10-4497-cv

To be Argued by:
ERIC B. FISHER

United States Court of Appeals

for the

Second Circuit

PENSION BENEFIT GUARANTY CORPORATION, on behalf of Saint Vincent Catholic Medical Centers Retirement Plan, SAINT VINCENT CATHOLIC MEDICAL CENTERS, QUEENSBROOK INSURANCE LIMITED,

Plaintiffs-Appellants,

– v. –

MORGAN STANLEY INVESTMENT MANAGEMENT INC.,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

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PRELIMINARY STATEMENT

Plaintiffs-appellants Pension Benefit Guaranty Corporation on behalf of the Saint Vincent Catholic Medical Centers Retirement Plan and Queensbrook Insurance Limited (collectively, "Plaintiffs") respectfully submit this reply brief in further support of their appeal from the district court's Order.[1]

As set forth in Plaintiffs' opening brief, the Complaint alleges sufficient facts to state a plausible claim that MSIM breached its fiduciary duties under ERISA with respect to defendant Morgan Stanley Investment Management, Inc.'s ("MSIM") mismanagement of the Plan's fixed-income portfolio. The Complaint details MSIM's mismanagement of the portfolio by (i) quantifying the extent to which the fixed-income portfolio managed by MSIM was overconcentrated in mortgage-backed securities in general, and non-agency mortgage-backed securities in particular, and (ii) identifying important facts that were available to MSIM, which should have caused MSIM to realize that the fixed-income portfolio contained an unacceptable level of risk and act prudently to diversify the portfolio. Because the facts alleged in support of Plaintiffs' ERISA claim easily meet the threshold imposed by Rule 8 of the Federal Rules of Civil Procedure, as interpreted

[1] Terms not otherwise defined herein shall have the meanings set forth in Plaintiffs' opening brief.

in the Supreme Court's *Twombly* and *Iqbal* decisions, the district court should not have dismissed the Complaint and the Order should be reversed.

In its brief, MSIM seeks to impose a pleading standard upon Plaintiffs far in excess of the "plausibility standard" required by *Twombly* and *Iqbal*. The "plausibility standard" does not demand comprehensive pleadings in which all conceivable facts are pleaded; nor does it require Plaintiffs to meet a standard that would be impossible without the benefit of discovery at the commencement of the case. Rather, a claim has "facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009) (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 556 (2007)). Here, the Complaint satisfies that standard.

Departing from that standard, MSIM criticizes the Complaint for failing to allege facts with a level of specificity beyond anything required by Rule 8. In doing so, MSIM attempts to set insurmountable hurdles for Plaintiffs, arguing, for example, that the Complaint fails to plead facts about MSIM's internal decision-making processes that could not possibly be known to Plaintiffs without discovery.

As it did in the district court, MSIM tries to repackage and politicize this case, claiming that Plaintiffs have failed to state a claim against MSIM because "virtually all regulators and market participants [failed] to predict the collapse of

the mortgage market and its subsequent effect on the overall economy." (MSIM Br. at 2.) This case, however, should not turn on MSIM's self-serving and generalized claims about the mortgage crisis, but rather upon the particular facts alleged in the Complaint. Focusing on the facts alleged in the Complaint, it is plausible that MSIM breached its fiduciary duty under ERISA as the Plan's fixed-income investment manager. Accordingly, the district court's dismissal of the Complaint was in error and should be reversed.

In addition, MSIM's brief fails to meaningfully address the district court's fundamental misreading of the Complaint. As explained in Plaintiffs' opening brief, the Order incorrectly states that MSIM invested between 9% and 12% of the Plan's fixed-income portfolio in mortgage-backed securities, while the record shows a 50% allocation to such securities. Further, the district court failed to address the fact that MSIM invested 9% to 12.6% of the Plan's fixed-income assets in non-agency mortgage-backed securities, even though the Benchmark did not have any investment in this riskier subclass of mortgage-backed securities. Rather than grapple with the district court's factual errors, MSIM simply denies that there were such errors. However, these errors are clear on the face of the Order and warrant reversal.

Finally, as it did before the district court, MSIM invites this Court to engage in fact-finding with respect to materiality and causation that is not

permitted when ruling upon a motion to dismiss. For example, MSIM argues that a 10% variance from the Benchmark's allocation was not "material" to the Plan's diversification. MSIM also argues that investing between 9% and 12.6% of the Plan's fixed-income portfolio in non-agency mortgage-backed securities, even though the Benchmark had none, was appropriate diversification. Just as it was inappropriate for the district court to engage in fact-finding, it would be inappropriate for this Court to do so.

ARGUMENT

I. THE COMPLAINT'S FACTUAL ALLEGATIONS SATISFY THE PLEADING STANDARD

There is no disagreement among the parties as to the correct pleading standard to be applied: Plaintiffs must state factual allegations that support a "plausible" claim for relief. (MSIM Br. at 7, citing *Twombly* and *Iqbal*). In other words, the allegations must be "enough to raise a right to relief above the speculative level." *Twombly*, 550 U.S. at 555. The issue, therefore, is the plausibility standard's application to this Complaint. Here, the facts in the Complaint state a plausible – indeed, compelling – inference that MSIM did not act "with the care, skill, prudence, and diligence" of the "prudent man" envisioned by ERISA. *See* 29 U.S.C. § 1104(a)(1)(B). The facts also state a plausible inference that MSIM breached its duty under ERISA to diversify the fixed-income portfolio. *Id*. § 1104(a)(1)(C).

A. The Facts Alleged State A Plausible Claim For Breach Of Fiduciary Duty

The elements of a breach of fiduciary duty claim under ERISA are: (1) that MSIM was a fiduciary of the plan, (2) that MSIM breached its fiduciary duties, and (3) that MSIM's breach caused harm to the Plan. *See, e.g., Jenkins v. Yager*, 444 F.3d 916, 924 (7th Cir. 2006).

MSIM does not dispute that it was an ERISA fiduciary of the Plan. With respect to the third element (causation), MSIM does not dispute, at this stage of the case, that the portfolio's overconcentration (relative to the Benchmark) in mortgage-backed securities, including non-agency mortgage-backed securities, accounts for approximately $25 million in losses to the Plan (relative to the Benchmark's performance during the comparable period).[2] Thus, the only *prima facie* element in dispute on this appeal is whether, in 2007 and 2008, MSIM breached its fiduciary duties by, among other things, investing and maintaining

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[2] *See generally Harris Trust and Say. Bank v. John Hancock Mut. Life Ins. Co.*, 302 F.3d 18, 34 (2d Cir. 2002) ("[T]he proper measure of damages is to be calculated by determining what the Plan would have earned had [defendant] exercised its discretionary authority with respect to its investment and allocation decisions in accordance with its fiduciary duties under ERISA."); *Trs. of the Local 464A United Food and Commercial Workers Union Pension Fund v. Wachovia Bank, N.A.*, No. 09-668 (WJM), 2009 WL 2152074, at *4 (D.N.J. July 14, 2009)(denying motion to dismiss where complaint alleged that over-concentration in mortgage-backed securities, including non-agency mortgage-backed securities, caused losses to pension plan).

approximately 50% of the portfolio in mortgage-backed securities, including approximately 10% in non-agency mortgage-backed securities.

As explained in the opening brief and below, the facts alleged in the Complaint plausibly support the conclusion that MSIM breached its fiduciary duties to the Plan. This assertion is not based in hindsight bias, but rather upon what was known to MSIM at the time of its investment decisions.

1. The Complaint Specifies the Extent of the Overconcentration in Mortgage-Backed Securities, Including Non-Agency Mortgage-Backed Securities

The Complaint contains detailed facts that show MSIM invested an excessive percentage of the fixed-income portfolio in mortgage-backed securities. Thereby, MSIM breached its duty to act prudently and diversify the portfolio. In particular, MSIM invested 60% of the fixed-income portfolio in a "single, proprietary fund of MSIM." (A-28.) This fund was itself overconcentrated in the mortgage-backed securities sector. Indeed, during the relevant period, MSIM invested approximately 50% of the fixed-income portfolio in mortgage-backed securities. (A-152.) Plaintiffs claim that this allocation was 10% greater than the allocation of mortgage-backed securities in the Benchmark, which was supposed to serve as MSIM's guidepost in managing the account. (A-28.)

Finally, during the relevant period, MSIM invested between 9% and 12.6% of the fixed-income portfolio in the even riskier subclass of mortgage-

backed securities, known as non-agency mortgage-backed securities. (A-28.) The Benchmark, in contrast, contained no allocation to this subclass of mortgage-backed securities. (*Id.*) Contrary to MSIM's argument, these are not "legal conclusions" or "formulaic recitations"; rather, these are specific facts that illustrate the portfolio's excessive concentration in an unduly risky class of securities.

2. The Complaint Pleads Specific "Warning Signs" That Should Have Caused MSIM To Reallocate And Diversify

In its "Statement of Facts" (MSIM Br. at 3-5), MSIM offers a superficial and selective summary of the Complaint, stating that the Complaint alleges that MSIM continued to maintain a high concentration of mortgage-backed securities in the account, "even after 'warning signs,' such as losses suffered by certain issuers of subprime securities began to emerge." (MSIM Brief at 4.) MSIM faults the Complaint for alleging "warning signs" that are too generic.

As with the Complaint's allegations about excessive concentration in mortgage-backed securities, the allegations about these warning signs are factual and specific. For example, the Complaint alleges that MSIM knew or should have known that its overexposure to mortgage-backed securities, including non-agency mortgage-backed securities, was imprudent because:

- Throughout 2007 and 2008, there were warning signs that these securities were not appropriate for the fixed-

income portfolio, including increasing defaults on the loans upon which these securities were based;

- MSIM invested the Plan's assets in subprime mortgage securities issued by IndyMac, Bear Stearns, Washington Mutual and Countrywide, among others, as to which there was public information about significant financial distress;

- In 2007, analysts recognized the exposure of Morgan Stanley to mortgages in similar securities, and predicted Morgan Stanley would write down $6 billion on the value of these securities;

- In IndyMac's 2007 Annual Report, its Chairman and CEO announced that, "[t]he 4th quarter of 2007 marked the eighth quarter of the current housing downturn (as measured by housing's contribution to GDP), making it already the fourth worst housing downturn in modern times, and many now predict that, before it turns around, it is going to be the longest and deepest since the Great Depression. . . . As a result of the housing bubble bursting, delinquencies and non-performing home loans increased rapidly in 2007";

- In the third quarter of 2007, IndyMac lost $202.7 million;

- On or about July 2007, Bear Stearns announced that investments backed by risky mortgages had left two of its hedge funds virtually worthless;

- In the second quarter of 2007, Countrywide's reported earnings fell 33 percent, to $485 million, largely because it had to write down the value of loans and other assets by $923 million. Moreover, Countrywide issued a statement saying "defaults and mortgages were rising across all mortgage categories"; and

- In December 2007, Standard & Poor's reduced its ratings on about $7 billion of Alt-A mortgage securities, loans considered a step above subprime, as a result of a

> sustained surge in delinquencies during the prior five months.

(A-30–A-31.)

Thus, the "warning signs" alleged in the Complaint are based upon specific facts. The facts pleaded are sufficient to give rise to a plausible inference that MSIM knew, or should have known, that it was not then prudent to invest 50% of the fixed-income portfolio in mortgage-backed securities, including approximately a 10% allocation to non-agency mortgage-backed securities.

MSIM attempts to minimize the allegations about these "warning signs," by arguing that the Complaint does not allege any "warning signs" with respect to the particular mortgage-backed securities in the pension account. With respect to IndyMac, Bear Stearns and Countrywide, however, the Complaint does tie specific warning signs to particular issuers of securities held in the portfolio (even if not necessarily to the precise securities in the account).

In any event, there is no requirement to plead "warning signs" for each particular security purchased by MSIM. Again, this is part of MSIM's effort to

describe the pleading standard in a manner that is impossible to meet.[3] Moreover, the Complaint is replete with specific, factual allegations about "warning signs" that should have caused MSIM to reduce the portfolio's exposure to mortgage-backed securities in general, and non-agency mortgage-backed securities in particular.

The allegation about Morgan Stanley's billions of dollars of write-downs related to mortgage-backed securities further demonstrates that MSIM knew that the fixed-income portfolio was not appropriate for the Plan's investment objective of preserving principal and managing the portfolio to meet the Plan's defined-benefit pension obligations. Certainly, whether MSIM knew of its parent's write-downs, a question raised by MSIM on this appeal (MSIM Br. at 21), is not an issue that may be appropriately resolved on a motion to dismiss because it requires a finding of fact. In any event, common sense supports the inference that MSIM

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[3] In *Ambac Assurance UK Ltd. v. J.P. Morgan Inv. Management, Inc.*, ___ N.Y.S.2d. ___, 2011 WL 2714176 (N.Y.A.D. 1st Dep't July 14, 2011), the court did not require allegations of warning signs that were specific to each security held in the portfolio. Rather, the court held that it was sufficient to allege warning signs that "embraced the entire mortgage market, including mortgage lending and mortgage products." *Id.* at 3. Here, the Complaint contains numerous allegations about contemporaneous red flags relating to the mortgage securities market in general, the non-agency mortgage-backed securities market in particular, and even the issuers of particular securities held by MSIM in the fixed-income portfolio. These facts are more than sufficient to satisfy the pleading standard.

knew of Morgan Stanley's massive write-down. *See Iqbal*, 129 S. Ct. 1937, 1950 (2009) (complaint must state a plausible claim for relief that "permit[s] the court to infer more than the mere possibility of misconduct" based upon "its judicial experience and common sense.").[4] Furthermore, ignorance of such a material and readily-available fact would violate MSIM's ongoing duty to monitor the Plan's investments. *See In re Schering-Plough Corp. ERISA Litig.*, No. 03-1204 (KSH), 2008 WL 4510255, at *12 (D.N.J. Jan. 31, 2008) (fiduciary should withdraw investment if "it becomes clear or should have become clear that the investment was no longer proper for the Plan").

MSIM attempts to deflect the Complaint's factual allegations about Standard & Poor's downgrade of $7 billion worth of mortgage securities in

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[4] MSIM's brief ignores *In re Morgan Stanley ERISA Litig.*, 696 F. Supp. 2d 345 (S.D.N.Y. 2009), in which the district court denied Morgan Stanley's motion to dismiss an ERISA claim. The plaintiffs in that case alleged that Morgan Stanley had breached its fiduciary duty to participants in its own pension plan by failing to disclose adequate information "at a time when Morgan Stanley was extremely vulnerable due to its undisclosed risky investments [in the subprime market, collateralized debt obligation, and secured investment vehicle markets]." *Id.* at 358 (brackets in original). According to the complaint in the *Morgan Stanley* case, "[d]espite repeated warnings throughout 2006 and 2007 that the subprime market was deteriorating, [] Morgan Stanley continued investment in mortgage backed securities and continued to make reassurances that it had sufficient internal controls to manage its risk." *Id.* at 352. In *Morgan Stanley*, unlike this case, the district court applied the correct standard, holding that plaintiffs had pled enough facts to raise their "right to relief above the speculative level. *Id.* (quoting *Twombly*).

December 2007, arguing that the Complaint does not "plead any facts linking [the $7 billion downgrade] to the expected or actual performance of the specific securities in the pension account." (MSIM Br. at 22.) MSIM does not cite any cases requiring that level of specificity from plaintiffs. Nor can MSIM cite any law that requires a single fact pleaded in a complaint to be read in isolation from other facts – rather, it is the cumulative effect of the many warning signs detailed in the Complaint that makes it sufficient. Moreover, based on the information available to MSIM at the time, it is logical to infer that the asset class in which MSIM had elected to concentrate the portfolio was in the throes of an unfolding crisis. This information should have prompted MSIM to reallocate the portfolio to a strategy that was consistent with the investment objective of preserving principal. Instead, as alleged in the Complaint, MSIM failed to heed any of the multiple warning signs.

MSIM faults Plaintiffs for failing to allege the precise percentage of the subprime loans contained within the 9%-12.6% of the portfolio allocated to non-agency mortgage-backed securities. The Complaint describes the skyrocketing defaults in the subprime market. Again, there may very well be other facts that could have been pleaded in further support of the ERISA claim; however, maximal pleading is not required.

According to MSIM, a fundamental flaw of the Complaint is its supposed failure to challenge the adequacy of the process by which MSIM selected the investments for the portfolio. (MSIM Brief at 4.) This argument fails for a number of reasons.

First, MSIM's focus on MSIM's investment-selection process is excessively narrow. Courts do not require Plaintiffs to plead defects in that process in order to withstand a motion to dismiss. Rather, a fiduciary breach may be inferred when the investment decisions appear to disregard risks that were known, or should have been known, to the investment advisor at the time of the investment decision. *See, e.g., Local 464A*, 2009 WL 2152074, at *3-*4.

Second, even if Plaintiffs were required to plead facts to show a flawed investment process, a flawed investment process can easily be inferred from MSIM's ultimate acts. At the end of its "process," MSIM decided to invest 60% of the Plan's assets in a single MSIM fund, depart markedly from the Benchmark's concentration in mortgage-backed securities, invest in a risky subclass of mortgage-backed securities not found in the Benchmark, and not alter the overall exposure to these securities, even as problems in this sector became well-known. These facts give rise to a plausible inference that there were flaws in the methods used by MSIM to "investigate, evaluate and structure the investment." *Laborers*

Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc., 173 F. 3d 313, 317 (5th Cir. 1999).

Finally, MSIM's focus on its own internal process is part of its campaign to impose insurmountable obstacles on Plaintiffs. Details of MSIM's internal decision-making process are unknown to Plaintiffs prior to discovery – and, indeed, typically unknown to any plaintiff in any ERISA case at the commencement of a case. Accordingly, the pleading standard urged by MSIM and adopted by the district court is at odds with what Rule 8 requires.

3. The Complaint Pleads Specific Facts Showing That MSIM Breached The Duty To Diversify

In addition to breaching the duty of prudence, MSIM breached its express duty to diversify assets "to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." *See* 29 U.S.C. § 1104(a)(1)(C). MSIM acknowledges the applicability of the duty to diversify (MSIM Br. at 8), but claims to have satisfied this duty. MSIM's claim is unconvincing, particularly in view of MSIM's 60% allocation to a single, proprietary fund, MSIM's 50% allocation to mortgage-backed securities in general, and MSIM's 10% allocation to non-agency mortgage-backed securities in particular. The district court did not cite any case law in support of its erroneous conclusion that the Complaint failed to state a claim for breach of MSIM's fiduciary duty to diversify the Plan's investment portfolio. This is another instance of the district court engaging in

improper fact-finding. The facts pleaded provide a plausible inference of insufficient diversification of the investments. *Local 464A*, 2009 WL 2152074, at *5 (investment advisor breached duty to diversify by investing 31% of portfolio in mortgage-backed securities).

B. MSIM's Attempts To Evade Certain Facts Alleged In The Complaint Do Not Negate Those Facts

Attempting to evade, rather than address, key facts alleged in the Complaint, MSIM argues that Plaintiffs have abandoned their claim that MSIM breached its duties by putting most of the fixed-income portfolio in a single, proprietary Morgan Stanley fund. This argument has no merit.

Plaintiffs consistently have argued that the facts alleged in the Complaint are sufficient to satisfy the pleading standard. Plaintiffs have never asked this Court to disregard any allegation in the Complaint. Among the many factual allegations to be assessed by this Court is the allegation that MSIM acted improperly by allocating 60% of the portfolio to a single, proprietary fund containing investments that were not well-suited to the pension account's "primary investment objective": the "preservation of principal with emphasis on long-term growth to meet the future retirement liability of the Plan." (A27).

The allegation about a 60% allocation to a single, proprietary fund is contained in the Complaint, MSIM does not dispute its accuracy, and Plaintiffs have never retreated from the allegation. It is one fact, among the many in the

Complaint, from which this Court can plausibly infer that MSIM breached its fiduciary duties to Plaintiffs.[5]

In a similar effort to avoid the factual allegations of the Complaint, MSIM argues that this Court should ignore the fact that approximately 50% of the fixed-income portfolio had been invested by MSIM in the single asset class of mortgage-backed securities. While this fact is set forth in a document that MSIM submitted to the district court and which is part of the record on appeal, MSIM argues that this fact should not be considered by this Court because it is not alleged in the Complaint.

MSIM's argument does not withstand scrutiny. The portfolio's approximately 50% allocation to mortgage-backed securities is a simple mathematical inference from facts in the Complaint. In particular, the Complaint alleges that the mortgage-backed securities concentration in the MSIM-managed portfolio was approximately 10% greater than the concentration in the Benchmark. MSIM acknowledges that the Benchmark's concentration was approximately

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[5] The case cited by MSIM in support of its argument that this allegation has been abandoned is not on point. *JPMorgan Chase Bank v. Altos Hornos de Mex., S.A. de C.V.*, 412 F.3d 418, 428 (2d Cir. 2005), concerns waiver of arguments not pursued on appeal. Here, this Court is asked to evaluate the adequacy of a Complaint based on facts that were expressly pleaded and that have never been abandoned by Plaintiffs. MSIM should not be permitted to excise from the Complaint allegations that it finds troubling.

38.9%. (MSIM Br. at 37.) Thus, the Complaint's express allegation that MSIM maintained a 10% higher concentration in mortgage-backed securities in the portfolio than the Benchmark is equivalent to the allegation that the overall concentration was approximately 50%.

Moreover, as explained in Plaintiffs' opening brief and in the next section of this brief, the district court fundamentally misunderstood the Complaint's allegations about the portfolio's concentration in mortgage-backed securities. The district court based its ruling on the mistaken understanding that only 9% to 12% of the portfolio was invested in mortgage-backed securities.

Finally, MSIM's argument is self-contradictory. MSIM advances arguments based upon the very account statement that it submitted to the district court, but also argues that the account statement should be disregarded by this Court. Specifically, MSIM contends that the account statement shows that, as of December 31, 2008, the fixed-income portfolio had only a 2% concentration in non-agency mortgage-backed securities. This point, of course, raises more questions than it answers: Is the smaller concentration in non-agency mortgage-backed securities a consequence of an investment decision by MSIM or is it simply a function of those securities approaching a value of zero as the mortgage-backed securities market collapsed? If it was an investment decision, at what point during the final quarter of 2008 did MSIM decide to reduce its exposure to non-agency

mortgage-backed securities? Other questions are raised as well, all of which are questions of fact that cannot be addressed on a motion to dismiss. Thus, as it did before the district court, MSIM seeks to involve this Court in fact-finding that is not allowed when ruling upon a motion to dismiss.[6]

C. MSIM Cannot Hide Behind The Mistaken Argument That The Investments Were Not Prohibited By The Investment Guidelines

MSIM contends that the ERISA claim against it is not plausible because the investment guidelines did not prohibit the investments in mortgage-backed securities. This case, however, is not a breach of contract case. Rather, it is an ERISA case, in which MSIM's behavior must be measured against the higher standards imposed upon ERISA fiduciaries – not merely the standards imposed by contract. *See generally Donovan v. Bierwith*, 680 F.2d 263, 272 n.8 (2d Cir. 1982) (ERISA imposes highest fiduciary standards known to law); *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1219 (2d Cir. 1987) (investment manager liable

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[6] MSIM also argues that this Court should be strict with Plaintiffs and not allow them to "rehabilitate" their Complaint because the district court supposedly afforded them an opportunity to do so. In fact, it is not precisely correct to say that the district court allowed Plaintiffs an opportunity to amend their Complaint. Unlike *Montanez v. Cuoco*, 361 F. App'x 291, 292 (2d Cir. 2010), a case relied on by MSIM, the district court here did not allow Plaintiffs to file an amended complaint. Rather plaintiffs would have had to file, and prevail upon, a motion for leave to file an amended complaint before the same judge who had already adopted MSIM's perspective on the case. Regardless, this is not an improper attempt to

under ERISA for wrongful investments). Thus, MSIM's repeated contention that its conduct was not inconsistent with the technical specifications of the investment guidelines is irrelevant. MSIM's fiduciary duties go well beyond the confines of the contract.

In any event, as demonstrated in the Appellate Division, First Department's recent decision in *Ambac*, the facts alleged in the Complaint would have been adequate to state a breach of contract claim against MSIM for failure to adhere to the objectives set forth in the investment guidelines. Given the higher fiduciary standard demanded by ERISA, there is no question that the Complaint states a claim for breach of fiduciary duty against MSIM.

In *Ambac*, the plaintiff conceded that the investment manager adhered to "contractual limitations on purchasing subprime securities." *Id.* at *1. The plaintiff nonetheless sued for breach of contract based on the investment manager's decision to continue to hold subprime securities, even after its parent company reduced its exposure to the "same type of securities" and the parent company's CEO said that those types of securities "could go up in smoke." *Id.* In reversing the lower court's dismissal of the complaint and reinstating the complaint, the First

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rehabilitate the Complaint. As explained above, the 50% allocation statistic is implicit in the facts that are explicitly pleaded in the Complaint.

Department held that the plaintiff's allegations were "sufficient to sustain a breach of contract claim." *Id. at *3*.

According to *Ambac*, compliance with sector and ratings limitations in an investment management agreement does not "foreclose[] a breach of contract action." *Id.* at *4. An investment manager may invest in permitted securities and stay within specified limits and nonetheless be "egregiously at odds with the stated contractual requirement that defendant pursue the investment objective of reasonable income and high level of safety of capital." *Id.* at *6.

Here, as in *Ambac,* MSIM's acts were egregiously at odds with the objectives set forth in the investment guidelines. Given that ERISA imposes a higher standard than the contractual limitations imposed upon the investment manager in *Ambac*, the Complaint states a viable claim and should not have been dismissed.

Also, *Ambac* expressly rejected the argument that there was no breach "so long as the defendant did not exceed the maximums stated in the sector and ratings provisions [of the investment management agreement]" *Id.* That argument is fundamentally flawed because such an approach would allow an investment manager to "insulate itself from liability by closing its eyes to known risks," and would render the investment guidelines' stated goal of preservation of principal

"impermissibly meaningless." *Id.*[7] Here too, the facts alleged give rise to a plausible inference that MSIM violated the fundamental objective of the investment guidelines, even if it complied with the technical limitations of the guidelines.

D. MSIM's Substantial Departures From The Benchmark's Allocations Breached Its Fiduciary Duty

MSIM attempts to dismiss as "lawyer's rhetoric" Plaintiffs' claim that the investment guidelines required MSIM to employ a conservative, low-risk investment strategy. (MSIM Br. at 10.) This claim is also without merit. The investment guidelines require as the "primary investment objective" for the Plan,

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[7] The *Ambac* decision is fully consistent with the principles set forth in *NM Homes One, Inc. v. JP Morgan Chase Bank, N.A.*, No. 08 Civ. 0769 (PAC) (S.D.N.Y. March 30, 2010), *modified upon reconsideration* (S.D.N.Y. Dec. 15, 2010) *denying motion to dismiss* (S.D.N.Y. Mar. 10, 2011), a case discussed at length in Plaintiffs' opening brief. In that case, the district court recognized that even technical compliance with the letter of investment guidelines may nonetheless give rise to a claim for breach of duty, when, as in this case, the technical compliance violates the underlying objective of the investment guidelines. (Plaintiffs' Opening Br. at 31-32.) The *NM Homes* court referred to such a circumstance as "pernicious compliance." MSIM's attempt to distinguish *NM Homes* is unsuccessful. MSIM resorts to fact-intensive distinctions, comparing the types of mortgage securities at issue in *NM Homes*, as opposed to those at issue here. MSIM also attempts to make distinctions based on the percentage allocations at issue. But there are no *per se* rules in this area, and "the degree of investment concentration that would violate the diversification requirements cannot be stated in terms of a percentage." H.R. REP. No. 93-1280 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5084. The only question is whether the factual allegations, including those dealing with the percentage allocations, the particular securities and other pertinent facts, give rise to a plausible claim. In this case, as in *NM Homes*, they do.

the "preservation of principal" in order to "meet the future retirement liability of the Plan." (A-27.)

MSIM is correct that it was not "required" to replicate the investments of the [Benchmark]." (MSIM Br. at 13.) However, MSIM was not free to diverge from the Benchmark to devise a portfolio with risk characteristics fundamentally inconsistent with the mandate to pursue the preservation of principal.

MSIM mischaracterizes Plaintiffs' case. Plaintiffs do not seek to hold MSIM liable "for failing to invest in the same types and amounts of securities that made up the benchmark index." (MSIM Br. at 13). Indeed, as investment advisor to the Plan, MSIM was charged with discretionary authority to make decisions consistent with the Plan's investment objectives and MSIM's fiduciary duties under ERISA. MSIM's decision (i) to invest 60% of the portfolio in a single proprietary fund, (ii) to allocate 50% of the portfolio to mortgage-backed securities, well in excess of the Benchmark's allocation to this asset class, and (iii) to invest 10% of the portfolio in non-agency securities, are all facts that support the claim for breach of fiduciary duty.

MSIM's investment decisions are egregious when viewed against the backdrop of what MSIM knew or should have known about mortgage-backed securities when these investment decisions were made. Thus, the Complaint does not rely upon departures from the index in a mechanistic fashion. Rather,

considered in the proper context, the extent and nature of MSIM's departures from the index are facts that support Plaintiff's claim for breach of fiduciary duty under ERISA.

E. **The Cases Relied On By MSIM Are Distinguishable**

The cases cited by MSIM are easily distinguished. First, many of the cases relied on by MSIM are securities cases that do not involve ERISA or even common law claims for breach of a fiduciary duty. Unlike the securities law cases cited by MSIM, this case is not about misrepresentations of fact by MSIM and does not involve other issues peculiar to the federal securities statutes. *See, e.g., Freidus v. ING Groep N.V.*, 736 F. Supp. 2d 816, 831 (S.D.N.Y. 2010) (dismissing federal securities claims, as untimely under Securities Act of 1933 and because allegations did not satisfy statutory prerequisites); *Charter Twp. of Clinton Police & Fire Ret. Sys. v. KKR Holdings LLC*, No. 08 Civ. 7062 (PAC) 2010 WL 4642554, at *16 (S.D.N.Y. Nov. 17, 2010) (dismissal of claim because complaint failed to plead actionable misrepresentations under Section 11 of the Securities Act); *In re Radian Sec. Litig.*, No. 07-3375, 2010 WL 1767195, at *8 (E.D.Pa. Apr. 30, 2010) (dismissing class action complaint because plaintiffs failed to satisfy the scienter requirement under section 10(b) of the Securities and Exchange Act of 1934); *Yu v. State St. Corp.*, 686 F. Supp. 2d 369, 373, 376 (S.D.N.Y.), *reconsideration granted on other grounds*, Nos. 08 MDL 1945, 08 Civ. 8235

(RJH), 2010 WL 2816259 (S.D.N.Y. July 14, 2010) (complaint dismissed for failure to allege actionable misrepresentation under Securities Act of 1933); *Plumbers & Steamfitters Local 773 Pension Fund v. Canadian Imperial Bank of Commerce*, 694 F. Supp. 2d 287, 300 (S.D.N.Y. 2010) (dismissal for failure to plead scienter under Securities Exchange Act of 1934).

Second, MSIM also relies upon *In re Citigroup Inc. S'holder Derivative Litig.*, No. 07 Civ. 9841 (SHS), 2009 WL 2610746, at *6 (S.D.N.Y. Aug. 25, 2009). Its reliance on that case is misplaced because the case involved a shareholder derivative lawsuit that was dismissed due to the plaintiffs' failure to comply with a "demand" requirement – a prerequisite unique to derivative lawsuits and inapplicable here.

Third, the ERISA cases cited by MSIM are easily distinguished on their facts. For example, in *Bd. of Trs. of So. Cal. IBEW-NECA Defined Contribution Plan v. Bank of New York Mellon,* 2010 WL 1558587 (S.D.N.Y. Sept. 7, 2010), the district court dismissed the complaint because the plaintiff failed to allege facts to show that defendant knew about Lehman Brothers' precarious financial condition. Unlike this case, the plaintiff in *Bank of New York Mellon* was suing based upon an allegation that defendants should have foreseen the collapse of Lehman Brothers and supported its claim with reference to news articles, some of which actually predicted that Lehman "will weather the credit storm." *Id.* at * 6. Here, in

contrast, the Complaint pleads numerous facts demonstrating that MSIM was aware, or should have been aware, of the crisis in the mortgage-backed securities sector, including write-downs by MSIM's parent company and negative announcements by issuers of mortgage-backed securities selected by MSIM, such as IndyMac, Countrywide and Bear Stearns.

Another ERISA case relied on by MSIM, *In re Huntington Bancshares Inc. ERISA Litig.*, 620 F. Supp. 2d 842 (S.D. Ohio 2009), is also not on point. In *Huntington*, the complaint asserted a claim for breach of fiduciary duty under ERISA on the grounds that the pension plan continued to invest in Huntington Financial's own stock, even after Huntington Financial acquired a company in the subprime lending business. Plaintiffs argued that Huntington Financial's stock became too risky as a result of that corporate acquisition. In dismissing the complaint, the district court in the Southern District of Ohio ruled that the complaint challenged a business decision to acquire the new business – not an ERISA plan decision that would be actionable under that statute. *Id.* at 850. Here, in contrast, the conduct at issue relates to a decision by MSIM as fixed-income investment advisor to the Plan. Indeed, MSIM does not argue to the contrary.

Finally, *In re Citigroup ERISA Litigation*, No. 07 Civ. 9790, 2009 WL 2762708 (S.D.N.Y. Aug. 31, 2009), is distinguishable. *In re Citigroup* concerned claims that administrators of Citigroup's Employee Stock Ownership Plan (ESOP)

breached their fiduciary duties under ERISA by offering Citigroup's own stock as an investment option to plan participants. In dismissing the complaint, the district court ruled that the plan had no investment discretion with respect to offering an option to invest in Citigroup's own stock and that the complaint failed to overcome the presumption of prudence applicable to the ESOP plan administrators in that case. In this case, in contrast, (i) MSIM concedes that it was vested with investment discretion over the Plan's fixed-income assets; (ii) the Plan was not an ESOP plan; and (iii) MSIM does not benefit from any "presumption of prudence."[8]

II. THE DISTRICT COURT MISCONSTRUED THE COMPLAINT'S ALLEGATIONS AND THUS MISAPPLIED THE LAW

Notwithstanding MSIM's argument to the contrary, the district court misconstrued the Complaint. Stated simply, the Complaint states that between 9% and 12.6% of the fixed-income portfolio was invested in non-agency mortgage-backed securities. The district court mistook those allegations to refer to the

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[8] The other cases cited by MSIM also miss the mark: *See CMMF, LLC v. J.P. Morgan Inv. Mgmt., Inc.*, No. 601924/09, at 6-7 (Sup. Ct. N.Y. County Dec. 10, 2009) *aff'd*, 915 N.Y.S. 2d 2 (1st Dep't 2010) (breach of contract claim dismissed only in part and rejecting arguments for dismissal that were "fact based"); *Vladimir v. Cowperthwait*, 839 N.Y.S. 2d 761, 762-63 (1st Dep't 2007) (dismissing claim for breach of fiduciary duty by sophisticated investor who was "looking for growth" and wanted to "beat the market"); *Henry v. Champlain Enterprises, Inc.*, 445 F.3d 610 (2d Cir. 2006) (appeal from a judgment on an ERISA claim following a complete trial on the merits, in a case involving claim that plan administrators did not properly value investment in convertible preferred stock);

portfolio's total concentration in mortgage-backed securities. In fact, the actual, overall concentration of mortgage-backed securities in the Plan's fixed-income portfolio was approximately five times greater than the 9% to 12% range incorrectly cited by the district court. (A-152.) The district court also relied on this same mischaracterization in erroneously distinguishing *Trustees of the Local 464A*, explaining that *Local 464A* involves "triple the percentage invested in mortgage securities here." (A221). In fact, the percentage concentrations in this case are approximately 150% of the concentration in *Local 464A*.[9]

This mistake is also the basis for the district court's erroneous conclusion that the Plan was adequately diversified. If the district court had understood that approximately 50% of the Plan's fixed-income portfolio was invested in mortgage-backed securities, it would not have reached the same conclusion.

Finally, the district court overlooked the fact that MSIM invested 9% to 12.6% of the Plan's fixed-income portfolio in non-agency mortgage-backed

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McCabe v. Capital Mercury Apparel, 752 F. Supp. 2d 396 (S.D.N.Y. 2010) (dismissing claim alleging that ERISA fiduciary relied upon stale valuation).

[9] In ruling that plaintiffs had adequately alleged that defendants had breached their duty to diversify in violation of ERISA, the *Local 464A* court noted: "[c]onsidering the stated aims of the Funds and the economic climate at the time, investing approximately one-third of Plaintiffs' assets in [collateralized mortgage obligations] does not appear to 'minimize the risk of large losses.'" *Id.* at *5; *see* 29 U.S.C. § 1104(a)(1)(C). The court's reasoning is all the more compelling in this case.

securities, even though the relevant Benchmark contained no investment in this riskier subclass of mortgage-backed securities. The district court appears to have assumed incorrectly that the non-agency mortgage-backed securities were a subset of the 9% to 12.6% figure. Had the district court appreciated the extent of the portfolio's exposure to mortgage-backed securities generally (50%) and non-agency mortgage-backed securities particularly (9%-12.6%), it would have seen this case in its proper light and denied MSIM's motion to dismiss.

III. THE DISTRICT COURT IMPROPERLY ENGAGED IN FACT-FINDING

MSIM faults the Complaint for supposedly failing to plausibly explain how a "10% variance from the Index is material to the [pension account's] diversification." (MSIM Br. At 16; A-220). The Complaint, however, contains factual allegations from which the Court can plausibly infer that MSIM's investment decision to concentrate investments in mortgage-backed securities was material. Specifically, the Complaint compares the results achieved by the Benchmark (with no non-agency mortgage-backed securities and a lower concentration of mortgage-backed securities overall) with those achieved by the MSIM-managed portfolio, alleging that the difference between the two is approximately $25 million. There can be no doubt that losses of this magnitude are material.

Second, as explained in Plaintiffs' opening brief, the district court's finding that MSIM's departures from the Benchmark were "immaterial" constitutes an erroneous, unsupported finding of fact. (*See* Plaintiffs' Br. at 22-23, citing *Roth v. Jennings*, 489 F. 3d 499, 515 (2d Cir. 2007); *Connolly v. Dresdner Bank AG*, No. 08-civ-5018 (SHS), 2009 WL 1138712, at *4 (S.D.N.Y. Apr. 27, 2009); *Safety Management Systems, Inc. v. Safety Software Ltd.*, 10 Civ. 1593 (RJH), 2011 WL 498313, at *2 (S.D.N.Y. Feb. 10, 2011)).

In addition to the materiality issue, the question of "[w]hat [the ERISA fiduciary] knew about the prudence of the investment in question" requires the Court to make factual findings that are inappropriate on a motion to dismiss. *Koch v. Dwyer*, No. 98 CV 5519 (RPP), 1999 WL 528181, at *10 (S.D.N.Y. July 22, 1999).

Thus, the arguments advanced by MSIM, and adopted by the district court, are not issues that can be resolved on a motion to dismiss. Because the district court weighed the evidence and made conclusions based on findings of fact, the Order should be reversed.

IV. QIL'S CLAIMS SHOULD BE REINSTATED

As explained in the opening brief, upon reinstatement of the ERISA claim, QIL's state law claims should also be reinstated. Supplemental jurisdiction is appropriate because QIL's claims arise out of virtually identical facts. MSIM

does not dispute that, in the event that Plaintiffs' ERISA claim is reinstated, QIL's claims should be revived as well because the district court would have supplemental jurisdiction over those claims.

CONCLUSION

The Order should be reversed and the case remanded for further proceedings.

Dated: August 12, 2011

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I, Eric B. Fisher, hereby certify that the total word count in the brief is 7,000 words in Times New Roman, 14 pt. type, and that the brief complies with Rule 32(a)(7) of the Federal Rules of Appellate Procedure.

Dated: August 12, 2011

/s/ Eric B. Fisher

STATE OF NEW YORK)
) ss.: **AFFIDAVIT OF**
COUNTY OF NEW YORK) **CM/ECF SERVICE**

I, Glenda Plair, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age.

On August 12, 2011

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Sworn to before me on August 12, 2011

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