

**One William St. Capital Mgt., LP v Education Loan
Trust IV**

2013 NY Slip Op 31977(U)

August 14, 2013

Sup Ct, New York County

Docket Number: 652274/2012

Judge: Eileen Bransten

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SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

HON. EILEEN BRANSTEN
J.S.C.

PRESENT: _____

PART 3

Index Number : 652274/2012
ONE WILLIAM STREET CAPITAL
vs
EDUCATION LOAN TRUST IV ET AL
Sequence Number : 001
OTHER RELIEFS

INDEX NO. 652274/12
MOTION DATE 12/11/12
MOTION SEQ. NO. 001

The following papers, numbered 1 to 2, were read on this motion to/for judgment on petition

Notice of Motion/Order to Show Cause - Affidavits - Exhibits No(s) 1, 2
Answering Affidavits - Exhibits No(s)
Replying Affidavits No(s)

Upon the foregoing papers, it is ordered that this motion is

IS DECIDED

IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION

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

Dated: 8-14-13

Eileen Bransten
EILEEN BRANSTEN, J.S.C.

- 1. CHECK ONE: CASE DISPOSED NON-FINAL DISPOSITION
2. CHECK AS APPROPRIATE: MOTION IS: GRANTED DENIED GRANTED IN PART OTHER
3. CHECK IF APPROPRIATE: SETTLE ORDER SUBMIT ORDER
DO NOT POST FIDUCIARY APPOINTMENT REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 3

-----X
ONE WILLIAM STREET CAPITAL
MANAGEMENT, LP.,

Petitioner,

Index No. 652274/2012
Motion Seq. No. 001, 002, 003,
004
Motion Date: 12/11/2012

-against-

EDUCATION LOAN TRUST IV, et al,

Respondents.

-----X

Eileen Bransten, J.:

Motion sequence numbers 001, 002, 003 and 004 are consolidated for disposition.

This is an action/special proceeding by plaintiff/petitioner One William Street Capital Management L.P. (“OWS”) seeking: (a) the payment of overdue principal and interest on \$10 million of notes issued by respondent U.S. Education Loan Trust IV, LLC (“ELT”) pursuant to an indenture; (b) an accounting; (c) a determination of OWS’s rights under a trust; and, alternatively, (d) damages.

In motion sequence 001, OWS seeks judgment on the first cause of action in the petition, for payment of overdue principal and interest. The remaining motions are motions to dismiss brought by various respondents. In motion sequence 002, ELT moves, pursuant to CPLR 3211(a)(1), (3) and (7), for an order dismissing the petition. OWS cross-moves for leave to amend the petition.

Respondents Kildare Capital, Inc. (“Kildare”) (motion sequence 003), as well as The Bank of New York (“BONY”) and Education Loan Trust IV (the “Trust”) (motion sequence 004), likewise seek dismissal of the petition pursuant to CPLR 3211(a)(7).

I. Background

Petitioner alleges that it is the owner of \$10 million worth of Series 2007-1B-1 Notes (Notes), which are backed by government-guaranteed student loans. The Notes were originally issued on October 19, 2007 by ELT, as Issuer, pursuant to an indenture and a supplemental indenture (together, “Indenture”). The Notes were part of a total of \$30 million worth of Notes issued by ELT. OWS purchased its Notes in January of 2011. The remaining notes are owned by non-party Merrill, Lynch, Pierce, Fenner & Smith (“Merrill”).

At the time of issue, the Notes were “Reset Rate Notes,” which, under the Indenture, means their interest rate reset quarterly during a “Floating Rate Term,” which ended on November 30, 2008. As Reset Rate Notes, the Notes paid interest of three-month LIBOR plus 1.50%. LIBOR is a published reference indicating the average interest rate that certain leading banks in London charge when lending to other banks.

Petitioner alleges that, on December 1, 2008, the Notes automatically converted to “Auction Rate Notes.” This meant that, starting on that date, ELT, as the issuer, and

BONY, as the auction agent, were required to hold auctions every 28 days, to set the interest rate for the Notes.

The auction procedure required the auction agent to compare the bids of buyers, who specified the price they would pay for the Notes, and sellers, who specified the price at which they would sell. The result would be either a successful auction, an “all-hold” auction, or a failed auction. An all-hold auction was one in which there were no sellers and the Notes would bear a rate equal to 90% of one-month LIBOR. (Petition ¶ 70.)

Petitioner states that no such auctions were held in the first two auction periods, or, in fact, for over two years thereafter. It alleges that the auctions were not held because “the credit markets had seized up.” (Petition ¶ 2.)

According to the petition, once the first two auction periods passed without an auction, the Notes had to be redeemed as soon as the Trust had funds available and, in the interim, had to bear interest at a rate of one-month LIBOR plus 2.50% until redeemed or until a successful auction at which there were sufficient closing bids.

Petitioner states that, contrary to the terms of the Indenture, ELT and BONY failed to provide timely notice of the conversion to Auction Rate Notes, failed to redeem the Notes after the first two missed auctions, failed to pay interest at the rate of one-month LIBOR plus 2.50%, and failed to provide notice to the noteholders of these any other defaults. (Petition ¶ 3.)

OWS states that it purchased its Notes in January 2011 because it had examined a prospectus and other information and concluded that the Indenture required a payment at the rate of one-month LIBOR plus 2.50%, despite the fact that the Notes appeared to be paying at LIBOR plus 1.50%. It further states that it contacted ELT, which allegedly stated that the Notes were supposed to pay one-month LIBOR plus 2.50% and that the discrepancy was being corrected. OWS alleges that it was not informed that the Notes should have been redeemed years earlier, or that ELT was in default on the timely payment of principal and/or interest under the Indenture.

OWS states that, in April, 2011, BONY recomputed the interest at one-month LIBOR plus 2.50%, but took no action to redeem the Notes. Thereafter, in June, BONY began conducting auctions. However, OWS asserts that ELT, BONY and Kildare, who was the broker-dealer hired by BONY to generate interest in auctions of the Notes, all failed to notify OWS or Merrill about the auctions. As such, because OWS and Merrill were the only owners of the Notes, there were no sellers.

The petition alleges that the result was an "all hold" auction, which lowered the interest rate from one-month LIBOR plus 2.50% to 90% of LIBOR, equivalent to less than 0.20%. Thereafter, ELT allegedly asserted that the Notes were "capped" at the net loan rate, set forth in the Indenture, which is computed by subtracting certain administrative fees from the Trust's interest income and dividing the net amount by the

total value of the Trust's assets. OWS states that ELT has taken the position that the net loan rate is zero, meaning that administrative fees are so high that they exceed the revenues the Trust receives from the underlying government-guaranteed student loans.

In June 2012, petitioner commenced this hybrid special proceeding/action, pursuant to article 77 of the CPLR. The petition sets forth causes of action for: 1) payment of principal and interest; 2) an accounting; 3) a declaratory judgment; 4) equitable estoppel; 5) breach of the covenant of good faith and fair dealing; 6) breach of fiduciary duty; 7) aiding and abetting breach of fiduciary duty; and 8) negligent misrepresentation.

First, OWS seeks to require ELT and BONY to redeem the Notes at par and to pay interest at the rate of one-month LIBOR plus 2.50%. Alternatively, it argues that ELT should be equitably estopped from denying that it owes interest at the rate of one-month LIBOR plus 2.50% or it should pay damages for breach of the covenant of good faith and fair dealing. In the third alternative, it argues that it is entitled to tort damages for BONY's breaches of its fiduciary duty, ELT's and Kildare's aiding and abetting of that breach, and for ELT's negligent misrepresentations.

II. Leave to Amend

In motion sequence 002, petitioner moves for leave to amend the petition.

Petitioner seeks to add two new petitioners, The Depository Trust Company (“DTC”) and Cede & Co. (“Cede”). According to the proposed amended petition, DTC is a securities depository and clearing agency, registered with the Securities and Exchange Commission, for the settlement of trades in corporate and municipal securities on behalf of the financial institutions that constitute its Participants. Cede is DTC’s nominee and is the record owner of the Notes beneficially owned by OWS.

The proposed amended petition also seeks to add two respondents, U.S. Education Servicing LLC (“Servicing”) and Dr. Henry Howard. Servicing is the master servicer for the loans issued by the Trust and the administrator for the Trust and the Issuer. Dr. Howard is the Chairman, President and Chief Executive Officer of ELT, and the principal of Servicing.

The proposed amended petition asserts three new causes of action: 1) fraud against ELT, Dr. Howard and Servicing; 2) fraudulent conveyance against ELT; and (3) surcharge against BONY. It additionally asserts a claim for punitive damages. In addition, the proposed amended petition adds numerous pages of additional facts in support of both the new causes of action and the causes of action in the original petition. It also deletes many factual allegations set forth in the original petition.

It is well-established that leave to amend pleadings under CPLR 3025(b) should be freely given, absent prejudice or surprise resulting directly from the delay. *See McGhee v. Odell*, 96 A.D.3d 449, 450 (1st Dep't 2012). "On a motion for leave to amend a pleading, movant need not establish the merit of the proposed new allegations, but must 'simply show that the proffered amendment is not palpably insufficient or clearly devoid of merit.'" *Miller v. Cohen*, 93 A.D.3d 424, 425 (1st Dep't 2012) (quoting *MBIA Ins. Corp. v. Greystone & Co., Inc.*, 74 A.D.3d 499, 500 (1st Dep't 2010)).

"A determination whether to grant such leave is within the Supreme Court's broad discretion, and the exercise of that discretion will not be lightly disturbed." *Aurora Loan Serv., LLC v. Dimura*, 104 A.D.3d 796, 796-797 (2d Dep't 2013) (internal citation and quotation marks omitted). "A party opposing leave to amend 'must overcome a heavy presumption of validity in favor of [permitting amendment].'" *McGhee v. Odell*, 96 A.D.3d at 450 (quoting *Otis El. Co. v. 1166 Ave. of Am. Condo.*, 166 A.D.2d 307, 307 (1st Dep't 1990)).

Here, none of the respondents argues that any prejudice would arise from an amendment to the petition. Therefore, the motion to amend is granted, except as to certain causes of action, set forth below, which are without merit.

A. *Payment of Principal and Interest*

The first cause of action seeks payment of principal and interest on the Notes under the terms of the Indenture. As described above, OWS alleges that it is entitled to such payments given the failure to hold auctions as required under the terms of the Indenture. Based on such allegations, OWS has demonstrated that the proposed first cause of action is not palpably insufficient or devoid of merit.

The court notes that, on the original motions to dismiss, the parties sharply disputed whether some or all of OWS's claims are barred by a no-action clause in the Indenture (section 6.08), which prohibits certain claims from being asserted. They also disagree on the effect of section 6.09 of the Indenture, which contains exclusions from the no-action clause.

Disposition of this issue requires development of the facts alleged in this proceeding. However, at this point, defendants have not demonstrated that OWS should be precluded from amending the petition on account of the no-action clause.

B. *Accounting*

The proposed amended petition's second cause of action seeks an accounting from BONY, the Trust and ELT. However, a party seeking an accounting must allege the existence of a confidential or fiduciary relationship. *Saunders v. AOL Time Warner, Inc.*,

18 A.D.3d 216, 217 (1st Dep't 2005). The amended petition no longer asserts the existence of such a relationship. Thus, the claim for an accounting is not sufficiently pled.

The court notes that the original petition asserted a claim against BONY for breach of fiduciary duty. However, the proposed amended petition removes the assertion that a fiduciary duty exists and asserts a claim for breach of a "duty of Indenture Trustee," i.e. that BONY failed to exercise due care in carrying out its duties under the Indenture. *See AG Capital Funding Partners, L.P. v. State St. Bank & Trust Co.*, 11 N.Y.3d 146, 157 (2008) ("an indenture trustee owes a duty to perform its ministerial functions with due care, and if this duty is breached the trustee will be subjected to tort liability"). Petitioner has not demonstrated that this allegation of a breach of a duty of care would be sufficient to support a claim for an accounting.

C. *Aiding and Abetting*

The proposed seventh cause of action is for aiding and abetting a breach of duty against ELT and Kildare. As noted above, the original petition asserted a claim against ELT and Kildare for aiding and abetting a breach of fiduciary duty, in relation to an alleged breach of such duty by BONY. However, the proposed amended complaint no longer asserts a claim for breach of fiduciary duty against BONY, and, in fact,

specifically removes the word fiduciary from the cause of action against BONY. As such, a claim for aiding and abetting a breach of fiduciary duty is no longer valid, since the underlying claim for breach of fiduciary duty has been withdrawn.

D. *Negligent Misrepresentation*

Petitioner's proposed eighth cause of action is against ELT for negligent misrepresentation. "A cause of action for negligent misrepresentation must allege (1) the existence of a special or privity-like relationship imposing a duty on the defendant to impart correct information to plaintiff; (2) that the information was incorrect; and (3) reasonable reliance on the information." *Flaherty Funding Corp. v. Johnson*, 105 A.D.3d 1445, 1446 (4th Dep't 2013) (internal citations and quotation marks omitted). "An arm's length business relationship. . . is not generally considered to be the sort of confidential or fiduciary relationship that would support a cause of action for negligent misrepresentation." *Greentech Research LLC v. Wissman*, 104 A.D.3d 540, 540 (1st Dep't 2013).

Here, the proposed amended complaint does not allege any facts to suggest any type of special relationship between OWS and ELT. At best, it suggests an arm's length business relationship. As such, the proposed eighth cause of action is without merit.

E. *Fraud*

The ninth cause of action in the proposed amended petition is for fraud against ELT, Dr. Howard, and Servicing. OWS alleges, among other things, that, at the time of purchase, it read the Prospectus Supplement prepared by ELT, and the Indenture, and concluded, based in part on this information, that the Indenture required a payment at the rate of one-month LIBOR plus 2.50% despite the fact that the Notes appeared to be paying at LIBOR plus 1.50%. OWS states that it contacted ELT, who stated that the Notes were supposed to pay one-month LIBOR plus 2.50% and that the discrepancy was being corrected.

OWS also alleges that it contacted Dr. Howard, who represented to OWS that the Notes bore interest at LIBOR plus 2.50%, that they were not subject to a cap that could drive the interest rate below that rate, and that “you could send your kids to college” with the interest payments. (Proposed Amended Petition ¶ 70.)

Dr. Howard also purportedly stated that his accountants had discovered that the Notes were paying quarterly at LIBOR plus 1.50% and that he had begun the process of correcting the payments to be LIBOR plus 2.50%.

OWS also asserts that Dr. Howard concealed material facts. Specifically, it alleges that he failed to disclose that there would soon be auctions and failed to state “that he read

the Supplemental Indenture to subject the Notes to a 'Net Loan Rate cap' if there was an all-hold auction, or that an all-hold auction would be 'deemed' successful." *Id.*

OWS states that it believed defendants' statements and believed that until a successful auction took place where there were sufficient buy orders to clear the sell orders, the interest rate would continue to be one-month LIBOR plus 2.50%.

Finally, OWS also alleges that Dr. Howard artificially inflated administrative fees and expenses in order to depress the "Net Loan Rate" cap, which, according to OWS, has been zero since 2011, thus depressing the value of the notes issued by the Trust.

(Proposed Amended Petition ¶ 110.)

Defendants contend that the proposed fraud claim is deficient for several reasons. First, they contend that certain of Dr. Howard's statements are "mere puffery." They also contend that the proposed cause of action fails to plead reasonable reliance because OWS is a sophisticated investor. Defendants further argue that they cannot be liable for omissions because there is no fiduciary relationship between the parties.

"The elements of fraud are a misrepresentation or a material omission of fact which was known to be false by the defendant, made for the purpose of inducing the other party to rely upon it, justifiable reliance of the other party on the misrepresentation or omission, and injury." *VisionChina Media Inc. v. S'holder Representative Serv., LLC*, -- A.D.3d --, 967 N.Y.S.2d 338, 343 (1st Dep't June 11, 2013).

It is well-settled that elements of a fraud claim, such as what constitutes a material representation or reasonable reliance, are fact intensive and, as such, not easily subject to summary disposition. *Gonzalez v. 40 West Burnside Ave. LLC*, 107 A.D.3d 542, 544 (1st Dep't 2013); *Brunetti v. Musallam*, 11 A.D.3d 280, 281 (1st Dep't 2004). As such, dismissal is less appropriate on a motion to amend a petition, in which the movant need not establish the merits of its claims. *See Miller v. Cohen*, 93 A.D.3d 424, 425 (1st Dep't 2012).

Here, the court finds that the proposed fraud claim is neither palpably insufficient nor devoid of merit. OWS has adequately set forth facts to support its fraud cause of action, including various alleged misrepresentations and omissions by defendants and its reliance on those statements to its detriment. Whether the fraud allegations will ultimately prove meritorious will involve resolution of certain factual questions that are not appropriately determined on this motion.

The court notes defendants' assertion that they cannot be liable for omissions, absent a fiduciary relationship. *See Levine v. Yokell*, 245 A.D.2d 138, 138 (1st Dep't 1997). However, such omissions may prove actionable if defendants' had special knowledge or information that was not attainable by OWS or because defendants' failure to disclose certain information constituted a misleading partial disclosure. *Williams v. Sidley Austin Brown & Wood, L.L.P.*, 38 A.D.3d 219, 220 (1st Dep't 2007).

F. *Fraudulent Conveyance*

The tenth cause of action is against ELT for fraudulent conveyance. OWS alleges that ELT and Dr. Howard wrongfully removed at least \$53 million from the Trust in order to avoid redeeming principal and interest on the Notes, in violation of Debtor and Creditor Law §§ 273-a and 276.” (Proposed Amended Petition ¶¶ 178, 179.)

Although defendants dispute this allegation, numerous fact questions exist which preclude dismissal of this claim at this point. For the purposes of this motion, the proposed amended petition sets forth sufficient facts to demonstrate that this claim is not palpably insufficient or devoid of merit.

G. *Additional Claims*

The proposed amended petition also sets forth claims for breach of the covenant of good faith and fair dealing, equitable estoppel and a declaration of rights. Defendants do not address these claims in their opposition to the motion to amend the petition. However, the proposed amended petition sets forth sufficient facts to demonstrate that these claims are not palpably insufficient or devoid of merit.

H. *Punitive Damages*

Petitioner's proposed claim for punitive damages is patently insufficient. To the extent that the proposed amended petition arises from the parties' contractual relationship, petitioner must allege, among other things, some type of conduct aimed at the public. *See New York Univ. v. Continental Ins. Co.*, 87 N.Y.2d 308, 315-316 (1995); *2470 Cadillac Resources, Inc. v. DHL Exp. (USA), Inc.*, 84 A.D.3d 697, 699 (1st Dep't 2011). No such allegations exist in the proposed amended petition. Nor has the petitioner alleged any morally culpable or reprehensible conduct on the part of any of the defendants such as might sustain a claim for punitive damages. *See New York Univ. v. Continental Ins. Co.*, 87 N.Y.2d at 315-316; *CDR Creances S.A.S. v. Cohen*, 62 A.D.3d 576 (1st Dep't 2009). In fact, the proposed amended petition does not set forth any specific facts in support of the claim for punitive damages. Therefore, the motion for leave to amend to assert a claim for punitive damages is denied.

III. **ELT, Kildare, BONY, and the Trust's Motions to Dismiss**

It is well-settled that once an amended complaint has been served, it supersedes the original complaint and becomes the only operative complaint in the case. *Pomerance v. McGrath*, 104 A.D.3d 440, 442 (1st Dep't 2013); *Baker v. 16 Sutton Place Apt. Corp.*, 2 A.D.3d 119 (1st Dep't 2003); *Aikens Const. of Rome v. Simons*, 284 A.D.2d 946 (4th

Dep't 2001). Moreover, service of an amended complaint "render[s] the sufficiency of the allegations in the original complaint academic." *Gay v. Farella*, 5 A.D.3d 540, 541 (2d Dep't 2004).

Here, each of the defendants has moved to dismiss the petition. However, in light of the granting, in part, of petitioner's cross motion to amend the petition, the underlying motions to dismiss the complaint have been rendered moot.

IV. Conclusion

Accordingly, it is

ORDERED that the cross-motion (sequence 002) by petitioner One William Street Capital Management L.P. to amend the petition is granted in part and denied in part, and petitioner must file and serve an amended petition, in compliance with this decision, within 20 days of service of a copy of this order with notice of entry; and it is further

ORDERED that the motion for judgment on the petition (sequence 001) by respondent by petitioner One William Street Capital Management L.P. is denied; and it is further


ORDERED that the motion to dismiss the petition (sequence 002) by respondent U.S. Education Loan Trust IV, LLC is denied; and it is further

ORDERED that the motion to dismiss the petition (sequence 003) by respondent Kildare Capital, Inc. is denied; and it is further

ORDERED that the motion to dismiss the petition (sequence 004) by respondents The Bank of New York and Education Loan Trust IV is denied.

Dated: New York, New York
August 14, 2013

ENTER:


Hon. Eileen Bransten