

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

**UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
SOUTHERN DIVISION**

ILLINOIS UNION INSURANCE CO.,

Plaintiffs,

vs.

**BROOKSTREET SECURITIES CORP.
ET AL.,**

Defendants.

Case No.: SACV07-01095-CJC(RNBx)

**ORDER GRANTING IN PART AND
DENYING AS MOOT IN PART
PLAINTIFF'S MOTION FOR
SUMMARY JUDGMENT**

INTRODUCTION

This case arises from several disputes between Brookstreet Securities Corporation (“Brookstreet”), a California financial services company, and its clients. Plaintiff Illinois Union Insurance Company, (“Illinois Union”) provided professional liability insurance to Brookstreet and its employees, officers and directors. (First Amended Compl. (“FAC”) ¶¶ 137- 138.) Illinois Union brought this action for interpleader and provided a \$3

1 million bond to the clerk of the court. (FAC ¶ 2.) Illinois Union now moves for
2 summary judgment as to claimants whose claims arise out of Collateralized Mortgage
3 Obligation (CMO) investments. For the following reasons, Illinois Union’s motion for
4 summary judgment is GRANTED¹ in part and DENIED AS MOOT in part.²

5
6 **BACKGROUND**

7
8 In early 2007, Brookstreet was a licensed securities broker-dealer, providing
9 services to clients nationwide. Brookstreet experienced a financial collapse in mid-2007
10 and ceased operations in June of 2007. Brookstreet is now apparently insolvent. Illinois
11 Union provided Brookstreet with a Securities Broker-Dealer Professional Liability
12 Insurance Policy (“the Policy”) covering the period from November 8, 2006 to
13 November 8, 2007. The Policy contains three separate insuring agreements that cover
14 “Wrongful Acts” in the rendering of various “Professional Services.” Section
15 IV.(W.)(1.) of the policy provides:

16
17 The Insurer shall not be liable for Loss on account of any Claim made
18 against the Insured: Based upon, arising out of, or attributable to the sale,
19 attempted sale, or servicing of:

20
21 ¹ Having read and considered the papers presented by the parties, the Court finds this matter
22 appropriate for disposition without a hearing. See FED. R. CIV. P. 78; LOCAL RULE 7-15.
23 Accordingly, the hearing set for November 23, 2009 at 3:30 p.m. is hereby vacated and off
calendar.

24 ² There are twenty-two Defendants addressed by the current motion. Several Defendants were
25 also referred to in Illinois Union’s motion for summary judgment as to claims that were either
26 made late, reported late or not timely noticed, filed September 30, 2009 (“late claims motion”).
27 These Defendants include Gerard and Benita Axel, Andrew and Joyce Eisenberg, Paulette Haim
28 and her daughter Denise Marino, Warren Kornfeld, Herman and Gloria Nadler and their
daughters Linda Nadler and Jacqueline S. Mishory, Joseph Nemeth, Claudia Johnson, Lyle
Fettig, Judy Schulman and Murray Bieda. The Court has granted Illinois Union’s late claims
motion for summary judgment as to these Defendants, accordingly, Illinois Union’s motion as to
these Defendants for the purposes of this motion is DENIED as moot.

- 1 1. Commodities, commodity future contracts, any type of option contract or
2 derivative.

3 (Aizley Decl., Ex. A.) The Policy does not define the term “derivative.” A “Claim” is
4 defined as “1. A written demand for monetary damages; 2. A civil proceeding
5 commenced by service of a complaint or similar pleading; and/or 3. An arbitration
6 proceeding.” (Decl. Aizley, Ex. A.)
7

8 Remaining Defendants not addressed by the late claims motion are Steven and Helene
9 Lipshutz, Stuart Miller, Gary Wiesman, Judith Chiosso Glass, and Sharon Larocque.
10 These Defendants are represented by two groups of attorneys: Wagner/Blum and Mr.
11 Liebrader. Mr. Wagner represents Steven and Helene Lipshutz, Stuart Miller,
12 Individually and as Trustee of the Stuart Miller Trust, and Gary Wiesman (collectively
13 “Wagner Defendants”). Mr. Liebrader represents Judith Chiosso Glass and Sharon
14 Larocque (collectively “Liebrader Defendants”). All of the remaining Defendants allege
15 that Brookstreet caused them financial losses due to improper investing in Collateralized
16 Mortgage Obligations (CMOs). The Court will address each group’s claims by attorney
17 group.
18

19 **1. Wagner/Blum Defendants**
20

21 As noted, Avi Wagner represents four of the remaining Defendants. The Statements
22 of Claim for arbitration filed on behalf of these Defendants were materially similar and
23 included the following “Brief Summary of the Facts”:
24

25 This is a unique case involving an esoteric product called Collateralized
26 Mortgage Obligation (“CMO”) derivatives. Brookstreet and its agents
27 routinely ran newspaper ads, radio shows and seminars promoting
28 themselves . . . as expert financial advisors who could create suitable
retirement portfolios utilizing, in part CMO’s. Brookstreet routinely told its
clients that they were buying AAA rated, government-backed bonds which

1 would provide the client with a significant return on their investment without
2 any risk to the client's principal. In reality, Respondents were trading risky
3 CMO derivatives which exposed their clients to tremendous risk due to the
4 highly sensitive and volatile nature of the product itself. Brookstreet and its
5 agents knowingly and intentionally lied to their clients about the risks
6 involved with investing in these "bonds" so that they could generate huge
7 commissions, fees, markups and other trading profits for themselves because
8 CMO derivatives trade on a shadow market, frequently with large spreads
9 due to their volatility, among other reasons.

10 (Decl. Aizley, Exs. F, G, J.) The Statements go on to allege that the Defendants suffered
11 serious financial losses as a result of inappropriate investments in CMOs, churning of
12 CMO accounts, and charging excessive margins on CMO accounts. (Decl. Aizley, Exs.
13 F, G, J.)

14 **2. Liebrader Defendants**

15 As noted, Mr. Liebrader represents Ms. Chiosso and Ms. Larocque. The Statements
16 of Claim allege the following:

17 This is a claim for the recovery of investment losses . . . Brookstreet, with
18 the aid of its clearing firm National Financial Services engaged in conduct
19 that caused the loss of over [tens of thousands] of Claimant's . . . savings.
20 The losses occurred through trading activity in what was described as an
21 Institutional Bond Fund, but was, in fact, a portfolio of illiquid, highly
22 leveraged collateralized mortgage obligations ("CMOs").

23 (Decl. Aizley, Ex. S at ¶ 10, Ex. T at ¶ 9.) Both Ms. Chiosso's and Ms. Larocque's
24 Statement of Claim alleges that their accounts were "invested 100%+ in a toxic mess of
25 CMOs including interest only derivative securities and inverse floaters – securities
26 completely inappropriate for an investor whose stated objective was saving for
27 retirement." (Decl. Aizley, Ex. S at ¶25, Ex. T at ¶ 22.) The complaints go on to allege
28

1 losses arising from these improper investments, churning, and charging excessive
2 margins.

3 4 5 **LEGAL STANDARD**

6
7 Summary judgment is proper if the evidence before the Court “show[s] that there is
8 no genuine issue as to any material fact and that the movant is entitled to judgment as a
9 matter of law.” FED. R. CIV. P. 56(c); *see also Celotex Corp. v. Catrett*, 477 U.S. 317,
10 322 (1986). A factual issue is “genuine” when there is sufficient evidence such that a
11 reasonable trier of fact could resolve the issue in the non-movant’s favor, and an issue is
12 “material” when its resolution might affect the outcome of the suit under the governing
13 law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). The moving party bears
14 the initial burden of demonstrating either that there are no genuine material issues or that
15 the opposing party lacks sufficient evidence to carry its burden of persuasion at trial.
16 *Celotex Corp. v. Catrett*, 477 U.S. at 325; *T.W. Elec. Serv., Inc. v. Pac. Elec. Contractors*
17 *Ass’n*, 809 F.2d 626, 630-31 (9th Cir. 1987). Once this burden has been met, the party
18 resisting the motion “must set forth specific facts showing that there is a genuine issue for
19 trial.” *Anderson*, 477 U.S. at 256. In considering a motion for summary judgment, the
20 court must examine all the evidence in the light most favorable to the non moving party.
21 *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962). The court does not make
22 credibility determinations, nor does it weigh conflicting evidence. *Eastman Kodak Co. v.*
23 *Image Tech. Servs., Inc.*, 504 U.S. 451, 456 (1992).

24 25 **ANALYSIS**

26
27 The heart of this dispute centers on whether CMOs are derivatives. Illinois Union
28 contends that they are. Additionally, Illinois Union asserts that since the Defendants’

1 Claims rest on the allegation that Brookstreet improperly directed their funds to CMOs,
2 the Defendants' claims are not covered because the Policy excludes coverage for Claims
3 "[b]ased upon, arising out of, or attributable to the sale, attempted sale, or servicing of . . .
4 derivatives." (Decl. Aizley, Ex. A.) To support its argument, Illinois Union presents
5 several cases in which courts have discussed CMOs extensively and described CMOs as
6 derivatives. *E.g.*, *Rodney v. KPMG Peat Marwick*, 143 F.3d 1140, 1142 (8th Cir. 1998);
7 *Banca Cremi, S.A. v. Alex Brown & Sons, Inc.*, 132 F.3d 1017, 1022-23 (4th Cir. 1997);
8 *Familienstiftung v. Askin Capital Mgmt.*, 178 F.R.D. 405, 408 (S.D.N.Y. 1998); *In re*
9 *TCW/DW North Am. Govt. Income Trust Securities Lit.*, 941 F. Supp. 326, 329 (S.D.N.Y.
10 1996). The Wagner Defendants fail to squarely address these authorities, choosing
11 instead to argue that CMOs are not derivatives by relying on inapposite SEC definitions,
12 "colloquial financial industry usage," and speculation about Brookstreet's intent when
13 agreeing to the Policy. (Opp. Summary Judgment at 17-20.) The Liebrader Defendants
14 also do not address these authorities and do not offer responsive evidence, instead, they
15 appear to argue that the Brookstreet accounts suffered from massive churning related to
16 CMO accounts, which is distinguishable from losses arising from CMOs, and that Illinois
17 Union has not identified the asset from which the CMOs derived their value.

18
19 In *Banca*, the Court explained that "CMOs, first introduced in 1983, are securities
20 derived from pools of private home mortgages backed by U.S. government-sponsored
21 enterprises." *Banca*, 132 F.3d at 1022. The Court went on to describe the basic concept
22 underlying a CMO:

23
24 A CMO issuer begins with a large pool of home mortgages, often worth
25 billions of dollars. Each pool of home mortgages generates two streams of
26 income. The first income stream is the aggregate of all interest payments
27 made on the underlying mortgages. The second income stream is the
28 aggregate of all principal payments made on the underlying mortgages.
These income streams are divided into numerous CMO "tranches," which
are the securities sold to investors. To determine what portion of the two

1 income streams are received by an investor in a CMO tranche, each tranche
2 has two unique formulae: one that determines the tranche's interest rate, and
3 the other that determines the tranche's principal repayment priority.

4 *Banca*, 132 F.3d at 1022. The Securities and Exchange Commission website explains
5 that derivatives:

6
7 are financial instruments whose performance is derived, at least in part,
8 from the performance of an underlying asset, security or index. For
9 example, a stock option is a derivative because its value changes in relation
10 to the price movement of the underlying stock.

11 U.S. Securities and Exchange Commission Website,
12 <http://www.sec.gov/answers/derivative.htm> (last accessed November 19, 2009.)
13

14
15 To demonstrate that CMOs are derivatives, Illinois Union has referred to the Real
16 Estate Investor's Deskbook, which provides:

17
18 A collateralized mortgage obligation (CMO) . . . is secured by a pool of
19 mortgages often originated by multiple lenders in different parts of the
20 country. . . . [M]any investors do not want to buy the typical pass-through
21 security because of the uncertainty of principal repayments. The CMO,
22 which was created in 1983 by Freddie Mac, solved this problem by being a
23 'derivative security.' Instead of distributing the cash flow from the
24 underlying mortgage pool pro rata among the various security holders, a
25 CMO allocates the cash flow from the underlying mortgage pool in
26 accordance with a predetermined plan. Because the special allocation
27 changes the normal distribution of cash flow, the CMOs are a different kind
28 of asset from the underlying securities even though the CMO distributions
are derived from the underlying mortgages. Hence, the term 'derivative.'

1 Alvin Arnold, *Real Estate Investor's Deskbook* at § 6.75 (3d Ed. 2009). Additionally,
2 numerous courts that have discussed CMOs have understood them to be derivatives.
3 *Rodney*, 143 F.3d at 1142 (“The Fund also traded heavily in a variety of mortgage-
4 backed derivatives. These included collateralized mortgage obligations (CMOs) . . .”);
5 *Cremi v. Brown*, 955 F. Supp. 499, 501-02 (D. Md. 1997), *aff'd* 132 F.3d 1017 (4th Cir.
6 1997); *Familienstiftung*, 178 F.R.D. at 408 (“CMOs are derivative securities that
7 represent distinct interests in the cash flow generated by an underlying collateral pool of
8 residential mortgages.”); *see also Hamilton v. Carell*, 243 F.3d 992, 994 (6th Cir. 2001);
9 *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 935-36
10 (2d Cir. 1998). Even the Wagner Defendants, in their Statements of Claim for
11 arbitration, repeatedly referred to CMOs as derivatives. (Decl. Aizley, Exs. F, G, J.)
12

13
14 Neither the Wagner Defendants nor the Liebrader Defendants offer persuasive
15 authority or evidence to suggest that CMOs are not derivatives.³ The Wagner Defendants
16 refer to “colloquial financial industry usage” to suggest that CMOs are not derivatives.
17 To support this, they rely on their own Statements of Claim, which allege that
18 Brookstreet employees solicited them to invest in ‘bonds.’ (Wagner Opp. at 19.)
19 Defendants’ own allegations concerning Brookstreet’s representations are not evidence
20 of “colloquial financial usage” sufficient to create a dispute as to whether CMOs are
21 derivatives. The Wagner Defendants also offer vague and unsupported arguments about

22
23 ³ The Wagner Defendants offer a definition of “derivative securities” promulgated by the SEC
24 in its regulations. The regulation defines “derivative securities” as any “option, warrant,
25 convertible security, stock appreciation right, or similar right with an exercise or conversion
26 privilege at a price related to an equity security . . . with a value derived from the value of an
27 equity security.” 17 C.F.R. § 240.16a-1. The regulation is explicit, however, that this definition
28 only applies to Section 16 of the Securities and Exchange Act of 1934, which regulates
disclosure requirements for directors, officers and principal stockholders. *Id.* In light of the fact
that the purpose of Section 16 is to require directors, officers and principal stockholders to
disclose their ownership interest in equity securities, it would make sense that the definition
would not refer to anything but equity securities. Accordingly, the Court does not find it
appropriate to apply that definition to this context.

1 what Brookstreet must have understood when it bought the Policy. (Wagner Opp. at 20.)
2 Such bald assertions are not sufficient to create a dispute as to whether the policy is
3 ambiguous. *Soremekun v. Thrifty Payless, Inc.*, 509 F.3d 978, 984 (9th Cir. 2007)
4 (“Conclusory speculative testimony in affidavits and moving papers is insufficient to
5 raise genuine issues of fact and defeat summary judgment.”) The Liebrader Defendants
6 merely suggest that certain types of CMOs might not be derivatives and so the exclusion
7 is ambiguous. Other than the Liebrader Defendants’ mere assertions that the Policy is
8 ambiguous, the Liebrader Defendants have offered no evidence to support these
9 statements. *Id.* The Court does not find that these statements create an issue of fact as to
10 whether the Policy is ambiguous. In light of the wealth of authority presented by Illinois
11 Union and the lack of evidence or persuasive argument presented by the Defendants, the
12 Court is convinced that CMOs are derivatives within the definition of the Policy.
13 Accordingly, claims “[b]ased upon, arising out of, or attributable to the sale, attempted
14 sale, or servicing” of CMOs are not covered. (Decl. Aizley, Ex. A.)

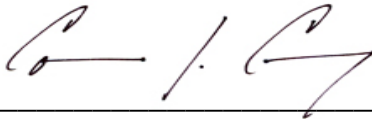
15
16 In the alternative, the Wagner claimants argue that even if the Court were to
17 conclude that CMOs are derivatives, the Defendants include non-CMO related
18 allegations in their claims, including improperly and fraudulently using margin, churning,
19 and adverse tax consequences. (Wagner Opp. Summary Judgment at 21-22.) While this
20 argument might give the illusion that these sorts of claims are not addressed by the
21 exclusion, the Statements of Claim are all predicated solely on losses arising from
22 investment in CMOs. Accordingly, the Defendants’ damages are “[b]ased upon, arising
23 out of, or attributable to the sale, attempted sale, or servicing of” CMOs, or, derivatives.
24 (Decl. Aizley, Ex. A.)

25
26
27 **Conclusion**
28

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

For the foregoing reasons, Illinois Union’s motion for summary judgment is GRANTED in part and DENIED AS MOOT in part.

DATED: November 20, 2009



CORMAC J. CARNEY
UNITED STATES DISTRICT JUDGE