10-4497-cv

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

BRIEF FOR PLAINTIFFS-APPELLANTS

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CORPORATE DISCLOSURE STATEMENT
PURSUANT TO RULE 26.1 OF THE
FEDERAL RULES OF APPELLATE PROCEDURE

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure and to enable Circuit Judges of the Court to evaluate possible disqualification or recusal, the undersigned counsel for Saint Vincent Catholic Medical Centers ("SVCMC") and Queensbrook Insurance Limited ("QIL") states that (i) SVCMC is not owned by any parent corporation and there is no public corporation owning 10% or more of its stock; and (ii) SVCMC is QIL's parent corporation.

Dated: New York, New York
May 26, 2011

Respectfully submitted,

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PRELIMINARY STATEMENT

Plaintiffs-appellants (1) Pension Benefit Guaranty Corporation ("PBGC"),[1] on behalf of the Saint Vincent Catholic Medical Centers Retirement Plan (the "Plan"), and (2) Queensbrook Insurance Limited ("QIL") appeal from the Memorandum and Order (the "Order") of the United States District Court for the Southern District of New York (Hon. P. Kevin Castel, J.), entered on October 4, 2010, dismissing the amended complaint (the "Complaint") against Morgan Stanley Investment Management, Inc. ("MSIM"). (A212 – A223).

MSIM served as an investment manager to the Plan, entrusted to manage the Plan's fixed-income portfolio in the interest of the Plan's beneficiaries. MSIM owed the Plan, a defined benefit pension plan governed by ERISA, the highest fiduciary duties known to law. As set forth in detail in the Complaint, MSIM breached its fiduciary duties.

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[1] By order of this Court entered on May 13, 2011, PBGC was added as an appellant. PBGC is the United States government agency that administers the nation's pension insurance program under Title IV of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Before November 1, 2010, Saint Vincent Catholic Medical Centers ("SVCMC") was the administrator and contributing sponsor of the Plan within the meaning of 29 U.S.C. § 1002(16). In the fall of 2010, PBGC determined that the Plan must terminate because SVCMC was liquidating and the Plan would be unable to pay benefits when due. PBGC further determined that it should become trustee to protect the interests of the Plan participants.

On November 1, 2010, SVCMC and PBGC entered into an agreement by which the Plan was terminated, as of September 14, 2010, and PBGC became trustee of the Plan under 29 U.S.C. § 1342(c), with the power to commence, prosecute or defend any action on behalf of the plan, 29 U.S.C. § 1342(d)(1)(B)(iv).

Among other breaches, MSIM irresponsibly concentrated approximately 50% of the Plan's fixed-income assets in the single asset class of mortgage-backed securities, even as MSIM became aware in 2007 and 2008 of the rapid and dramatic deterioration of the mortgage-backed securities market. This high concentration in mortgage-backed securities was markedly greater than the Salomon Brothers Broad Bond Index, now known as the Citigroup Broad Investment Grade index (the "Benchmark"), which, according to the governing investment guidelines for the Plan, served as the guidepost for MSIM's investment decisions.

Further, between 9% and 12.6% of the overall fixed-income portfolio was invested in a subclass of mortgage-backed securities known as "non-agency mortgage-backed securities." Non-agency mortgage-backed securities are a particularly risky subclass of mortgage-backed securities because the loans underlying these securities were not guaranteed by Fannie Mae or Freddie Mac; and thus non-agency mortgage-backed securities did not meet the underwriting standards imposed by those agencies and were more prone to default. The Benchmark, by contrast, did not contain any non-agency mortgage-backed securities. Again, MSIM maintained these investments during 2007 and 2008, even as it became aware of specific facts disseminated in the market indicating that these investments were subject to unacceptable risks.

Due to MSIM's breach of its fiduciary duties, the Plan sustained losses in excess of $25 million. The Plan would not have suffered these losses had MSIM invested in a portfolio with characteristics similar to the Benchmark, as required under the Plan investment guidelines.

To survive MSIM's motion to dismiss, plaintiffs were required to plead facts sufficient to state a "plausible" claim for breach of fiduciary duty. That is, plaintiffs were required to plead a claim that was something more than "speculative." As the detailed discussion of the Complaint herein demonstrates, plaintiffs have met the burden of pleading a claim for breach of fiduciary duty.

The district court's dismissal of the Complaint should be reversed because it rests on a number of significant errors.

First, the district court effectively demanded that plaintiffs prove – and not merely plead – their claim for relief. While the district court purported to apply the pleading standard elaborated in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), in fact, when considering the motion to dismiss, the district court demanded much more of the plaintiffs' Complaint. Here, the Complaint's allegations were more than sufficient to state a plausible claim for breach of fiduciary duty.

Second, the district court fundamentally misread and overlooked material facts in the Complaint. On several occasions, the district court's Order incorrectly asserts that the Complaint alleges that Morgan Stanley invested between 9% and

12% of the Plan's fixed-income portfolio in mortgage-backed securities. This characterization of the Complaint's allegations is simply wrong. The record demonstrates that MSIM invested approximately 50% of the portfolio in mortgage-backed securities – not the 9% to 12% stated by the district court. Furthermore, 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 securities, even though the relevant Benchmark contained no investment in this riskier subclass of mortgage-backed securities.

Finally, the district court engaged in fact-finding that was inappropriate when considering a motion to dismiss. For example, the district court found that a 10% variance from the Benchmark was not "material" to the Plan's diversification. There is no basis in the record for the district court to so find, and the ultimate issue of diversification is one that requires expert analysis and cannot be considered when deciding a motion to dismiss.

For all of these reasons, the Order should be reversed.

STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

The district court had subject matter jurisdiction under 28 U.S.C. §§ 1331 and 1367. This court has appellate jurisdiction pursuant to 28 U.S.C. § 1291. The Order, which is a final order disposing of all parties' claims, was entered on

October 4, 2010 (A223); appellants filed their notice of appeal on October 27, 2010 (A224).

ISSUES PRESENTED FOR REVIEW

1. Whether the district court erred in dismissing the Complaint for failure to state a plausible claim for relief under ERISA, in circumstances where the Complaint contains specific factual allegations about MSIM's breaches as investment manager to the Plan.

2. Whether the district court erred in misconstruing and overlooking various key facts, especially those relating to the concentration of the Plan investments in mortgage-backed securities generally, and non-agency mortgage-backed securities in particular.

3. Whether the district court erred in applying a standard of review that required plaintiffs to prove, and not merely plead, the claim against MSIM when the court considered the motion to dismiss.

4. Whether the district court erred in engaging in "fact finding" when considering the motion to dismiss.

5. Whether, if the case is remanded to the district court, the district court should hear the state claims brought by QIL.

STATEMENT OF THE CASE

SVCMC[2] and QIL commenced this action on November 23, 2009. (A2). SVCMC claimed that MSIM had breached its fiduciary duties under ERISA by mismanaging the Plan's assets (A14); QIL, a subsidiary of SVCMC, asserted claims for breach of contract and fiduciary duties arising out of MSIM's similar mismanagement of QIL's insurance fund. (A15 – A16).

Plaintiffs filed an amended complaint on February 17, 2010. (A3). MSIM filed a motion to dismiss the Complaint on March 2, 2010. (A4). While the motion to dismiss was pending, SVCMC commenced chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York. (A4). On October 4, 2010, the district court granted MSIM's motion, dismissing the Complaint. (A4).[3] In particular, the district court ruled that the Complaint failed to state a claim under ERISA and declined to exercise supplemental jurisdiction over QIL's common law claims. (A223). The plaintiffs noticed an appeal.

Thereafter, in 2010, PBGC was appointed trustee to protect the interests of the Plan participants. *See* 29 U.S.C. § 1342(c). In its capacity as trustee for the

2 Before filing for bankruptcy protection, SVCMC, under the sponsorship of the Roman Catholic Bishop of Brooklyn and the Sisters of Charity of New York, operated St. Vincent's Hospital Manhattan and St. Vincent's Westchester, as well as health care facilities in Brooklyn and Staten Island. (A25).

3 On April 25, 2011, more than six months after entering the Order, the district court entered judgment on the Order in favor of MSIM.

Plan, PBGC pursues this appeal. The amount of assets in a terminated plan, including PBGC's recoveries of assets on behalf of the plan, may affect the benefit amount paid by PBGC to participants and beneficiaries. *See* 29 U.S.C. §1344(a).

STATEMENT OF FACTS

A. The Allegations In The Complaint

As alleged in the Complaint, until about October 2009, MSIM served as the investment manager for the fixed-income portfolio of the Plan, a defined benefit pension plan governed by ERISA. (A23-A26). In that capacity, (A25, A32), MSIM exercised authority and control over the management and disposition of the Plan's assets and was subject to the fiduciary duties imposed by ERISA. (A26 (citing ERISA § 3(21) (29 U.S.C. § 1102(21))).

ERISA required MSIM to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. (A26 (citing 29 U.S.C. §§ 1104(a)(1)(A) and (B))). It further required MSIM to diversify the Plan's portfolio to minimize the risk of large losses, unless under the circumstances it was clearly not prudent to do so. (A26). The statute also required MSIM to determine that the particular investment strategy was reasonably designed to further the purposes of the Plan by considering the risk of loss and the opportunity for gain associated with the investment strategy. (A27).

Investment guidelines issued by the Plan sponsor instructed MSIM as to the investment strategy and risk tolerance. Specifically, the investment guidelines provided that the "primary investment objective for the Pension Plan shall be preservation of principal with emphasis on long-term growth to meet the future retirement liability of the Plan. Assets shall be invested in accordance with ERISA standards." (A20). The investment guidelines communicated a low risk-tolerance by designating the Salomon Brothers Broad Bond Index, now known as the Citigroup Broad Investment Grade Index or the "Citigroup BIG", as the applicable benchmark (the "Benchmark") against which MSIM's performance as investment manager would be measured. (A27). The Citigroup BIG is an index commonly used as a benchmark with regard to the management of large debt portfolios. (A27). Adoption of the Citigroup BIG as a benchmark signaled to MSIM that, as an ERISA fiduciary, it was required to execute a low-risk, conservative investment strategy. (A27).

Beginning at least in 2007 and continuing throughout 2008, MSIM acted inconsistently with the Plan's investment guidelines, departing markedly from the low-risk, conservative strategy required by those guidelines. Specifically, during this period of time, as MSIM continued to invest a substantial percentage of the Plan's fixed-income portfolio in mortgage-backed securities, information was disseminated in the marketplace highlighting the extreme risk of such investments. (A30). By 2007, analysts recognized the exposure of Morgan Stanley to mortgages in similar securities, and predicted that Morgan Stanley would write down the value of these mortgage-backed securities by $6 billion. (A30). Further, MSIM invested in mortgage-backed securities issued by Indy Mac, Bear Stearns and Countrywide, despite clear signs of increased risk and instability as to each of these issuers. (A30). For example, IndyMac's 2007 Annual Report quoted its Chairman and CEO announcing 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." (A30). In fact, in the 3rd quarter of 2007, IndyMac lost $202.7 million and eventually required rescue by the FDIC. (A30).

In July 2007, Bear Stearns announced that investments in mortgage-backed securities had left two of its hedge funds virtually worthless. (A30). By the second quarter of 2007, Countrywide's reported earnings fell 33%, to $485 million, largely because it had to write down the value of loans and other assets by $923 million; and it issued a statement saying "defaults and mortgages were rising across all mortgage categories." (A30). Moreover, in December 2007, Standard &

Poor's reduced its ratings on approximately $7 billion of Alt-A mortgage-backed securities, loans considered a step above subprime. (A31). The ratings were reduced as a result of a sustained surge in mortgage delinquencies during the prior five months. (A31).

Despite publicly-known information demonstrating the extreme risk and instability of mortgage-backed securities, MSIM continued to aggressively invest in these assets. (A28). Beginning in the fourth quarter of 2007, and throughout 2008 and the first three quarters of 2009, the Plan's exposure to mortgage-backed securities in its fixed-income portfolio consistently exceeded that of the Citigroup BIG by a substantial percentage. (A28). As of year-end 2008, approximately 50% of the Plan's fixed-income portfolio was concentrated by MSIM in mortgage-backed securities. (A152).

A portion of these high-risk investments were in the even riskier subclass of non-agency mortgage-backed securities, so called because they were not guaranteed by Fannie Mae or Freddie Mac, as the underlying mortgages did not meet the agencies' underwriting standards and criteria. (A28). Investments in such non-agency mortgage-backed securities further exposed the Plan to risk levels inconsistent with both MSIM's fiduciary duties and the objectives expressed in the Plan's investment guidelines. (A28).

The Plan experienced significant exposure to non-agency mortgage-backed securities beginning in the fourth quarter of 2007 and throughout 2008 and the first three quarters of 2009. (A28). In particular, MSIM invested 12.6% of the Plan's fixed-income portfolio in non-agency mortgage-backed securities during the fourth quarter of 2007, and investment in such securities exceeded 9% in all four quarters of 2008. (A28). Importantly, the Citigroup BIG, which served as MSIM's benchmark index, had no exposure to non-agency mortgage-backed securities and a much more limited exposure to mortgage-backed securities generally. (A23-A29).

MSIM's excessive concentration of the Plan's assets in mortgage-backed securities generally, and its investment of Plan assets in even riskier non-agency mortgage-backed securities, resulted in significant underperformance by the Plan in comparison to the Citigroup BIG benchmark. (A28). In fact, for 2008, the Plan's fixed-income portfolio sustained losses of 12.0%; meanwhile during the same period the Citigroup BIG had gains of 7%. (A28). Also, in the fourth quarter of 2007, the Plan's fixed-income portfolio ended the quarter up 0.8%, while the Citigroup BIG ended the quarter up 5.7%. (A28). During the relevant time period, the fixed-income portfolio managed by MSIM caused damages to the Plan's assets in excess of $25 million. (A29).

MSIM also served as the investment manager of QIL's insurance fund. The Complaint details facts in support of QIL's claims against MSIM. Because the district court did not reach the merits of these claims, those facts are not relevant to this appeal.

B. The District Court's Decision

On October 4, 2010, the district court dismissed the Complaint, ruling that it failed to state an ERISA claim against MSIM. (A212). Notwithstanding the Complaint's detailed allegations, the district court found that the "Complaint sets forth no facts that [give rise] to a claim that Morgan Stanley breached its fiduciary duty of prudence" with respect to the Plan. (A218).

The district court characterized the plaintiffs' claim as one based solely upon the "poor results of the investments." (A218). The court found the Complaint's allegations about departures from the Benchmark to be irrelevant because the "Complaint does not allege that Morgan Stanley was required to replicate the investments of the Index." (A218).

The district court also ruled that the Complaint failed to state a claim that MSIM breached its fiduciary duty to diversify the Plan's investment portfolio without citing any case law in support of that conclusion. Again, the district court characterized this element of the claim as a non-actionable "hindsight critique of returns." (A220). According to the district court, it was not a "material" fact that the Plan's overall exposure to mortgage-backed securities exceeded that of the Benchmark by approximately 10%. (A220).

The backdrop to the district court's analysis was a misread fact: the court was under the mistaken impression that the Complaint stated that 12.6% of the

Plan's fixed-income portfolio was invested in mortgage-backed securities in 2007 and 9% in 2008. (A221). Those percentages actually note the portfolio's concentration in the riskier non-agency mortgage-backed securities. Nearly 50% of the portfolio managed by MSIM was invested in mortgage-backed securities generally. (A152). Based upon this misreading of the facts alleged in the Complaint, the district court distinguished ***Trustees of the Local 464A United Food and Commercial Workers Union Pension Fund v. Wachovia Bank, N.A.***, Civ. No. 09-668 (WJM), 2009 WL 2152074 (D.N.J. July 14, 2009), explaining that ***Local 464A*** involves "triple the percentage invested in mortgage securities here." (A221). In actuality, the percentage concentrations in this case are approximately 150% of the concentration in ***Local 464A.***

Finally, after dismissing the ERISA claim, the district court declined to exercise supplemental jurisdiction over the state law claims asserted by QIL. (A221).

SUMMARY OF ARGUMENT

The district court's Order dismissing the Complaint should be reversed because it is based on legal and factual errors.

First, contrary to the district court's holding, the Complaint's factual allegations are more than sufficient to satisfy the criteria for pleading a claim under ERISA for breach of fiduciary duty. Under the applicable pleading standard imposed by ***Twombly*** and ***Iqbal***, plaintiffs were required only to include in their

Complaint facts sufficient to render their claim for breach of fiduciary duty "plausible." That standard is easily met by the Complaint.

In particular, the Complaint alleges that MSIM breached its fiduciary duty of prudence and the duty to diversify by concentrating approximately 50% of the Plan's fixed-income portfolio in mortgage-backed securities, when MSIM knew of specific facts pointing to the excessive risk inherent in such a portfolio. This allocation to mortgage-backed securities was significantly greater than the allocation in the Benchmark, which was supposed to serve as MSIM's guidepost.

MSIM further breached its fiduciary duties by concentrating between 9% and 12.6% of the Plan's fixed-income assets in non-agency mortgage-backed securities. Non-agency mortgage-backed securities are a riskier subclass of this asset class because these securities are based upon loans that do not meet the underwriting criteria imposed by Freddie Mac and Fannie Mae. Notably, the Benchmark did not contain any non-agency mortgage-backed securities. Throughout 2007 and 2008, MSIM persisted with its investment of a substantial portion of the Plan's assets in non-agency mortgage-backed securities, even while it knew that there were no such securities in the Benchmark and even after it became aware of the dramatic deterioration of the market for those securities. The Complaint also alleges as a consequence of MSIM's breach of its fiduciary duties that the Plan sustained losses of approximately $25 million.

Accordingly, the Complaint sets forth a compelling claim for breach of fiduciary duty. Certainly, those facts meet the "plausibility" standard imposed by *Twombly* and *Iqbal*.

Second, the district court fundamentally misread the Complaint. On several occasions, the district court's Order incorrectly asserts that the Complaint alleges that MSIM invested between 9% and 12% of the Plan's fixed-income portfolio in mortgage-backed securities. This characterization of the Complaint's allegations is simply wrong. The record demonstrates an overall portfolio concentration in mortgage-backed securities of approximately 50% – not 9% to 12%. On the basis of that fundamental mistake, the district court erred by distinguishing a key case that it should have followed. Likewise on the basis of that fundamental mistake, the district court erred in concluding that the Plan's concentration in mortgage-backed securities was not excessive.

The district court also completely overlooked the fact that MSIM invested 9% to 12.6% of the Plan's fixed income portfolio in non-agency mortgage-backed securities, even though the relevant Benchmark contained no investment in this riskier subclass of mortgage-backed securities.

Third, the district court required that plaintiffs prove – and not merely plead – their claim for relief. While the district court purported to apply the pleading standard set forth in *Twombly*, in fact, the district court improperly demanded much more of plaintiffs. For example, the district court based its decision on the supposed failure to plead facts that would only become available to plaintiffs during discovery.

Here, the Complaint's allegations about the Plan's excessive concentration in mortgage-backed securities generally, and non-agency mortgage-backed securities in particular, coupled with specific factual allegations that MSIM knew about the deteriorating market for mortgage-backed securities were sufficient to state a plausible claim for breach of fiduciary duty. The district court erred by demanding a higher standard when considering a motion to dismiss.

Finally, the district court erred by engaging in fact finding in considering a motion to dismiss. For example, the district court declared that a 10% variance from the Benchmark was not "material" to the Plan's diversification, even though there was no basis in the record for the district court to so find. The ultimate issue of diversification is one that requires expert analysis and cannot be decided at the pleading stage of the case. The district court also found that investing 9% to 12% of the Plan's assets in mortgage-backed securities was appropriate diversification. Again, there is no basis for this finding (especially given that the percentage is vastly understated by the district court's prior error).

In sum, when properly construed, the Complaint's allegations about MSIM's over-concentration of the portfolio's assets in these securities, despite the warning signs known to MSIM regarding this class of securities, state a compelling claim that MSIM breached its duties to the Plan and are more than adequate to satisfy the applicable "plausibility" standard.

ARGUMENT

I. THE COMPLAINT STATES A CLAIM AGAINST MSIM FOR BREACH OF FIDUCIARY DUTY UNDER ERISA

The district court's Order should be reversed because the allegations of the Complaint are sufficient to state a claim for breach of fiduciary duty under ERISA.

A. Standard Of Review and Pleading Standard

This Court reviews "the district court's grant of a Rule 12(b)(6) motion to dismiss *de novo*, accepting all factual claims in the complaint as true, and drawing all reasonable inferences in the plaintiff's favor." *Famous Horse Inc. v. 5th Ave. Photo Inc.*, 624 F.3d 106, 108 (2d Cir. 2010); *see also In re Morgan Stanley ERISA Litigation*, 696 F. Supp. 2d 345, 353 (S.D.N.Y. 2009) (citing *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1174 (2d Cir. 1993) (denying defendants' motion to dismiss an ERISA claim). The issue "'is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims.'" *In re Morgan Stanley ERISA Litigation*, 696 F. Supp. 2d at 353 (citing *Villager Pond, Inc. v. Town of Darien*, 56 F.3d 375, 378 (2d Cir. 1995) (quoting *Scheuer v. Rhodes*, 416 U.S. 232, 236-37 (1974))).

Courts apply a two-prong test to a motion to dismiss. First, the court construes the allegations in a complaint as true, and the court is not bound to accept the veracity of legal conclusions couched as factual allegations. (A216 (citing *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949-50 (2009))). Second, "a court must then consider whether the complaint 'states a plausible claim for relief,' which is 'a context-specific task that requires the reviewing court to draw on its judicial experiences and common sense.'" (A216 (quoting *Iqbal*, 129 S. Ct. at 1950)). 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." *Iqbal*, 129 S. Ct. at 1949 (citing *Bell Atl. Corp. v. Twombly*, 550 U.S. at 556); *see also Teoba v. Trugreen Landcare LLC*, No. 10 Civ. 6132 (CJS), 2011 WL 573572 at *3 (W.D.N.Y. Feb. 15, 2011) (Twombly adopted a "flexible plausibility standard, which obliges a pleader to amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim plausible.") (citation omitted).

Here, as detailed below, the Complaint far exceeds the applicable pleading requirements. The Complaint's factual allegations concerning MSIM's excessive concentration of the Plan's assets in mortgage-backed securities generally, and non-agency mortgage-backed securities in particular, during a period of time when MSIM was aware of the significant investment risks in that sector, paint a compelling picture of MSIM's breach of its fiduciary duties. Certainly, based upon those allegations, the district court should have found that the Complaint stated a "plausible" claim for breach of fiduciary duty.

B. The Complaint's Factual Allegations State A Plausible Claim For Breach Of Fiduciary Duty

Under ERISA, the elements of a cause of action for breach of fiduciary duty 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). The Complaint satisfies each of those elements and, accordingly, states a claim for breach of fiduciary duty.

1. MSIM Was A Fiduciary of The Plan

MSIM was a fiduciary of the Plan. Under 29 U.S.C. § 1105(d)(1), once the appointment of an investment manager is made, the professional advisor becomes a fiduciary with a duty of care and duty of loyalty to the plan. *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1219 (2d Cir. 1987) (investment manager liable under ERISA for wrongful investments). Here, a fiduciary relationship existed between MSIM and the Plan. St. Vincent's Hospital, a predecessor of SVCMC, entered into an investment management agreement in October 1997 with Miller Anderson & Sherrerd, LLP, a predecessor of MSIM, to manage the fixed-income assets of the Plan. (A42-A46).

As a fiduciary of the Plan, MSIM was subject to the highest fiduciary duties known to the law. *Donovan v. Bierwith*, 680 F.2d 263, 272 n.8 (2d Cir. 1982). As a "discretionary investment manager for the Plans, [MSIM] was under an obligation to the Plan[s] to make a professional and independent judgment as to the wisdom of the proposed investments." *Lowen*, 829 F.2d at 1219.

2. MSIM Breached Its Fiduciary Duties

MSIM breached its fiduciary duties to the Plan, including the duty to invest the Plan's assets prudently and the duty to diversify the Plan's fixed-income portfolio. ERISA specifically requires that MSIM, as a fiduciary, act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B); *Local 464A*, 2009 WL 2152074 , at *3 (D.N.J. July 14, 2009).

Whether MSIM acted prudently is determined by using "an objective standard, focusing on whether the fiduciary used appropriate methods to investigate the merits of a particular investment based on the character and aims of the plan served." *Id.* (citations omitted). "[T]he thoroughness of a fiduciary's investigation is measured not only by the actions it took in performing it, but by the facts that an adequate evaluation would have uncovered." *Id.* at *4 (citing *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 436 (3d Cir. 1996)). Additionally, "[w]hat [the ERISA fiduciary] knew about the prudence of the investment in question" is a factual question inappropriate for resolution 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).

In addition to its duty to act prudently, ERISA also requires that MSIM, as a plan fiduciary, diversify plan assets "so as to minimize the risk of large losses, unless under the circumstances, it is clearly prudent not to do so." 29 U.S.C. §§ 1104(a)(1)(C). "[T]he 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. Congress has laid out seven factors that MSIM should have considered in determining how to diversify the fixed-income assets in the Plan: "(1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; and (7) the dates of maturity." *Id.*

Here, MSIM breached the duties to act prudently and the duty to diversify. The Plan's investment guidelines specified that the "primary investment objective for the Pension Plan shall be preservation of principal with emphasis on long-term growth to meet the future retirement liability of the Plan." (A27). With this objective in mind, MSIM was required to investigate the merits of the investments it made on behalf of the Plan, including its decision to invest nearly 50% of the fixed-income portfolio in mortgage-backed securities generally and between 9% and 12.6% in non-agency mortgage-backed securities in particular.

The Complaint contains specific, factual allegations that MSIM knew or should have known about the risks concerning investments in mortgage-backed securities. For instance, the Complaint alleges that:

- in 2007, analysts predicted Morgan Stanley would be required to "write down" $6 billion on the value of mortgage-backed securities on its books;

- Indy Mac, Bear Stearns and Countrywide—all issuers of securities purchased by MSIM—made public statements in 2007 about deteriorating conditions in the mortgage-backed securities market; and

- in 2007, Standard & Poor's reduced its ratings on about $7 billion of Alt-A mortgage-backed securities, loans considered a step above subprime, which were among the investments made by MSIM on behalf of the Plan. (A29-A31).[4]

Thus, MSIM failed to reduce the Plan's exposure to mortgage-backed securities, even as the rapid deterioration in the market for those securities became evident. In fact, as of December 31, 2008, 49.6% of the Plan's portfolio consisted of mortgage-backed securities. (A152). Further, MSIM knowingly maintained a concentration in mortgage-backed securities that was consistently greater than the Benchmark's concentration in that general asset class.

[4] Since the district court's decision to dismiss the complaint, additional facts evidencing MSIM's knowledge of the risks have come to light. For example, in *Staehr v. Mack*, No. 07 Civ. 10368 (DAB), 2011 WL 1330856, at *2 (S.D.N.Y. Mar. 31, 2011), plaintiffs alleged that Morgan Stanley acquired Saxon, a subprime mortgagor, originator, and servicer, in December 2006, giving Morgan Stanley "an insider's view of the unfolding crisis in the subprime market."

MSIM's breach of its fiduciary duties was even more egregious in connection with its decision to invest between 9% to 12.6% of the Plan's fixed-income portfolio in non-agency mortgage-backed securities, a riskier subclass of such securities, as it knew that the Benchmark contained no such exposure. (A28). In the fourth quarter of 2007, 12.6% of the Plan's fixed-income portfolio was invested in non-agency mortgage-backed securities, and in each of the four quarters of 2008, that percentage concentration exceeded 9%. (A28).

Thus, the Complaint alleges facts sufficient to state a compelling claim that MSIM breached its duties to the Plan. Certainly, the Complaint satisfies the "plausibility" threshold required by ***Twombly*** and ***Iqbal***. Accordingly, MSIM's motion to dismiss should have been denied.

3. MSIM's Breaches Caused The Losses Suffered By The Plan

Finally, the Complaint alleged that the Plan was damaged by MSIM's breaches and by MSIM's decision to direct large amounts of the Plan's fixed-income assets into high-risk investments. (A29). In particular, the losses attributable to mortgage-backed securities total approximately $25 million. (A29).

The Complaint alleged that the over-concentration in mortgage-backed securities generally, and non-agency mortgage-backed securities in particular, proximately caused the losses the Plan seeks to recover. (A29). If MSIM had invested the fixed-income portfolio in accordance with the Benchmark, the fixed-income portfolio would not have suffered those losses. The Plan is entitled to recover the difference between what the fixed-income portfolio would have yielded if MSIM had managed the assets prudently and the actual performance of the fixed-income portfolio. *Harris Trust and Sav. 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."); ***see generally*** *Local 464A*, 2009 WL 2152074, at *4 (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).

C. The District Court Erred By Fundamentally Misconstruing The Complaint's Allegations And Thus Misapplying The Law

The district court's decision rests on a mischaracterization of a basic and material fact. In particular, on the first page of the Order, the district court described the allegations in the Complaint as follows: "plaintiffs contend, Morgan Stanley concentrated between approximately 9% and 12% of the Plan's fixed-income portfolio in mortgage-backed securities[.]" (A212). This characterization of the allegations is plain error. 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. As demonstrated by the account statement attached as Exhibit 10 to the Affidavit of Joseph A. Braccia, which was submitted by MSIM, as of December 31, 2008, 49.6% of the Plan's fixed-income portfolio was invested in mortgage-backed securities. (A152).

The district court's error appears to have resulted from its misreading of the Complaint's allegation that between 9% and 12.6% of the fixed-income portfolio was invested in non-agency mortgage-backed securities. (A11). As explained in the Complaint, the non-agency portion of the portfolio was the riskiest sector, but the overall concentration in mortgage-backed securities was much greater than 9 to 12%. The district court simply misread these allegations.

The district court also relied on this same mischaracterization of the Complaint on pages 9 and 10 of the Order. (A220-A221). This mistake is the linchpin of the district court's decision, serving as the basis for the district court's erroneous contention that this case is distinguishable from *Local 464A* and the basis for its mistaken conclusion that the Plan's assets were sufficiently diversified. If the district court had understood that approximately 50% of the Plan's fixed-income portfolio was invested in mortgage-backed securities, it almost certainly would not have reached the same conclusion.

The district court's error is further compounded by its failure to appreciate the significance of MSIM's decision to invest between 9% and 12.6% of the Plan's fixed-income assets in non-agency mortgage-backed securities. The district court's Order does not discuss the fact that non-agency mortgage-backed securities are an even riskier subclass of the mortgage-backed securities asset class. Further, the district court completely overlooked the critical fact that the Benchmark did not contain any non-agency mortgage-backed securities, yet MSIM invested between 9% and 12.6% of the Plan's fixed-income portfolio in such securities. (A11). The district court erred in attaching no weight to, and indeed completely overlooking, this fact.

The district court should have followed ***Local 464A***, in which the district court denied a motion to dismiss in factually similar circumstances. In ***Local 464A***, plaintiffs made nearly identical claims to the ones asserted in the Complaint. In particular, plaintiffs alleged that defendant (investment managers) breached their duty to prudently invest a plan's assets by investing substantial portions of the plan's fixed-income portfolio in non-agency mortgage-backed securities and collateralized mortgage obligations. ***Id.*** at *1, 3. Plaintiffs also alleged that the overconcentration of their investments in the mortgage market "led to reduced positions in conservative investments like treasuries and agency paper." ***Id.*** at *3. The court determined that "the allegations that Defendants continued to invest in [mortgage-backed securities] and [collateralized mortgage obligations] despite problems in the mortgage and credit markets are sufficient" to state a claim that is plausible on its face. ***Id.*** at *4.

Here, as in ***Local 464A***, MSIM was required to execute a low-risk, conservative investment strategy. (A27, 29). MSIM deviated from this specified strategy and directed increasingly large amounts of the Plan's assets into high-risk investments including non-agency mortgage-backed securities and mortgage-backed securities generally. (A28). Despite the warning signs, MSIM continued to invest the Plan's assets in such high-risk investments. (A30-31). Therefore, the Complaint stated a claim that is plausible on its face for breach of MSIM's duty to invest prudently.

In *Local 464A*, plaintiffs similarly alleged "that Defendants breached their duty to diversify by overweighting the fixed-income portfolios with" mortgage-backed securities and collateralized mortgage obligations. *Local 464A*, 2009 WL 2152074, at *5. In that case, plaintiffs' investment guidelines designated the Lehman Aggregate Bond Index as a benchmark index, which remained stable as plaintiffs suffered losses. *Id.* at *1. In ruling that plaintiffs had adequately alleged that defendants had breached their duty to diversify, the 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 held that plaintiffs satisfied the notice pleading requirements of FRCP 8(a), as "[s]pecific facts are not necessary; the statement need only 'give the defendant fair notice of what the . . . claim is and the grounds upon which it rests.'" *Local 464A*, 2009 WL 2152074, at *5 (citing *Erickson v. Pardus*, 551 U.S. 89, 94 (2007) (quoting *Twombly*, 550 U.S. at 555).

Here, SVCMC provided MSIM with written investment guidelines to follow, and these guidelines provided that the "primary investment objective for the Pension Plan shall be preservation of principal with emphasis on long-term growth to meet the future retirement liability of the Plan." (A27). The investment guidelines also designated the Benchmark for MSIM to use in determining how to invest the Plan's fixed-income assets. *Id.* Adoption of the Benchmark required MSIM to execute a low-risk, conservative investment strategy. *Id.* As a fiduciary, MSIM had a duty to consider these investment guidelines in determining how to diversify the Plan's fixed-income assets. Accordingly, MSIM's failure to adhere to the strategy specified by the Plan's investment guidelines is sufficient to state a claim that is plausible on its face for breach of MSIM's fiduciary duties.

The district court's chief ground for distinguishing *Local 464A* from this case was that one-third of the fund in *Local 464A* was invested in mortgage-backed and collateralized mortgage obligations, "which is approximately triple the percentage invested in mortgage securities here." (A221). The district court's distinction is clearly wrong. It is unsupported by the allegations in the Complaint and directly contradicted by the record. As stated above, approximately 50% of the Plan's fixed-income portfolio consisted of mortgage-backed securities (A152) — not 9% to 12% as the Court found. (A212). Instead of the concentration of mortgage-backed securities in *Local 464A* being triple what it is here (as erroneously stated by the district court), in fact the concentration here is 150% of the amount in ***Local 464A.*** The district court's error thus flowed directly from its fundamental misunderstanding of the Complaint's factual allegations.

D. The District Court Misapplied The Pleading Standard

The district court erred by applying a pleading standard significantly higher than that required by law. In the Complaint, plaintiffs were required to plead a claim for breach of fiduciary duty that was plausible. In assessing whether this threshold had been satisfied, the district court was required simply to construe the factual allegations in the Complaint and draw all reasonable inferences in plaintiffs' favor. Here, the district court overstepped those boundaries, writing an opinion that is based not only on a misreading of key facts in the Complaint, but also upon unsupported findings of fact, including the district court's own statement that the Plan's greater concentration in mortgage-backed securities relative to the Benchmark was not "material." In sum, the district court erred by prematurely requiring plaintiff to prove its case, rather than merely stating a "plausible" claim for relief.

The district court also demanded more than what is required by ***Twombly*** and ***Iqbal*** when it faulted plaintiffs for not alleging specific facts to show that MSIM failed to appropriately investigate the mortgage-backed securities it selected for the portfolio. Such facts would only be available to plaintiffs during discovery. Here, the Complaint's allegations about the Plan's excessive concentration in mortgage-backed securities generally, and non-agency mortgage-backed securities in particular, coupled with specific factual allegations that MSIM knew about the deteriorating market for mortgage-backed securities were sufficient to state a plausible claim for breach of fiduciary duty. The district court erred by demanding more at the pleading stage of the case.

NM Homes One, Inc. v. JP Morgan Chase Bank, N.A., No. 08-Civ.07679 (PAC) (S.D.N.Y. Mar. 30, 2010 Order) ("Mar. 2010 Order"), ***modified upon reconsideration*** (S.D.N.Y. Dec. 15, 2010 Order) ("Dec. 2010 Order"), ***denying motion to dismiss*** (S.D.N.Y. Mar. 10, 2011 Order) ("2011 Order"), is on point. In *NM Homes One*, plaintiff brought an action against its investment advisor ("JP Morgan") and its fixed-income portfolio manager alleging ten claims, including breach of contract and breach of fiduciary duty. (Add-1, Mar. 2010 Order, at 1).[5] Plaintiff alleged that JP Morgan had discretionary trading authority over the investment management account, and exposed plaintiff to the volatile mortgage market which provided inadequate liquidity. *Id.*

Similar to the facts here, in *NM Homes One*, the parties executed a mandate outlining the "philosophy and investment principles," which described the account as "conservative," with a purpose to "seek income and principal stability." (Add-3,

[5] The *NM Homes One* court's Mar. 2010 Order is important to understanding the factual background of the *NM Homes One* case and its similarities to this case. That Mar. 2010 Order was modified upon reconsideration in the district court's subsequent Dec. 2010 Order with respect to the issue of whether the fiduciary breach claim against JP Morgan was preempted by New York's Martin Act, an issue that is not pertinent to this appeal. Finally, as explained above, in its 2011 Order, the district court denied JP Morgan's motion for judgment on the pleadings on grounds that are instructive with respect to this case.

Mar. 2010 Order, at 3). However, JP Morgan deviated from this investment strategy by directing more than half of plaintiff's account into mortgage-linked securities, including home equity loan asset-backed securities, collateralized mortgage obligations, and floating-rate notes. (Add-1, 4, 6, Mar. 2010 Order, at 1, 4, and 6). Additionally, as is the case here, the guidelines and account documents allowed and "expressly contemplate[d]" investment in mortgage-backed securities. (Add-16-17, Mar. 2010 Order, at 16-17). Further, like this case, plaintiff alleged various red flags that should have made defendants aware of the risks of investing in mortgage-backed securities. (Add-4-6, 17, Mar. 2010 Order, at 4-6, and 17).

JP Morgan moved for dismissal on the pleadings, contending that it did not breach the investment guidelines. (Add-28, 2011 Order, at 3). The court found that the issue was whether JP Morgan mismanaged plaintiff's assets, and "at this stage, prior to answer and any discovery, it is not correct to hold that [JP Morgan] is entitled to judgment on the pleadings." *Id.*

In *NM Homes One*, the district court also recognized that even technical compliance with the letter of investment guidelines may nonetheless give rise to a claim for breach of duty, when the technical compliance violates the fundamental basis for the investment guidelines:

> [i]t is an open question whether "pernicious compliance" with one provision of the contract satisfies all other provisions . . . . Again, it is a fair ground for factual dispute whether holding on to failing fixed-income securities; indeed, continuing to invest in such securities

> long after alarm bells were ringing off the wall, met the requirements of the parties' contract - even if concentration ratios were satisfied. . . . It is also fair grounds for factual dispute whether the securities selected were suitable (or the most attractive), given the needs for preservation of capital and liquidity.

(Add-29, 2011 Order, at 4). Accordingly, the *NM Homes One* court correctly held that factual issues remained in dispute which precluded the court from granting defendant's motion for judgment on the pleadings. *Id.*

Here, as in *NM Homes One*, the Complaint adequately states a claim against MSIM for breaching its fiduciary duties to the Plan. Similar to the facts in *NM Homes One*, plaintiffs in this case adequately pled a claim that MSIM's heavy concentration of the portfolio in risky mortgage-backed securities was inconsistent with the conservative strategy mandated by the Plan's investment guidelines. Accordingly, MSIM's motion to dismiss should have been denied.

E. The District Court Improperly Engaged In Fact-Finding

A "ruling on a motion for dismissal pursuant to Rule 12(b)(6) is not an occasion for the court to make findings of fact." *Roth v. Jennings*, 489 F.3d 499, 509 (2d Cir. 2007); *Connolly v. Dresdner Bank AG*, No. 08-Civ.-5018 (SHS), 2009 WL 1138712 at *2 (S.D.N.Y. Apr. 27, 2009). Rather, the factual allegations of the Complaint must be accepted as true. Here, the district court violated this principle by making unsupported factual findings in connection with its decision on the motion to dismiss. Specifically, the district court made a finding that a 10%

variance from the Benchmark was not "material" to the Plan's diversification (A220), and that investing between 9% and 12.6% of the portfolio in non-agency mortgage-backed securities was appropriate diversification. (A221). There is no basis in the record for either finding, and in any event such a finding is inappropriate when considering a motion to dismiss. ***Roth, 489*** F.3d at 509; ***see also Koch***, 1999 WL 528181, at *10 ("What [the ERISA fiduciary] knew about the prudence of the investment in question" is a factual question inappropriate for resolution on a motion to dismiss"); ***Safety Management Systems, Inc. v. Safety Software Ltd.***, No. 10 Civ. 1593 (RJH), 2011 WL 498313 at *2 (S.D.N.Y. Feb. 10, 2011) (on a motion to dismiss, the "Court's place is not to weigh the evidence and make conclusions based on findings of fact"). Accordingly, the Order should be reversed.

II. QIL's Claims Should Be Reinstated

QIL's state law claims against MSIM for breach of contract and breach of fiduciary duty are supported by nearly identical factual allegations as those alleged with respect to the Plan. The district court dismissed QIL's state law claims by refusing to exercise supplemental jurisdiction over such claims after the court dismissed the sole federal claim. As discussed above, the district court's dismissal of the ERISA claim should be reversed. Accordingly, this Court should vacate the dismissal of QIL's state law claims and reinstate such claims. ***See Famous House***, 624 F.3d at 115.

CONCLUSION

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

Dated: New York, New York
May 26, 2011

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CERTIFICATE OF COMPLIANCE

I, Eric B. Fisher, hereby certify that the total word count in the brief is 7,458 words in Times New Roman, 14 pt. type and that it has complied with the Federal Rules of Appellate Procedure Rule 32(a)(7).

Dated: New York, New York
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