HGT LAW

Client Newsletter

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Pinnacle Notes: Southern District Of New York Denies Motion To Dismiss, Allowing Singapore Investors To Proceed With Class Action In Federal Court In New York

On October 31, 2011, Judge Sand of the United States District Court for the Southern District of New York issued a decision in Dandong v. Pinnacle Performance Limited, No. 10-civ-8086 (S.D.N.Y.), denying in part and granting in part a motion to dismiss filed by the defendants, various Morgan Stanley-affiliated entities. The upshot of the decision is that the Singapore plaintiffs in Dandong may now move forward in New York with respect to their claims for: (a) fraud and fraudulent inducement; (b) breach of the implied covenant of good faith and fair dealing; and (c) aiding and abetting. The plaintiffs' other claims were dismissed. The decision is interesting in several respects.

Credit-Linked Notes That Were Designed To Fail.

In the first place, *Dandong* is revealing for the type of fraudulent scheme that the defendants are alleged to have perpetrated. In *Dandong*, the Singapore investors bought securities, called "credit-linked notes", issued by Pinnacle Performance Limited. Credit-linked notes are instruments in which the purchasers of the notes agree to assume a defined credit risk in return for periodic payments for assuming that risk. This shifting of risk is accomplished through a credit default swap. Thus, by buying a credit-linked note, an investor effectively agrees to provide insurance against a certain credit risk, such as an event of default, and receives insurance premiums ("credit protection payments") for insuring that risk. In *Dandong*, the Pinnacle credit-linked notes purchased by the Singapore investors provided insurance against certain credit risks associated with highly-rated sovereign nations or global corporations. However, none of these nations or corporations defaulted, so that is not how the Singapore investors lost their money.

When investors buy credit-linked notes, the principal invested by the investors constitutes the source of funds to cover the insurance obligations if the credit risk that is being insured by the investors materializes. However, until the credit risk materializes, the principal must be invested in certain underlying assets to generate income. In fact, it is the income from holding these underlying assets, along with the credit protection payments received from the counter-party to the credit default swap, that are passed on to the purchasers of the credit-linked notes, accounting for the attractive yield on these instruments.

In *Dandong*, the fraudulent scheme that is alleged against the Morgan Stanley defendants centers around the conduct of the defendants in departing from industry practice and placing the investors' principal into underlying assets that were not only risky, but that were *designed to fail*. Typically, the investors' principal is invested in liquid, low-risk collateral to be held until such time as any obligations to provide insurance are triggered by an event of default for which the credit-linked notes were meant to provide protection. In *Dandong*, however, the Singapore investors allege that their principal was invested in highly risky instruments called synthetic collateralized debt obligations ("CDOs").

Synthetic CDOs, like credit-linked notes, are structured around a credit default swap, and serve the purpose of providing insurance against default on a certain collateral pool of assets. In essence, one party takes a "long" position in the synthetic CDO and agrees to provide protection against default on the pool of assets, while the counter-party takes a "short" position in the synthetic CDO and pays premiums in return for receiving protection on the pool of assets. Viewed another way, a synthetic CDO is really just a bet between two parties as to the likelihood of default on a particular collateral pool of assets.

In the case of *Dandong*, not only did Morgan Stanley *select* the assets for inclusion in the collateral pool of assets that were being insured by the synthetic CDOs, Morgan Stanley also took the *short* position on the synthetic CDOs. In other words, Morgan Stanley is alleged to have entered into a bet with the investors to whom it marketed the Pinnacle credit-linked notes, and then rigged the bet in such a way that Morgan Stanley was the pre-ordained winner. According to the Singapore investors, the pool of assets was chosen by Morgan Stanley to include exposures to Icelandic banks and entities that were heavily exposed to the housing market, so that default was likely or inevitable. When these banks and entities ultimately defaulted, Morgan Stanley, as the holder of the short position in the bet, demanded and received payments from the Singapore investors, who held the long position on the synthetic CDOs. Thus, when the losses came for the Singapore investors, it was not because of a default by sovereign nations or corporations that the investors thought they were insuring. Instead, investors were wiped out because of losses on the underlying assets in which the investors' principal was parked.

In alleging such a fraudulent scheme involving rigged bets, the *Dandong* plaintiffs describe the same type of misconduct that has recently been exposed by the SEC in its settlements against Goldman Sachs and Citigroup. In *SEC v. Goldman Sachs & Co.,* No. 10-cv-3229 (S.D.N.Y.), Goldman agreed to pay a record $550 million to settle charges that it marketed a synthetic CDO, known as ABACUS 2007-AC1, that Goldman rigged in such a way that it was designed to fail, benefiting one of Goldman's hedge fund clients, Paulson & Co. Inc., which not only played a role in the portfolio selection process, but also took a short position against the CDO. Similarly, on October 19, 2011, Citigroup agreed to pay a $285 million fine to settle *U.S. SEC v. Citigroup Global Markets, Inc.,* No. 11-cv-7387 (S.D.N.Y.), in which Citigroup was alleged to have structured and marketed a CDO called Class V Funding III and exercised significant influence over the selection of $500 million of the assets included in the CDO portfolio. Citigroup then took a proprietary short position against those mortgage-related assets from which it would profit if the assets declined in value.

In some ways, however, the allegations against Morgan Stanley in *Dandong* are more serious than what was alleged against Goldman Sachs and Citigroup. That is because the Singapore investors allege that Morgan Stanley lured them into acquiring the Pinnacle credit-linked notes through a classic "bait and switch." Investors thought they were purchasing conservative, run-of-the-mill credit-linked notes insuring against default by various sovereign nations and global corporations. Outwardly, this was true. This was the bait. But, underneath the hood, the investors' principal was invested in a bet structured and designed by Morgan Stanley, in which Morgan Stanley took the opposite side of the bet. This was the switch.

Singapore investors can bring action in U.S. courts.

Perhaps of greatest importance to the Singapore investors in *Dandong* is the ruling by Judge Sand that they may now proceed with their claims in federal court in New York. In their motion to dismiss, the Morgan Stanley defendants had asserted several arguments for sending the case back to Singapore, but each of these arguments was rejected by Judge Sand.

For example, Morgan Stanley argued that the investors had accepted a forum selection clause in which they purportedly agreed that "all applications, acceptances or contracts resulting [from their completion of the relevant application forms] shall be governed by and construed in accordance with the laws of Singapore" and "irrevocably submit[ted] to the exclusive jurisdiction of the Singapore courts." However, Judge Sand held that this forum selection clause applied only to the application form submitted by each investor, and therefore could only conceivably govern the investors' claims against the *distributors* of the credit-linked notes (i.e., the Singapore banks which distributed the notes to investors). In contrast, the investors' fraud claims against the *Morgan Stanley defendants* were based on the misstatements and omissions contained in the Base Prospectus and Pricing Statements given to each investor, and the court held that these specific documents did not contain any forum selection clause that required claims to be brought in Singapore.

As a secondary argument, the Morgan Stanley defendants argued that New York was not a convenient forum, because the core allegations in *Dandong* "make clear that this is a dispute centered on activities that occurred in Singapore." Again, Judge Sand disagreed. Judge Sand observed that, as alleged by the *Dandong* investors, the synthetic CDOs in which the investors' principal was invested were created and structured in New York, the selection of the collateral pool of assets for the synthetic CDOs also occurred in New York, and the offering materials containing the misleading statements and omissions were drafted in New York. In contrast, the actions in Singapore of the Singapore brokerages that distributed the Pinnacle notes was not central to the investors' claims, so that Singapore had a more tenuous connection to the investors' claims.

The ability to bring an action in New York in itself constitutes a major victory for Pinnacle notes investors. Until now, Singapore investors have had incomplete recourse with respect to their claims. Under a dispute resolution system announced by the Monetary Authority of Singapore in 2009, investors could file claims, but only against the Singapore brokerages that distributed the Pinnacle notes, but not against Morgan Stanley itself. Judge Sand's decision opens up a new front in the Pinnacle notes litigation, and possibly for investors in other securities that were sold to Asian investors in the lead-up to the financial crisis, such as the Lehman "Minibonds" and the LinkEarner Notes issued by Jubilee Global Finance Limited.

For more information on *Dandong* v. *Pinnacle Performance Limited,* No. 10-civ-8086 (S.D.N.Y.), or if you hold Pinnacle notes or other notes and would like to discuss your potential claims with a New York lawyer, please contact us (info@hgtlaw.com) to arrange a free consultation.