

C. FGIC's Request for Future Damages Is Speculative, and Therefore Is Precluded Under New York Law

New York law provides that "projections" of future loss that are "subject to adjustment and modification," like those FGIC would need to show to support its request for future damages, do not suffice to support an award of future damages. *Kenford Co. v. Cnty. of Erie*, 67 N.Y.2d 257, 262 (1986). Future "damages may not be merely speculative, possible or imaginary, but must be reasonably certain and directly traceable to the breach, not remote or the result of intervening causes." *Id.* at 261. The court in *Assured Guaranty Municipal Corp. v. Flagstar Bank, FSB*, recently applied this rule in a suit by a monoline insurer, rejecting plaintiff's argument that the damages award should include a "cushion" to protect against potential future claims. No. 11 Civ. 2375 (JSR), 2013 WL 1620567, at *1 (S.D.N.Y. Apr. 15, 2013). The court thus limited plaintiff-insurer's damages to claim payments already made, and excluded claims for "undefined and speculative future claim amounts that [it] might have to pay." *Id.*

The "future damages" alleged here are especially speculative because the shortfalls on the Notes are subject to the uncertainty of the shortfalls in the Underlying Securitizations. Though the Complaint notes that certain securitizations are not performing, lawsuits by the trustees demanding cure or repurchase may well infuse money back into the securitizations, thus restoring cashflows that are now absent. Indeed, a number of the Underlying Securitizations are either currently or have recently been involved in repurchase litigation.[9] These litigations, along with future repurchase litigations involving any of the 48 Underlying Securitizations, make estimating the shortfalls on the Notes, and thus FGIC's ultimate liability, uncertain, because such estimates are subject to adjustment and modification based on the results of the repurchase litigations. Future damages are accordingly prohibited under New York law, and even if FGIC had validly pleaded a cause of action, it can seek only damages it has actually incurred.

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[9] *See* Summons with Notice, *Fed. Hous. Fin. Auth. v. HSBC Fin. Corp.*, No. 653373/2012 (Sup. Ct. N.Y. Cnty. Sept. 26, 2012) (repurchase action involving Morgan Stanley ABS Capital I Inc. Trust, Series 2006-HE6); Amended Complaint, *Deutsche Bank Nat'l Trust Co. v. Morgan Stanley ABS Capital I Inc.*, No. 650291/2013 (Sup. Ct. N.Y. Cnty. Feb. 3, 2014) (repurchase action involving Morgan Stanley ABS Capital I Inc. Trust, Series 2007-NC1); Complaint, *Natixis Real Estate Capital Trust 2007-HE2 v. Natixis Real Estate Holdings, LLC*, No. 153945/2013 (Sup. Ct. N.Y. Cnty. Oct. 4, 2013) (repurchase action involving Natixis Real Estate Capital Trust 2007-HE2). The Court may take judicial notice of these filings. *See In re Justin EE*, 153 A.D.2d 772, 774 (3d Dep't 1989) ("A court may take judicial notice of prior judicial proceedings though in a different court and involving different parties."); *see also Liberty Mut. Ins. Co. v. Rotches Pork Packers, Inc.*, 969 F.2d 1384, 1388 (2d Cir. 1992) ("A court may take judicial notice of a document filed in another court not for the truth of the matters asserted in the other litigation, but rather to establish the fact of such litigation and related filings." (internal quotation marks omitted)).

II. FGIC's Allegations Concerning the Owner-Occupancy Statistics and CLTV Ratios in the Underlying Securitization Documents Fail to State a Claim for Breach of Warranty

FGIC's breach claims rely on the allegations that, based on the computer models run by its litigation consultants, the owner-occupancy and CLTV statistics reported in the Underlying Securitization Documents were inaccurate. (*See, e.g.*, Compl. ¶ 10.) In particular, FGIC alleges that (1) borrowers misrepresented whether they intended to occupy the homes for which they were receiving mortgages; and (2) while the CLTV ratios in the Underlying Securitization Documents accurately stated the CLTV ratios based on the appraisals that were done on the properties, those appraisals inflated the actual values of the properties, and therefore the CLTV ratios were understated. (*Id.* ¶¶ 75-90.) These claims fail to assert claims for breach of contract against Morgan Stanley because, in the Underlying Securitization Documents, Morgan Stanley did not make an independent statement as to the validity of the owner-occupancy information provided by borrowers; it expressly stated that the owner-occupancy statistics were based on the information provided by borrowers, and there is no allegation that Morgan Stanley failed to accurately reflect the information provided by borrowers. Similarly, the Underlying Securitization Documents expressly defined CLTV to be calculated based on the appraisals that were obtained—as a ratio of the loan value to the appraised value—without separately warranting the accuracy of the appraised value. FGIC has not brought a fraud claim here, only a breach of contract claim, and that claim fails under the plain terms of the governing documents.

A. FGIC's Claims Based on Owner-Occupancy Statistics Fail

In the Underlying Securitization Documents, when reporting owner-occupancy statistics, Morgan Stanley expressly states that these statistics are based on the information provided by the individual borrowers; FGIC does not allege otherwise.[10] Courts have held that there is no actionable misstatement "when the defendants report, as they did here, that the occupancy data was based upon representations of the related borrowers at the time of origination." *Fed. Hous. Fin. Auth. v. Countrywide Fin. Corp. (In re Countrywide Fin. Corp. Mortg.-Backed Secs. Litig.)*, 932 F. Supp. 2d 1095, 1114 (C.D. Cal. 2013) (brackets and internal quotation marks omitted).

To be sure, this Court has held that "if defendants knew that their originators had abandoned underwriting guidelines and were permitting borrowers to falsify information, they cannot hide behind the borrowers' representations." *HSH Nordbank AG v. Barclays Bank plc*, 42 Misc. 3d 1231(A), 2014 WL 841289, at *19 (Sup. Ct. N.Y. Cnty. Mar. 3, 2014). Yet the Court also cited *In re Countrywide* as a point of comparison, noting that the court there had "distinguish[ed] cases upholding [a] claim [based on misrepresented owner-occupancy statistics] where [the] complaint alleged that defendants passed on information they knew to be false." *Id.* This case is like *In re Countrywide* in that there are no allegations of fraud, or even knowing misrepresentation, in the reporting of owner-occupancy statistics. In fact, there are no allegations of fraud at all, and FGIC concedes that Morgan Stanley had no role in over half of the Underlying Securitizations—undercutting any claim that Morgan Stanley knew or would have known of false reports by borrowers about their occupancy statuses.

[10] For example, the PSA for Morgan Stanley Home Equity Loan Trust 2007-1, one of the Underlying Securitizations, states that occupancy statistics were based on what "the Mortgagor represented at the time of origination." (Rouhandeh Aff. Ex. 7 at S-IV-7.) The same or equivalent statements were made in Underlying Securitization Documents for all Underlying Securitizations involving Morgan Stanley. Again, FGIC does not allege otherwise, and therefore Morgan Stanley has not burdened the Court by attaching and citing each of the Underlying Securitization Documents for these 22 securitizations, but in the event that FGIC challenges this assertion in its opposition brief, Morgan Stanley can provide those documents and citations to the Court.

Consequently, FGIC's allegations of breach based on allegedly inaccurate owner-occupancy statistics must be dismissed.

B. FGIC's Claims Based on CLTV Ratios Fail

FGIC's effort to state a breach of contract based on allegedly incorrect CLTV ratios fails for similar reasons. CLTV ratios are derived using a mathematical formula, and there is no allegation that these ratios—*as defined in the Underlying Securitization Documents*—were false. (*See, e.g.*, Rouhandeh Ex. 8 (MSHEL 2007-1 Prospectus Supp.) at S-27 ("The 'combined loan-to-value ratio' of a mortgage loan at any time is the ratio of the principal balance of the second-lien mortgage loan, together with the outstanding balance of the related first-lien mortgage loan, at the date of determination to (a) in the case of purchase, the lesser of the sale price of the mortgaged property and its appraised value at the time of sale or (b) in the case of a refinancing modification, the appraised value of the mortgaged property at the time of the refinancing or modification.").[11]) The Underlying Securitization Documents expressly define CLTV ratios as being based on the *appraised values*, not an independent assessment of the values by Morgan Stanley. Accordingly, FGIC's allegation that the underlying appraisals were inflated does not render the CLTV ratios—as defined in the Underlying Securitization Documents—false. *See Union Cent. Life Ins. Co. v. Credit Suisse Sec. (USA), LLC*, No. 11 Civ. 2327 (GBD), 2013 WL

[11] This document was included in Exhibit H to the PPM and thus is an example of the documents that FGIC claims to be untrue. Because such documents form the basis of the complaint, they are properly considered on this motion. *See supra* note 1. The same or equivalent statements were contained in each of the Underlying Securitization Documents. FGIC does not allege otherwise, and therefore Morgan Stanley has not burdened the Court by attaching and citing each of the underlying documents, but in the event that FGIC challenges this assertion in its opposition brief, Morgan Stanley can provide those documents and citations to the Court.

1342529, at *8 (S.D.N.Y. Mar. 29, 2013) ("Plaintiffs do not allege that [d]efendants were reporting different information than that provided to them by the loan originators.").

Even if it were otherwise, an appraisal is a non-actionable, subjective opinion of value based on the particular methods and assumptions the appraiser uses. *See, e.g.*, *Newman v. Wells Fargo Bank, N.A.*, 85 A.D.3d 435, 435 (1st Dep't 2011) ("Appraisals are not actionable because they are matters of opinion"). The CLTV ratios reported in the Offering Materials, which were mathematically derived from appraised values (Compl. ¶ 10), likewise cannot be rendered false by allegations of inflated appraisals, absent allegations that the appraisers subjectively disbelieved their opinions—allegations that are absent here. *See Tsereteli v. Residential Asset Securitization Trust 2006-A8*, 692 F. Supp. 2d 387, 393-94 (S.D.N.Y. 2010) (dismissing claims of inflated loan-to-value ratios, which was "completely derivative of the improper appraisal practices claim," because the appraisal practices claim was "devoid of any . . . allegation" that appraisers "did not truly" believe their appraised values at the time of appraisal).

And as with FGIC's allegations about misstated owner-occupancy rates, there is no allegation here that Morgan Stanley knew the CLTV ratios to be based on inflated appraisals. *Cf. HSH*, 2014 WL 841289, at *18 (sustaining claims about inflated CLTV ratios where the complaint "plead[ed] defendants' knowledge of the falsity of the appraisals based on their due diligence").

III. FGIC Fails to Plead Causation

FGIC's first, second, and third causes of action fail because FGIC has not adequately pleaded that the contractual breaches caused its losses. The first and second causes of action are based on the statements in the Underlying Securitization Documents reporting owner-occupancy and CLTV statistics, as discussed above. FGIC does not make any effort to connect these allegations to any payment FGIC has made under the Insurance Policy. By failing to allege such a connection, FGIC pleads itself out of court. The third cause of action is based on an alleged "breach of an obligation to notify" FGIC of defaults that were causing losses in the Underlying Securitizations. FGIC, whose entire business was to insure against such losses, does not explain how it was harmed by Morgan Stanley's purported failure to notify. Nor does it allege that it was not already aware of such defaults—and it is implausible that it was not.

A. The Causation Standard: Insurance Law Section 3106

FGIC's breach-of-contract claims require application of New York's Insurance Law because FGIC sues as a monoline insurer in connection with an insurance contract. *See Countrywide II*, 105 A.D.3d at 412 ("[T]he motion court [i]s not required to ignore the insurer/insured nature of the relationship between the parties to the contract in favor of an across the board application of common law." (citing Ins. L. §§ 3105, 3106)). In particular, Section 3106, which governs "breach[es] of warranty," requires an insurer to show that the "breach materially increase[d] the risk of loss, damage or injury within the coverage of the contract." Ins. L. § 3106(b). This section applies to FGIC's claims, and FGIC invokes it in its Complaint. (*See* Compl. ¶¶ 247, 252.) Because FGIC has not pleaded that the contractual breaches here materially increased its risk of loss covered by the Insurance Policy, its claims must be dismissed.[12]

[12] A second provision of the Insurance Law, Section 3105, governs "misrepresentations" by the insured and typically applies to fraud claims. *See MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, 34 Misc. 3d 895, 906 (Sup. Ct. N.Y. Cnty. 2012) ("*Countrywide I*"), *aff'd in part, rev'd in part on other grounds*, *Countrywide II*, 105 A.D.3d 412. That section is not relevant here, where no fraud claim has been alleged.

B. FGIC's First and Second Causes of Action Must Be Dismissed

Under Section 3106, FGIC must plead that Morgan Stanley's "alleged misrepresentations materially increased [FGIC]'s risk of loss" and that FGIC "was damaged as a direct result." *Countrywide I*, 34 Misc. 3d at 906. As Justice Bransten observed, "this [is] not . . . an easy task." *Id.* FGIC has failed to do so.

To begin, FGIC fails to tie its own allegations about CLTV ratios and owner-occupancy statistics to any loss it actually suffered. FGIC relies principally on a computerized automated valuation model ("AVM") to show alleged discrepancies between reported and actual CLTV ratios and owner-occupancy rates. (*See* Compl. ¶ 74 & n.14.) Critically, however, FGIC makes no allegations tying the discrepancies allegedly observed through its AVM to the insurance payments that FGIC has thus far made.

Nor does FGIC allege how such discrepancies materially increased the risk of loss. As noted above, NIM securities are extremely susceptible to losses from missed payments on the Underlying Loans. *See supra* pp. 3-4. FGIC must plead that the allegedly misreported CLTV and owner-occupancy statistics about the loans *materially* increased the risk that the notes that FGIC insured, backed by the bottom rung of the collateral structure for 48 securitizations,[13] would suffer losses triggering FGIC's obligation to pay. Yet FGIC does not allege that misreported CLTV ratios and owner-occupancy rates in certain Underlying Loans—rather than myriad other factors, including the worst housing and credit crisis in recent history—made its

[13] As one regulator has explained, "A NIM securitization structure is created when an issuer securitizes residual cash flows from existing asset-backed transactions. Residual certificates receive cash flow on a monthly basis *only after all fees and expenses related to the transaction and amounts due on all other classes of certificates have been paid*." Office of Thrift Supervision, Regulatory Bulletin 37-51, 2010 WL 1390842, at *107 (Jan. 15, 2010) (emphasis added).

obligation to insure NIM securities any riskier, let alone materially so. The requirement that FGIC allege that the alleged misrepresentations materially changed the risk profile is especially important here, given the nature of NIM securities, which are impaired as soon as the Underlying Loans begin experiencing losses. (*See* PPM at 15 ("[T]he amount of excess cashflow distributable on the Underlying Excess Cashflow Certificates (and as a result, payable on the related Underlying NIM Security) is extremely sensitive to losses on the related Mortgage Loans (and the timing thereof), because the entire amount of realized losses will be allocated directly or indirectly to such Underlying Excess Cashflow Certificates . . . .").) By failing to so plead, FGIC does not allege that "it was damaged as a direct result" of these discrepancies, *see Countrywide I*, 34 Misc. 3d at 906, and its first and second causes of action must therefore be dismissed.

Rather than grapple with causation under Section 3106, FGIC alleges that it "would not have agreed to issue the Policy if Morgan Stanley had not provided" a warranty of the accuracy of information, or had it known that the warranty was false. (Compl. ¶ 63.) But that allegation only relates to the standard under Section 3105—for a claim sounding in fraud—not under Section 3106. *See* Ins. L. § 3105(a) ("A representation is a statement as to past or present fact, made to the insurer by . . . the applicant for insurance . . . at or before the making of the insurance contract *as an inducement* to the making thereof." (emphasis added)); *id.* § 3105(b)(1) ("No misrepresentation shall be deemed material unless knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make such contract."); *see also Countrywide I*, 34 Misc. 3d at 906 ("[T]o show materiality, as defined by Insurance Law § 3105(b) and case law, [plaintiff] must show that it relied on [defendants'] alleged misrepresentations in that the alleged statements induced [plaintiff] to take action which [it] might otherwise not have taken, or would have taken in a different manner."). FGIC has not alleged fraudulent inducement, and thus the representations that it claims induced it to enter into the contract are irrelevant to its claims.

FGIC has therefore not alleged causation under Section 3106, and its first and second causes of action should be dismissed.

C. FGIC's Third Cause of Action Must Be Dismissed

FGIC's third cause of action, for breach of I&I Section 2.02(e), likewise fails to plead causation. FGIC contends that Morgan Stanley failed to notify it of "interest payment shortfalls" affecting the Underlying Securitizations (Compl. ¶ 70), thus violating Morgan Stanley's notification obligation under the I&I. (*See* (I&I § 2.02(e)(iii)-(iv).) Not only does this allegation fail to explain how Morgan Stanley's supposed breach materially increased FGIC's risk of loss, but it also fails to explain how FGIC was harmed at all. Indeed, FGIC does not claim that untimely notice prejudiced it in any way. For instance, FGIC does not contend that it would have taken quicker action had it known of breaches earlier, or that such action would have enabled it to stem the losses it has suffered.

FGIC would be hard pressed to allege that the required notice would have altered its conduct. These events occurred during the worst financial crisis in recent memory. FGIC, which insured numerous mortgage-backed securitizations, would have been well aware that the Underlying Securitizations were sustaining losses, and FGIC has not made any allegations to the contrary, nor has FGIC pleaded how it was "damaged as a direct result" of the alleged failure to notify. *Countrywide I*, 34 Misc. 3d at 906.

CONCLUSION

For the reasons stated above, defendants respectfully request that this Court dismiss plaintiff's complaint with prejudice.

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