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ANTIFRAUD

First Department Allows $45 Million Fraud Claim To Proceed Against Patriarch Partners

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In *Norddeutsche Landesbank Girozentrale v. Tilton*, No. 651695/15, 2017 BL 55790 (App Div, 1st Dep't Feb. 23, 2017), a divided panel of the New York Appellate Division, First Department, affirmed a Commercial Division order that denied a motion to dismiss a $45 million fraud claim against Lynn Tilton, Patriarch Partners LLC (''Patriarch''), and two Patriarch affiliates, stemming from their management of two collateralized debt obligation (''CDO'') funds. Justices Richard T. Andrias and David B. Saxe dissented in part, opining that the majority should have dismissed the fraud claim as time-barred because the plaintiffs-investors were on notice of the alleged fraud more than two years before they filed suit.

In January 2005 and April 2007, the plaintiffs, Norddeutsche Landesbank Girozentrale, a German bank, and Hannover Funding LLC, Norddeutsche's commercial paper conduit, purchased $135 million of notes issued by two ''Zohar'' branded CDO funds (the ''Funds''). Patriarch managed the Funds through two of its affiliates. Tilton, the founder and CEO of Patriarch, was the principal and controlling member of the two affiliates that managed the Funds. The Funds were ''blind,'' meaning that investors did not know the identities of the companies to which the underlying loans were made (the ''Portfolio Companies''). [*Norddeutsche Landesbank Girozentrale v. Tilton*, No. 651695/15, 2017 BL 55790, at *1 (App Div, 1st Dep't Feb. 23, 2017).]

In March 2015, the United States Securities and Exchange Commission (''SEC'') commenced an administrative cease-and-desist proceeding against defendants, alleging that they had defrauded the Funds and investors by providing false and misleading information regarding the value of the Funds' assets. [*Id.*]

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Plaintiffs' Suit. According to plaintiffs, news of the SEC proceeding alerted them to conduct an investigation of their own. They claim to have discovered that the defendants were not operating the Funds like typical CDOs, which acquire or originate corporate debt, but instead were operating the Funds to make private equity-type investments that included millions of dollars in management fees. [*Id.* at *1-2.]

Within two months of the SEC case, plaintiffs sued the defendants for fraudulent and negligent misrepresentation. The defendants moved to dismiss both claims. Justice Eileen Bransten of the New York County

Commercial Division denied the defendants' motion to dismiss the fraud claim under the statute of limitations, holding that the plaintiffs were not on notice of the alleged fraud until the SEC commenced its proceeding, less than two years before the plaintiffs filed suit. However, Justice Bransten dismissed the negligent misrepresentation claim because the plaintiffs had alleged an arm's length relationship and not a special relationship of trust. [*Id*. at *2-4.]

On Appeal. The Appellate Division affirmed Justice Bransten's ruling. As to the negligent misrepresentation claim, the court held that dismissal was appropriate because the plaintiffs had not alleged a special relationship of trust or confidence. [*Id*. at *8.]

The court noted that the timeliness of the fraud claim depended on whether the plaintiffs discovered, or could have discovered through reasonable diligence, the fraud more than two years before they filed suit. Mere suspicion is insufficient, the court noted, and if it does not "conclusively" appear that the plaintiffs had knowledge of facts from which the fraud could reasonably be inferred, the complaint should not be dismissed. However, "if a party omits an inquiry when it would have developed the truth, and shuts his eyes to the facts which call for investigation, knowledge of the fraud will be imputed to him." [*Id*. at *5.]

The court held that the Commercial Division properly declined to dismiss the fraud claim at the pleading stage of the litigation, because the evidence presented by the defendants did not conclusively establish that the plaintiffs could have discovered the alleged fraud more than two years before they filed suit. [*Id*.]

The court affirmed the trial court's ruling despite defendants' argument that the plaintiffs were on notice, years before the SEC proceeding, that the Funds were acquiring equity interests in the Portfolio Companies. The defendants first pointed to the indenture agreements governing the Funds, which noted that one of the Funds would purchase equity interests in twenty-four of the Portfolio Companies. The majority noted, however, that the existence of some equity in the Funds "was not something that should have surprised plaintiffs" because the indenture agreements permitted the Funds to hold equity "kickers" (*i.e.*, equity offered by a borrowing company to entice the lender) from the Portfolio Companies. [*Id*.]

The defendants also offered a 2007 marketing presentation in which Patriarch stated that one of the Funds was created "in order to purchase companies and originate loan assets to companies undergoing pervasive change," and projected that the Funds would acquire majority stakes in twenty-three Portfolio Companies, and a 100% stake in another seven. Nonetheless, the majority was not persuaded; it noted that the defendants had failed to identify anything in the presentation signaling that the defendants' "raison d'ètre" was to use the Funds as a vehicle to acquire companies wholesale for their own benefit, rather than to acquire equity incidentally through the Funds' debt holdings. [*Id*. at *5-6.]

Finally, the defendants cited an SEC filing and publicly available court documents that discussed the Funds' equity investment activities, as well as a 2011 investor call during which Tilton discussed the acquisition of equity in distressed Portfolio Companies and the impact of the growth of those companies on the value of the Funds. According to the defendants, the plaintiffs attended the investor call and declined an invitation to ask questions. [*Id*. at *6.]

The majority concluded that the SEC filing did not put the plaintiffs on notice of the alleged fraud because it merely noted that Patriarch affiliates could purchase equity positions in Portfolio Companies; it did not state that those affiliates would use Fund assets to do so. As to the court documents, the court reasoned that even if they were sufficient to put the plaintiffs on notice of the alleged fraud, the defendants had offered no authority placing the onus on the plaintiffs to monitor all court proceedings concerning their investments. Finally, the court found that Tilton's statements during the 2011 investor call were at odds with the plaintiffs' fraud theory. According to the plaintiffs' allegations, Tilton asserted during the call that Patriarch, not the Funds, would acquire equity interests in the Portfolio Companies. [*Id*.]

Construing the allegations in the plaintiffs' favor, and finding that the defendants' evidence could be interpreted in "a myriad of ways," the majority concluded that the defendants had not conclusively established that the plaintiffs could have discovered the alleged fraud more than two years before they filed suit. The court therefore allowed the fraud claim to proceed, and noted that the defendants' statute of limitations defense could be revisited on a motion for summary judgment or at trial when the factual record would be fully developed. [*Id*. at *7.]

Dissent. Writing for the dissent, Justice Andrias opined that the indenture agreements, marketing presentation, SEC filing, court documents, and investor call provided a "wealth of information" from which the plaintiffs could have inferred the alleged fraud well over two years before they filed suit. In light of this information, Justice Andrias noted, "a person of ordinary intelligence would have been aware that the Funds were not being operated as typical CDOs and that they were acquiring substantial equity interests in the portfolio companies." The dissent concluded that the plaintiffs failed to satisfy their duty to inquire into this information, and that the fraud claim should have been dismissed as untimely. [*Id*. at *10-13.]

The dissenters agreed that Justice Bransten had properly dismissed the plaintiffs' negligent misrepresentation claim. [*Id*. at *8.]

Take-Away. The key take-away from the First Department's ruling here is that whether and when a plaintiff could have discovered a defendant's alleged fraud is a highly fact-intensive inquiry and—at the motion to dismiss stage—depends in the first instance on the allegations set forth in the complaint. Because the evidence proffered by defendants did "not facially clash with plaintiffs' position," the court did not believe a duty to investigate arose under this fact pattern and declined to dismiss the claim on statute of limitations grounds. [*See Id*. at *7-8.]

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