One William St. Capital Mgt., LP v Education Loan Trust IV
2015 NY Slip Op 31364(U)
July 18, 2015
Supreme Court, New York County
Docket Number: 652274/2012
Judge: Eileen Bransten

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

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ONE WILLIAM STREET CAPITAL MANAGEMENT, LP.,

Petitioner,

-against-

Index No. 652274/2012
Motion Seq. No.: 008, 009
Motion Date: 12/9/2014

EDUCATION LOAN TRUST IV, et al,

Respondents.

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Eileen Bransten, J.:

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

Motion sequence numbers 008 and 009 are consolidated herein for disposition.

In motion sequence 008, OWS seeks summary judgment on its first cause of action for breach of contract. In motion sequence 009, respondents ELT, U.S. Education Servicing LLC ("Servicing"), and Dr. Henry Howard seek summary judgment in their own right, dismissing the petition for lack of standing.

For the reasons stated below, respondents' motion for summary judgment is granted as to the breach of contract claim, and OWS's motion for summary judgment is denied as moot.

I. BACKGROUND[1]

The facts of this case have been set forth in detail in this court's previous decision in this action and are only briefly recited herein. *See One William Street Capital Management, LP v. Educ. Loan Trust IV*, 2013 WL 4494379 (Sup. Ct. N.Y. Cnty. Aug. 14, 2013), *aff'd* 116 A.D.3d 512 (1st Dep't 2014).

A. *The Notes and the Dispute*

On October 19, 2007, ELT issued $30 million of notes (the "Notes") backed by government-guaranteed student loans, pursuant to an Indenture and a Supplemental Indenture (together "Indenture"). OWS states that it purchased $10 million of the Notes in January 2011. The remaining Notes are owned by non-party Merrill, Lynch, Pierce, Fenner & Smith ("Merrill").

The Notes were originally "Reset Rate Notes," whose interest rate reset quarterly during a "Floating Rate Term," which ended on November 30, 2008. The Notes paid

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[1] The allegations described below are drawn from the second amended petition, unless otherwise noted.

interest of three-month LIBOR[2] plus 1.50%. According to OWS, the Notes automatically converted to "Auction Rate Notes" on December 1, 2008. As such, starting on that date, ELT, as the issuer, and BONY, as the auction agent, were required to hold auctions every twenty-eight days to set the interest rate.

OWS alleges that no auctions were held in the first two auction periods. According to OWS, the failure to conduct auctions required that the Notes be redeemed as soon as the Trust had funds available and, in the meantime, that the Notes 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.

OWS also maintains that 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.

OWS states that it originally purchased its Notes in January 2011 because it believed 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%. In fact, OWS contends that ELT informed it that the Notes were supposed to pay one-month LIBOR plus 2.50% and that the discrepancy was being corrected. OWS alleges that it

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[2] LIBOR is a published reference indicating the average interest rate that certain leading banks in London charge when lending to other banks.

was not informed, however, 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.

In April 2011, BONY purportedly recomputed the interest at one-month LIBOR plus 2.50% but took no action to redeem the Notes. In June 2011, BONY began conducting auctions but neither OWS or Merrill was notified about the auctions. Since OWS and Merrill were the only alleged owners of the Notes, there were no sellers. 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%.

B. *Procedural History*

OWS commenced this action in June 2012, pursuant to Article 77 of the CPLR. In an August 14, 2013 decision, this Court, *inter alia*, denied motions to dismiss the petition brought by the various respondents. This decision was affirmed by the Appellate Division, First Department in 2014, as set forth above.

Presently before the Court is OWS' second amended petition, which asserts claims for: payment of principal and interest; declaration of rights; equitable estoppel; breach of the covenant of good faith and fair dealing; breach of duty of indenture trustee; fraud; fraudulent conveyance; surcharge; and, aiding and abetting fraud.

II. DISCUSSION

The parties now bring cross-motions for summary judgment. OWS seeks partial summary judgment in its favor on count one of the second amended petition for payment of principal and interest. Respondents ELT, Servicing, and Howard seek summary judgment dismissing the second amended petition in its entire for lack of standing.

A. *ELT, Servicing, and Howard's Motion for Summary Judgment*

In motion sequence 009, ELT, Servicing and Howard move for an order granting summary judgment dismissing the petition for lack of standing on the part of OWS.

As a threshold matter, the Court notes that, although respondents request dismissal of the entire petition, their papers only address whether OWS has standing to assert the first cause of action for unpaid interest and principal under the Indenture. Therefore, the court has no basis to consider, and declines to dismiss, any of the remaining causes of action asserted against the moving respondents in the petition.

In its August 14, 2013 decision, this Court denied motions by the various respondents to dismiss count one for failure to state a claim. Respondents now assert, however, that OWS lacks standing to pursue this claim because through discovery – in July and August 2014 – respondents became aware that OWS was not, in fact, the owner of the Notes at issue here.

Specifically, respondents assert that simultaneously with the settlement of its purchase of the Notes on January 14, 2011, OWS engaged in a repurchase transaction with Merrill, whereby OWS sold the Notes to Merrill subject to an agreement to buy them back in the future ("Repurchase Agreement"). The Repurchase was governed by a "Master Repurchase Agreement," dated March 18, 2009 ("MRA").

Respondents state, and submit evidence to demonstrate, that the Repurchase Agreement has been continuously extended since January 2011, meaning that OWS has not yet repurchased the Notes. Respondents argue that, since OWS is not the actual owner of the Notes, it does not have standing to assert a claim under the Indenture for unpaid interest and principal.

OWS argues that the Repurchase was not a sale of the securities, but rather, was a loan transaction between itself and Merrill. Accordingly, OWS maintains that it is still the owner of the Notes and, therefore, is entitled to pursue a claim for unpaid interest and principal. Notably, OWS does not put forth evidence to dispute respondents assertion that the Repurchase Agreement has been continuously extended or to demonstrate that the Notes have been transferred back to it in exchange for funds, as required by the MRA and discussed below.

1. New Evidence

OWS asserts that respondents are incorrect in asserting that the Repurchase Agreement between OWS and Merrill constitutes new evidence. OWS states that respondents should have been aware of this arrangement since March 27, 2014, when OWS produced trade tickets demonstrating both its original purchase of the Notes and the existence of the Repurchase Agreement.

To the extent that OWS is arguing that respondents should be precluded from relying on the Repurchase Agreement as the basis for the instant motion, that argument is unpersuasive. First, although OWS references the trade tickets in their memorandum of law, it does not produce copies of such tickets. The exhibit to which OWS refers only contains a copy of a letter with no specific reference to the tickets. In any event, even assuming that the trade tickets somehow put respondents on notice of the Repurchase Agreements, such tickets were produced after this Court's decision on the motions to dismiss. OWS has pointed to nothing that would demonstrate that respondents are somehow precluded at this stage of the litigation from arguing that OWS lacks standing to pursue this action.

2. Collateral Estoppel

OWS also contends that the issue of standing already has been adjudicated in its favor by the Appellate Division, First Department, in its 2014 decision in this action. In

that decision, the First Department stated that the "argument that petitioner is not a 'Holder of any Note' with standing to sue under § 6.09 of the indenture lacks merit, since petitioner cured its lack of standing by adding the Depository Trust Company and Cede & Co. to this proceeding as nominal petitioners." *One William Street Capital Mgmt. L.P. v. U.S. Educ. Loan Trust IV*, 116 A.D.3d 512, 512 (1st Dep't 2014).

OWS's argument is unpersuasive. The First Department's decision indisputably addressed the issue of whether OWS lacked standing to assert its claims because it was not the actual holder of any given notes, as required by the terms of the Indenture. As the First Department found, that issue had been resolved at that point by the addition of Depository Trust Company and Cede & Co. as nominal petitioners.

The court did not address, nor did it have before it, the issue presented here – whether OWS is the owner of the notes in the first instance. Therefore, the First Department's decision does not preclude respondents' assertion that OWS lacks standing to pursue the instant action.

3. Standing

As set forth above, the parties dispute whether OWS is the owner of the Notes and, as such, whether OWS has standing to assert its cause of action for breach of contract. Specifically, the parties disagree as to whether the Repurchase constituted a sale of the

Notes, pursuant to which OWS transferred ownership, or a loan transaction, pursuant to which OWS retained ownership.

The Court concludes that the Repurchase at issue in this litigation constituted a sale of the Notes and a transfer of ownership, rather than a loan transaction. Although OWS may have viewed that transaction as a form of financing for its own purchase of the Notes, it is clear that ownership of the Notes was transferred to Merrill under the Repurchase Agreement.

Moreover, as of yet, OWS has not put forth any facts or evidence to demonstrate that ownership has yet been transferred back to OWS. First, OWS has not refuted respondents' assertion that the Repurchase Agreement has been continuously extended. Nor has OWS demonstrated that it received the Notes back from Merrill in exchange for a transfer of funds, as required by paragraph 1 of the MRA. OWS therefore does not have standing to maintain this action for unpaid principal and interest under the Indenture.

In general "[a] repurchase agreement involves two separate but related transactions: (1) a sale of assets by the 'repo seller' in exchange for cash; and (2) an agreement by the repo seller to repurchase them or their equivalent for a specified price in the future." *In re USA Commercial Mortg. Co.*, 802 F.Supp.2d 1147, 1159-60 (D.Nev. 2011) (citing *Granite Partners, L.P. v. Bear, Stearns & Co.*, 17 F.Supp.2d 275, 298 (S.D.N.Y. 1998)).

Repurchase transactions have been described as "hybrid transactions" because, on the one hand, they involve a sale of a security, while on the other, the ultimate goal of the seller may be a "temporary exchange of a security for cash." *In re County of Orange*, 31 F.Supp.2d 768, 777 (C.D. Cal. 1998) (citing *Matter of Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 67 B.R. 557, 596-597 (D.N.J. 1986)). Thus, the seller may intend the transaction to ultimately function as financing for its purchase of the security. *See Springwell Navigation Corp. v. Sanluis Corp., S.A.*, 14 Misc.3d 1206(A), at *4 (Sup. Ct. N.Y. Cnty. 2006) (quoting *Garvin GuyButler Corp. v. Cowen & Co.*, 155 Misc.2d 39, 41 (Sup. Ct. N.Y. Cnty. 1992) ("Generally, repo transactions involve the sale and repurchase of securities for the purpose of obtaining short-term financing at a low rate of interest.")).

Ultimately, however, "[a] repurchase agreement differs from a loan because, '[u]nlike a lender taking collateral for a secured loan, a repo buyer 'take[s] title to the securities received and can trade, sell or pledge them.'" *In re USA Commercial Mortg. Co.*, 802 F.Supp.2d at 1160 (quoting *Granite Partners, L.P. v. Bear, Stearns & Co.*, 17 F.Supp.2d at 298).

A repurchase agreement is also "'critically different' from a secured loan because the assets subject to the repurchase agreement are held by the repo buyer and are 'assets available for satisfaction of its debts and thus could be seized by [its] creditors.'" *In re USA Commercial Mortg. Co.*, 802 F.Supp.2d at 1160 (quoting *S.E.C. v. Drysdale Sec. Corp.*, 785 F.2d 38, 41-42 (2d Cir. 1986)). In *Drysdale*, the Second Circuit explained

that the secured lender "holds pledged collateral for security and may not sell it in the absence of a default," whereas a repurchase buyer takes title to and "is free to deal the collateral." *Drysdale Sec. Corp.*, 785 F.2d at 41.

"Under New York law....the objective intention of the parties, as reflected in their contract language, dictates whether a repurchase agreement is a purchase-and-sale transaction or a collateralized loan." *In re USA Commercial Mortg. Co.*, 802 F.Supp. 2d at 1160 (citing *Granite Partners, L.P.*, 17 F.Supp.2d at 300). "The mere presence of secured loan characteristics in [repurchase] agreements is not enough to negate the parties' voluntary decision to structure the transactions as purchases and sales." *Id.*

In the case at hand, numerous factors demonstrate that the Repurchase constituted a sale, not a loan, and that OWS transferred ownership of the Notes to Merrill. First, the language of the repurchase agreements demonstrate that the parties intended the transaction to be a sale. Indeed, paragraph 6 of the MRA specifically states that "the parties intend that all Transactions hereunder be sales and purchases and not loans..." *See In re Palmdale Hills Prop., LLC*, 457 B.R. 29, 43 (B.A.P. 9th Cir. 2011). Also, paragraph 1 of the MRA specifically requires Merrill to transfer funds to OWS in return for the transfer of the Notes to Merrill. OWS is then obligated, at a later date, to transfer funds to Merrill in order to have the Notes transferred back to OWS. Further, OWS is defined in paragraph 1 of the MRA as the "Seller" and the MRA consistently refers to the parties as "Buyer" and "Seller" and refers to "the Purchased Securities" and the "Purchase Date,"

which also demonstrates that the transaction was a sale, not a loan. *See id.*; *see also In re American Home Mortg. Holdings, Inc.*, 388 B.R. 69, 91 (Bankr. D.Del. 2008).

Moreover, paragraphs 3(a) and 8 of the MRA provided that all of Seller's interest in the Purchased Securities passed to the Buyer on the Purchase Date. Paragraph 8 also permitted Merrill to resell the Notes to third-parties. Significantly, although Merrill was eventually supposed to resell the Notes to OWS, paragraph 11 of the MRA contemplated that Merrill might not be able to reacquire the Notes before the date on which it was supposed to resell them to OWS. The MRA provided a mechanism for compensating OWS in such a case.

Despite the foregoing, OWS argues that the Repurchase Agreement should be viewed as a loan because the parties intended OWS to receive the benefit of any income paid under the Notes. Specifically, under paragraph 5 of the MRA, the parties agreed that OWS would be entitled to receive from Merrill an amount equal to all income paid or distributed under the Notes to the extent that OWS would have been entitled to such payments had the Notes "not been sold to Buyer."

This argument is unpersuasive. It is undisputed that any actual income from the Notes was paid to Merrill, not to OWS. While the intent may have been for OWS to receive the ultimate benefit of any income paid under the Notes, that benefit derived from the terms of the MRA, not under the Indenture pursuant to which the Notes were issued and which forms the basis for OWS's breach of contract claim.

In support of its argument, OWS cites to cases noting that the original seller in a repurchase transaction retains both the economic benefits and market risk of the securities at issue because that party intends to repurchase the securities. *See, e.g., Board of Trustees of Aftra Ret. Fund v. JPMorgan Chase Bank, N.A.*, 806 F.Supp.2d 662, 666 (S.D.N.Y. 2011). However, as the court noted in *Board of Trustees*, the seller in such transaction passes legal title of the securities to the buyer. *Id.* Therefore, since OWS does not have legal title to the Notes, it cannot assert a claim for breach of the Indenture, despite its interest in the market value of the Notes.

OWS also relies on Justice Bernard Fried's decision in *Springwell Navigation Corp. v. Sanluis Corp., S.A.*, 14 Misc.3d 1206(A) (Sup. Ct. N.Y. Cnty. 2006), in which Justice Fried determined that the seller in a given repurchase transaction had standing to sue for unpaid interest under certain notes. However, nothing in that decision indicates that the transaction at issue there contained any of the language set forth in the MRA at issue in this litigation. Moreover, while Justice Fried's decision discussed how repurchase agreements work generally, the decision does not stand for the proposition that all sellers in repurchase transactions retain standing to maintain an action for unpaid interest or principal before they have repurchased the securities at issue.

Finally, OWS argues that respondents are precluded from asserting the defense of standing based on Uniform Commercial Code § 8-202(f), which precludes an issuer from asserting "any defense that the issuer could not assert if the entitlement holder held the

security directly" in cases where a security is held by an intermediary. OWS's argument relies on its assertion that Merrill is holding the Notes for OWS's benefit and that OWS is an entitlement holder. However, this argument fails given the Court's determination that, at this point, Merrill, not OWS, owns the Notes.

B. *Petitioner's Motion for Partial Summary Judgment*

Since the Court has granted Respondents' motion for summary judgment as to count one on standing grounds, Petitioner's motion seeking judgment on the same claim is necessarily denied as moot.

III. CONCLUSION

Accordingly, it is

ORDERED that Respondents' motion for summary judgment (motion sequence 009) is granted to the extent that the first cause of action is dismissed and that the Clerk is directed to enter judgment accordingly; and it is further

ORDERED that Respondents' motion is otherwise denied; and it is further

ORDERED that the first cause of action is severed and the action shall continue as to the remaining causes of action; and it is further

ORDERED that the motion for summary judgment by petitioner One William Street Capital Management L.P. (motion sequence 008) is denied.

Dated: New York, New York
July 15, 2015

ENTER

Hon. Eileen Bransten, J.S.C.