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Be Careful What You Warrant and Represent In Your Deal Documents; You May Be Liable To A Sophisticated Party For Fraudulent Inducement Even When That Party Fails to Conduct Due Diligence Or Was On Notice Of Potential Problems

By Mark McGrath

In *MBIA Insurance Corporation v. Credit Suisse Securities (USA) LLC, DLJ Mortgage Capital, Inc., and Select Portfolio Servicing, Inc.*, Index No. 603751/2009 (Sup Ct, NY County, Aug. 9, 2010), Justice Shirley Werner Kornreich denied, in large part, the defendants' motion to dismiss fraudulent inducement and breach of contract claims based on certain representations and warranties provided to the plaintiff in the parties' deal documents.

The plaintiff, MBIA Insurance Corporation ("MBIA"), alleged that the defendants were affiliated entities under common control that entered into a transaction to securitize $900 million in approximately 15,000 closed-end, second-lien residential mortgages (the "Transaction"). Defendant DLJ Mortgage Capital, Inc. ("DLJ") aggregated the loans into a loan pool that was transferred to a trust, which was formed to issue securities. Defendant Select Portfolio Servicing, Inc. ("SPS") was to service the underlying loans. Credit Suisse Securities (USA) LLC ("CS Securities") was the underwriter and, thus, marketed the securities to investors. In order to make the securities more attractive to potential investors, CS Securities solicited MBIA to issue a financial guaranty insurance policy guaranteeing the payment of the loans' interest and principal.

MBIA was contacted in March of 2007 and was told it would have to decide quickly whether to issue the policy because the Transaction would close that month. CS Securities provided MBIA with a loan schedule that contained certain information about each loan, spreadsheets illustrating the due diligence that had been performed, and assurances that the loans were underwritten to strict guidelines. MBIA eventually entered into an insurance agreement with DLJ and SPS (the "Insurance Agreement"), which contained express representations and warranties and incorporated by reference the representations and warranties contained in a Pooling and Service Agreement among DLJ, SPS and others (the "PSA"). The representations and warranties were made for both the Transaction and the underlying loans and, in general, related to the alleged quality and attributes of the loans and the underwriting practices.

After a large number of defaults on the underlying loans, MBIA became obligated to pay under

the Insurance Agreement. MBIA exercised its contractual right to review the loan origination files in the possession of SPS, and determined that many of the underlying loans were not in conformity with the representations and warranties in the Insurance Agreement and the PSA and that certain breaches of contract had occurred. MBIA sued CS Securities, DLJ and SPS for, *inter alia*, fraudulent inducement, breach of contract, breach of the covenant of good faith and fair dealing, indemnification and reimbursement.

The defendants moved to dismiss those claims. In regard to the fraudulent inducement claim, the defendants argued that MBIA was a sophisticated party that was not entitled to rely on the representations and warranties because it failed to conduct due diligence and was on notice of deficiencies in the loans from information in the prospectus and a supplement to that document and, therefore, could not have reasonably relied on it.

Justice Kornreich rejected the defendants' arguments based on the Court of Appeals' decision in *DDJ Capital Management, LLC v. Rhone Group L.L.C.*. 15 N.Y.3d 147 (2010). According to Justice Kornreich, the Court of Appeals rejected the defendants' argument that a party who obtains representations and warranties is obligated, in all cases, to review the underlying documents in order to confirm a representation because "where a plaintiff has gone to the trouble to insist on a written representation that certain facts are true, it will often be justified in accepting that representation rather than making its own inquiry." Justice Kornreich also relied on Justice Bransten's decision in *MBIA Insurance Corporation v. Countrywide Home Loans, Inc.*, Index No. 602825/2008 (Sup Ct, NY County, July 13, 2009), which also held that a lack of due diligence was not sufficient to dismiss a fraud claim.

Justice Kornreich held that the disclosures and disclaimers in the prospectus and the supplemental prospectus were not sufficient to dismiss the fraudulent inducement claim on a motion to dismiss, because "a hint of a 'considerable risk' will not necessarily trigger an obligation to do more than obtain representations and warranties." *Id.* (quoting *DDJ Capital*, 15 N.Y.3d at 156). Since the defendants only identified disclosures that "raised the possibility" that the loans might be problematic and failed to identify any disclosures "that would have conclusively alerted MBIA to the pervasive loan fraud," Justice Kornreich could not rule as a matter of law that the disclosures were a bar to the fraudulent inducement claim.

The import of Justice Kornreich's decision, as well as the Court of Appeals decision, is that a party making representations and warranties about existing facts or procedures may be liable for fraud or other tortious conduct if those representations and warranties are false, even in the face of disclaimers or disclosures. Moreover, a party to a contract that obtains representations and warranties relating to present facts may have no obligation to conduct any due diligence except when the party receiving the representations and warranties is on notice of more than a possibility that there may be problems.

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