21 Misc.3d 1133(A)
Unreported Disposition
(The decision of the Court is referenced in a table in the New York Supplement.)
Supreme Court, New York County, New York.

MUNICIPAL HIGH INCOME FUND, INC., Smith Barney Managed Municipals Fund, Inc., Managed Municipals Portfolio, Inc., Managed Municipals Portfolio II, Inc., Smith Barney Income Funds–Smith Barney Municipal High Income Fund, and Smith Barney Muni Funds–National Portfolio, Plaintiffs,
v.
GOLDMAN, SACHS & CO., and R.W. Beck, Inc., Defendants.
Goldman, Sachs & Co., Third–Party Plaintiff,
Western Asset Management Company, a subsidiary of Legg Mason Inc., f/k/a Smith Barney Fund Management LLC, formerly a subsidiary of Citigroup, Inc., f/k/a Greenwich Street Advisors, a division of Smith Barney Mutual Funds Management Inc., Third–Party Defendant.

No. 600012/06.
|
Oct. 30, 2008.

Attorneys and Law Firms

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Warren Hutchison, Esq. (LeClair Ryan PC), for defendant R.W. Beck.

Donald F. Luke, Esq. (Jaffe Asher LLP), **Mark H. Moore**, Esq. (Jaffe Asher LLP), for defendant Western Asset Mgt.

Opinion

CHARLES E. RAMOS, J.

***1** Defendants Goldman, Sachs & Co. (Goldman) and R.W. Beck Inc. (Beck) move separately, pursuant to CPLR 3212, to dismiss the complaint on statute of limitation grounds. Plaintiffs Municipal High Income Fund, Inc., Smith Barney Managed Municipals Fund, Inc., Managed Municipals Portfolio, Inc., Managed Municipals Portfolio II, Inc., Smith Barney Income Funds–Smith Barney, Municipal High Income Fund, and Smith Barney Muni Funds–National Portfolio (collectively "plaintiffs") oppose the motions and seek a trial.

Summary Judgment

Pursuant to CPLR 3212(b), a court will grant a motion for summary judgment upon a determination that the movant's papers justify holding, as a matter of law, "that there is no defense to the cause of action or that the cause of action or defense has no merit." Further, all of the evidence must be viewed in the light most favorable to the opponent of the motion. *Insurance Co. of N.Y. v. Central Mut. Ins. Co.,* 47 AD3d 469 (1st Dept 2008).

The proponent of a motion for summary judgment must make a prima facie showing of entitlement to judgment as a matter of law by tendering sufficient evidence to eliminate any material issues of fact as to the claim or claims at issue. *Alvarez v. Prospect Hosp .,* 68 N.Y.2d 320, 324 [1986]. Failure to make such a showing requires denial of the motion, regardless of the sufficiency of the opposing papers. *Winegrad v. New York Univ. Med. Ctr.,* 64 N.Y.2d 851, 853 [1985]).

Once the prima facie showing has been made, the party opposing a motion for summary judgment bears the burden of "produc[ing] evidentiary proof in admissible form sufficient to require a trial of material questions of fact" *Amatulli v. Delhi Constr. Corp.,* 77 N.Y.2d 525 (1991).

Background[1]

On May 27, 1998, the Michigan Strategic Fund, a state agency responsible for economic development, sold $80 million in Resource Recovery Limited Obligation Revenue Bonds (the "Bonds") to finance the conversion of the Central Wayne County Sanitation Authority Municipal Solid Waste Incineration Project into a waste-to-energy project (the "Project"). Goldman was the underwriter for the Bonds and prepared a Limited Offering Memorandum (LOM). Beck prepared an

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Independent Engineer's Report for inclusion in the LOM concerning the feasibility of constructing and operating the Project (the "Beck Report").

Plaintiffs, six municipal bond mutual funds, and admittedly sophisticated investors, purchased $50.5 million of the Bonds. The interest and principal on the Bonds were payable solely from revenues that were projected to be generated by the Project. These revenues stemmed from tipping fees charged in exchange for the dumping of waste, the sale of metals recovered from the waste, and the electricity generated by incinerating the waste.

The Beck Report contained, among other things, annual projections of tipping fees for the life of the Bonds, a detailed description of the methodology by which the projections were developed, and the assumptions on which they were based. The Beck Report projected that tipping fees would be $18.50 per ton in 1998, $19.51 in 2000, $20.04 in 2001, $20.58 in 2002, and further escalations thereafter. Plaintiffs understood that tipping fees would represent about 51% of total Project revenues.

***2** From the outset, the Project encountered difficulties with regard to construction and operation, which resulted in the shutdown of at least one boiler for varying periods of time. Separate and apart from these setbacks, the projected tipping fees were never met.

On June 26, 2000, Beck released a report to the plaintiffs projecting "a significant shortfall in the availability of funds to meet the monthly requirements," including interest payable on the Bonds. The reasons for the shortfall, according to Beck, included a "softening of the market for spot market disposal, and a market that had become "increasingly competitive during the last two years ..."

Beginning in May 2001, plaintiffs received reports from the Project specifically listing, among other things, the actual tipping fees on a month-by-month basis. The tipping fees ranged mostly on the low end of a scale ranging from $9.22 to $15.51 in 2001 and 2002, below projections. Due to these shortfalls in revenue, plaintiffs decided to enter into a Forbearance Agreement ceasing all accrual and payment of interest on the Bonds.

On July 13, 2001, the portfolio manager e-mailed plaintiffs stating: "[T]he project has not been able to improve its financial position and has now depleted the debt service reserve fund. At this time we have no reason to believe that the project is likely to show any improvement in the near term." On October 12, 2001, plaintiffs formally designated the Bonds a matter of heightened credit concerns. As of April 30, 2002, the plaintiffs had written down the value of the Bonds by about $20.2 million. By May 2003, plaintiffs valued their total holdings of the Bonds at $12.625 million, representing a $37.875 decline in value.

Plaintiffs first commenced an action against Beck in Michigan, alleging negligent misrepresentation. Applying New York law, the Michigan court dismissed the case as barred by the Martin Act. After the filing of a third amended complaint, plaintiffs alleged that Goldman and Beck defrauded them. The case was dismissed again, this time on *forum non-conveniens* grounds.

On May 5, 2005, nearly seven years after the plaintiffs purchased the Bonds, and after several years has passed since discovery that Beck's projections were inaccurate, the plaintiffs commenced this action alleging claims for fraudulent misrepresentation and non-disclosure against Goldman and Beck.

Discussion

A cause of action for fraud must be commenced within six years of the date of the fraudulent act, or within two years of the date the fraud was, or with reasonable diligence could have been, discovered.[2] CPLR 213(8). An inquiry as to the time a reasonably diligent plaintiff could have discovered the fraud turns upon whether a person of ordinary intelligence possessed knowledge of facts from which the fraud could be reasonably inferred. *Rite Aid Corp. v. Grass,* 48 AD3d 363 (1st Dept 2008).

However, an analysis of a plaintiff's duty to inquire may not be necessary where it can be proven by undisputed evidence that the plaintiff had actual knowledge of the facts giving rise to an action for fraud, and did not initiate the action within the statutory time. See generally, *Avalon LLC v. Coronet Properties Co.,* 306 A.D.2d 62, 63 (1st Dept), appeal denied, 100 N.Y.2d 513 (2003)(case dismissed on statute of limitation grounds where plaintiff had actual knowledge of the fraud prior for two years before commencement of the action).

***3** Having positive knowledge of fraud is not required to commence the running of the two-year statute of limitations. *Watts v. Exxon Corp.,* 188 A.D.2d 74 (3rd Dept 1993). Rather, in order to start the limitations period regarding discovery, a plaintiff need only be aware of enough operative facts so that, with reasonable diligence, it could have discovered the fraud. *Id.* In other words, all

that is necessary are sufficient facts to suggest to a person of ordinary intelligence the probability that he/she "may have been defrauded." *Id.*

Therefore, even if every element of the fraud was not actually known, such as Beck and Goldman's scienter, plaintiffs had every opportunity to initiate a timely action for fraud upon information and belief[5] (along with negligent misrepresentation) when it first became aware, or should have become aware, that material misrepresentations had been made. Failure to do so is fatal a claim for fraudulent misrepresentation, as barred by the statute on limitations. *See Waters of Saratoga Springs, Inc. v. State of New York,* 116 A.D.2d 875 (3rd Dept) affirmed, 68 N.Y.2d 777 (1986).

There is ample evidence cited in the record pointing to plaintiffs' actual knowledge, before May 5, 2003, of Beck's alleged misrepresentation of the tipping fee projections which were published in the Official Statement. A non-exhaustive list is as follows:

1. October 6, 1999: After meeting with the plant operator, plaintiff's research director, Mike Maher and analyst Rocco Gagliardi wrote that "per the Official Statement," "tipping fees are low in the area right now." Maher cautioned: "short term operations and profitability of the facility has to be questioned."

(Exhibit 5, Barrett Affidavit).

2. April 28, 2000: Gagliardi learned from the plant operator that "lower than expected tipping fees" partly caused "a loss of over $3 million in revenues." Senior portfolio manager Joseph Deane testified that this loss was "meaningful" and he was "aware that tipping fee income was less than projected in the Official Statement ." (Exhibit 9, Barrett Affidavit).

3. March 29, 2001: Maher and Gagliardi received the first of regular monthly updates with detailed financial information from the plant operator. Actual tipping fees averaged $9.81 to 10.42 per ton compared to projected $20.04. (Exhibit 19, Barrett Affidavit).

4. May 2001: Deane admitted it was "Maher's responsibility in May of 2001" to "look into why the tipping fees ... were substantially lower" than projections in the Official Statements; Deane was "sure" Maher had done so. (Exhibit 75, Barrett Affidavit).

5. July 2001: Plaintiffs hired outside engineer David Ross to "evaluate and opine [on] the facility," including its operations and tipping fee problems. (Exhibit 76; 30; Barrett Affidavit).

6. July 13, 2001: Portfolio manager David Fare e-mailed Smith Barney Fund Management executives McLendon, Cumming, Deane, Coffey, Maher and in-house counsel Gordon Swartz, stating: "[T]he project has not been able to improve its financial position and has now depleted the debt service reserve fund. At this time we have no reason to believe that the project is likely to show any improvement in the near term." (Exhibit 26, Barrett Affidavit).

***4 7. July 13, 2001:** When asked why Fare e-mailed in-house counsel Swartz, Deane admitted that the Bonds were "uncomfortably below par. In case some legal action at some point in time in the future had to take place we wanted to keep them in the loop." (Exhibit 75, Barrett Affidavit).

8. September 5, 2001: Maher and Gagliardi received regular monthly updates from the plant operator. Actual tipping fees averaged $9.22 per ton in July 2001, compared to projected $20.04. (Exhibit 31, Barrett Affidavit).

9. October 12, 2001: Bonds are placed on internal "credit concerns" watch list due to "severe cash flow problems ... tipping fees much lower than anticipated ... no debt service monies available-need to restructure the debt or sell the plant ..." (Exhibit 33, Barrett Affidavit).

10. May 23, 2002: Smith Barney's research and legal departments "reviewed and approved" a Standstill Agreement which acknowledged "unanticipated shortfalls in projected revenues"; "failure[s] to pay or provide for payment of principal and interest"; and that Plant operator "anticipates ... similar events of default" in the future." (Exhibit 50; 78, Barrett Affidavit).

11. August 13, 2002: Smith advised Maher, Gagliardi and Ross of a Detroit News article reporting that the Central Wayne municipalities had "hired an attorney in case the [Plant operator] files for bankruptcy" because the Project did "not have significant cash flow to meet their payment bonds ... that sent up a red flag." (Exhibit 52, Barrett Affidavit)

12. December 12, 2002: Plant operator discusses with Maher possibly shutting down the Project due to cash flow shortages. (Exhibit 58; 78 Barrett Affidavit)

13. January 3, 2003: Monthly operations report sent to Maher and Gagliardi reported actual tipping fees for year 2002 averaged $11.78 per ton compared to $20.58 projected in the Official Statement. (Exhibit 59; 82 Barrett Affidavit).

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14. May 2, 2003: Plaintiffs valued Bonds at only 25[cents] on the dollar. Plaintiffs' financial statements filed with the SEC showed write down totaling nearly $38 million of the original $50.5 million investment. (Exhibit 7, Barrett Affidavit).

Plaintiffs argue that these known, undisputed facts evidencing the Project's poor performance, which was substantially accredited to the (also known, undisputed) disparity between actual and projected tipping fees, *did not* suggest the probability to the plaintiffs that they may have been defrauded. Rather, plaintiffs point to mechanical failures and operational issues that "overshadowed" and were "intertwined with" the changing market that negatively affected tipping fees. Plaintiffs assert their ignorance of the probability of being defrauded until July 2003, when the Project ultimately failed. This Court is not persuaded.

It is undisputed that tipping fees were a primary source of the Project's revenue stream and substantially affected the value of the Bonds. It is of no consequence that other factors contributed to the Project's failure. The very predicate to the plaintiffs' fraud claim were the misrepresentations in the Official Statement that clearly came to light between 1999 and 2001, more than two years prior to filing suit. Therefore, the complaint is time-barred.

***5** Notwithstanding the above dispositive analysis, it is clear from the numerous instances of red flags that became apparent throughout the Project, that consist mostly of reports of massive Bond value loss, that a duty to investigate a possible fraud was triggered long before May 5, 2003.

In May 2001, Deane admitted in his deposition that it was Maher's responsibility to look into the cause for low tipping fees. This is a clear admission that plaintiffs possessed enough operative facts in 2001 to trigger a duty to inquire, thus commencing the two-year limitations period. It is unclear from the record what, if any, conclusions were made after Maher's supposed inquiry, or if such an inquiry was diligently undertaken. Nonetheless, no lawsuit was initiated at that time. It can only be concluded that plaintiff failed to conduct a diligent inquiry, or otherwise failed to act on the fruits of a diligent investigation. If the former, the complaint is time barred. CPLR 213(8). If the latter, the complaint is time barred. *Cruden v. Bank of New York,* 957 F.2d 961 (2nd Cir1992) (when a plaintiff "shuts his eyes to the facts which call for investigation, knowledge of the fraud will be imputed to him.")

Lastly, the law imposes an affirmative duty on sophisticated investors to protect themselves from misrepresentations made during business acquisitions by investigating the details of the transactions and the business they are acquiring. *Global Mins. & Metals Corp. v. Holme,* 35 AD3d 93 (1st Dept 2006), appeal denied, 8 NY3d 804 (2007). Plaintiffs are indisputably sophisticated investors that failed to adequately or timely investigate the market for waste disposal in Michigan prior to purchasing over $50 million in municipal bonds. If plaintiffs had endeavored to conduct meaningful vetting of the Project at its inception, the record suggests that public information would have exposed the poor state of the market for waste disposal and Beck's inflated and allegedly fraudulent tipping fee report.

On this record, the facts of the fraud claim against defendants, to the extent that they were not already known, could have been discovered with the exercise of due diligence more than two years before the action was commenced. Therefore, the complaint must be dismissed as untimely, and judgment entered in favor of defendants.

All further arguments were considered and found unavailing.

All Citations

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Footnotes

1 The facts have been gleaned from the Rule 19A Statements submitted by the parties and the Court's independent analysis of the supporting affidavits and exhibits.

2 It should be noted that "the burden of establishing that the fraud [was not or] could have been discovered before the two-year period prior to the commencement of the action rests on the plaintiff, who seeks the benefit of the exception." *Lefkowitz v. Appelbaum,* 258 A.D.2d 563 (2nd Dept 1999).

3 It should be noted that on this record, such a claim would not have been dismissed on particularity grounds. The purpose of CPLR 3016(b)'s pleading requirement is to inform a defendant with respect to the incidents complained of. *Pludeman v. Northern Leasing Sys., Inc.,* 10 NY3d 486 (2008).

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