

Update

Spring 2009

Domestic Producers Bring \$700M Class Action Against Sureties of Customs Bonds

Sioux Honey Association, et al v. Hartford Fire Insurance Company, et al, in the United States Court of International Trade, Court No. 09-00141

This creative complaint, filed by John Heintz of Kelley Drye, seeks \$700M in damages from insurance companies that issued surety bonds for imports subject to antidumping duties assessed by U.S. Bureau of Customs (“Customs”). If successful, this action could reek financial havoc for the named sureties and their reinsurers.

In the complaint, certain domestic producers, the class action plaintiffs, bring suit against 17 insurance companies (the “sureties”) that posted customs surety bonds that allowed businesses to import food products from China at “dumping” prices, causing the domestic producers financial harm. The complaint alleges that the insurers negligently issued customs surety bonds to thinly capitalized companies that were not credit worthy. These importers have now defaulted on paying hundreds of millions of dollars in dumping duties assessed by Customs and guaranteed by the sureties. Although neither the importers nor the sureties have paid the duties Customs has made little or no effort to prosecute any collections lawsuits against them. Two antidumping rules go to the core of this case.

When a foreign producer sells his goods for export to the U.S. below prices at which they are sold in the home market and when such sales injure a domestic industry, the government can collect an antidumping duty equal to the amount by which merchandise in the home market exceeds the price of the same merchandise for export to the U.S. Only two elements need be shown by the complaining domestic industry – that the merchandise is being sold below fair value and that it is causing injury to the members of the U.S. industry. The imposition of these special duties is permitted under an international Trade Agreement, the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade, 1994.

The Department of Commerce (“Department”) conducts the less than fair value investigation in two phases – the preliminary and the final phase. The preliminary determination is based exclusively on the information furnished by the foreign producers, without either verification of the accuracy of the data by the Department, or scrutiny of the data by the domestic industry. Because the preliminary findings are made so early in the investigation, and so likely to be subject to adjustment, Federal Regulations require only that these importers post either cash or a surety bond for the potential payment of the duties. Once a bond is posted or cash deposited, the goods are available for release upon importation. The federal remedy lies now exclusively against the posted cash or surety, and the government releases its lien over the goods. Once the preliminary antidumping finding becomes final, and an antidumping duty order is imposed, absent unusual circumstances, importers are required to post cash equal to the amount by which the merchandise was found to be sold below fair value. The certainty of the final order extinguishes the alternative of the surety bond.

Second, during the period recited in the complaint, federal law required that Customs treat a dumping duty entirely differently from an ordinary duty. As most

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of us learned in civics class, from the Tariff Act of 1789 until the passage of the Internal Revenue Act of 1914, the primary method by which the federal government collected revenue was through the imposition of customs duties. However, in 2000, during the time of the importations which are the subject of this complaint, Congress enacted an amendment to the antidumping law (known as the Byrd Amendment) that required that Customs distribute antidumping duties collected to those industry members that were injured by the less than fair value sales. Thus, these customs duties took on a very different character. Arguably, these duties ceased being federal revenues and became “other people’s money” merely collected by Customs. The Byrd Amendment has since been repealed, but while it was in effect, it created an entirely new paradigm that Heintz hopes to exploit.

The difficulty for plaintiffs is that they are not parties to the contracts that resulted in the issuance of the bonds i.e., they are not in privity with the sureties. Surety is a three party relationship – principal (importer of dumped merchandise), obligee (Customs) and guarantor (the sureties). The principal posts the bond and obligee calls on that bond, in accordance with its terms, at its discretion. Although the domestic industry is not a party to any of the bonds at issue, the complaint contends that they are third party beneficiaries whose rights have been unlawfully compromised by Customs.

CEO Concealment Of Debt Triggers Exclusion Of Two Insurers’ D&O Liability Coverage To All Former Refco Directors And Officers

XL Specialty Insurance Co. v. John D. Agolia, et al, 2009 U.S. Dist. LEXIS 16244 (S.D. N.Y. Mar. 2, 2009)

The former officers and directors of Refco, Inc. (“Refco”), the bankrupt commodities and futures broker, now face an avalanche of litigation, resulting from the CEO’s concealment of \$430 million in uncollectible receivables, without the full protection of the company’s D&O insurance. In a recent ruling, the U.S. District Court for the Southern District of New York dismissed the claims of Refco’s former officers and directors against two excess of loss insurers from whom they sought indemnity and defense under D&O liability policies based on a prior known acts exclusion.

Refco’s D&O insurance consisted of a primary policy and five excess of loss policies, totaling \$70 million coverage. The two policies in question, issued by Allied World Assurance, Co., Inc. (“Allied”) and Arch Insurance Co., (“Arch”) provided the third and fourth layers, respectively. Obtained by Refco to cover the period of August 11, 2005 through August 10, 2006 in advance of its initial public offering, the policies both provided coverage that followed the form of the underlying policy.

Beginning in the late 1990s, Refco’s CEO had been concealing uncollectible debts that he successfully hid from the company’s auditors and insurers through fraudulent loan transactions with Refco Group Holdings, Inc., an entity he controlled. The scheme effectively inflated the value of the company and misrepresented the performance of its investments. Discovery of the scheme in 2005 led Refco to disavow its financial statements, plunging the company into bankruptcy and igniting a storm of litigation against the company as well as its officers and directors.

The primary D&O policy included a full severability clause providing that knowledge or information of one insured could not be imputed to any other insured. Such a clause is intended to protect innocent insureds from the conduct of their colleagues. However, the Allied and Arch policies each contained a prior knowledge exclusion (“PKE”). The PKE provided that the insurers would not be liable for any claims or losses arising from facts of which “any Insured” had knowledge prior to inception of coverage.

Aside from its CEO, Refco’s officers and directors apparently had no knowledge of the debt concealment and sought coverage in reliance upon the severability clause. In resolving the conflicting language of the underlying and excess policies, Judge Gerard E. Lynch held that the language of the excess policies superseded the language of the primary policy. The excess policies followed the form of the primary policy except where the excess policy explicitly deviated from or limited the underlying coverage. Judge Lynch found that the excess policy superseded the primary policy in the event of a conflict. The PKE in the two excess policies excluded from coverage all of the former officers and directors of Refco because the multiple claims against the insureds resulted from Refco’s debt concealment, a fact not disclosed to the insurers.

The Court denied the insureds’ motion for summary judgment, and granted Allied’s and Arch’s motions for summary judgment.

Judge Lynch went on to deny XL Specialty Insurance Company's (the 5th layer) motion for summary judgment motion using the same reasoning. Where the Allied and Arch policies followed form with the primary policy to the extent that the primary policy did not conflict with the excess policy, the XL policy did not follow form. Instead, the XL policy included its own severability clause as well as a PKE. The XL policy specifically stated that all other terms of the policy "shall remain unchanged" by the inclusion of the PKE. Judge Lynch found that the exclusion did not supersede the policy's severability clause, and therefore denied XL's motion for summary judgment.

An Arbitration Award Finding No Monetary Damages Eliminates Federal Jurisdiction

Hansen Beverage Company v. DSD Distributors, Inc., 2008 U.S. Dist. LEXIS 101022 (S.D. Cal., Dec. 12, 2008)

In the recent case of *Hansen Beverage Company v. DSD Distributors, Inc.*, 2008 U.S. Dist. LEXIS 101022 (S.D. Cal., Dec. 12, 2008) a federal trial court in California held that it did not have subject matter jurisdiction under the Federal Arbitration Act to confirm an award in which no monetary damages were assessed by the panel. Consequently, the court dismissed the action. It has long been recognized that the FAA does not provide an independent basis for subject matter jurisdiction in federal courts. Rather, parties seeking to enforce rights under the FAA must establish either that the controversy involves a "federal question" or that there is "diversity of citizenship" among the parties. In the context of reinsurance arbitrations, subject matter jurisdiction of an action under the FAA almost always must be based on diversity of citizenship grounds because reinsurance disputes rarely involve federal questions. To establish the existence of diversity jurisdiction, the party filing the lawsuit must allege two things. First, it must be demonstrated that each party to the action is of diverse citizenship, that each party is a citizen of a different state. For a corporation citizenship is determined by reference to the corporation's state of incorporation or state of its principal place of business. If both the cedent and the reinsurer are citizens of the same state, diversity will be lacking, and a federal court will not have subject matter jurisdiction. The second requirement to establish "diversity" jurisdiction is that the "amount in controversy" exceeds \$75,000.

The court concluded that since the arbitrators awarded no monetary relief, there was no amount in controversy and the \$75,000 threshold had not been satisfied. Accordingly,

the court held that the diversity jurisdiction requirements had not been satisfied and that it, therefore, lacked subject matter jurisdiction. The party seeking confirmation of the arbitral award argued that the value of the matter in dispute in the arbitration exceeded \$75,000 which satisfied the amount in controversy requirement. The court rejected this argument, noting that neither party sought to "reopen" the arbitration, that is, to vacate the award. Although this issue was not before the court, it discussed cases in which federal courts had found that the amount in controversy requirement was satisfied in a case in which the arbitrators awarded no monetary relief if one of the parties sought to vacate the award and reopen the arbitration to pursue recovery of a claim worth in excess of \$75,000.

Whether or not a party may bring an action in federal court to confirm or vacate an arbitration award may depend upon the form of relief granted by the arbitrators. In a typical reinsurance arbitration, the cedent seeks to collect money damages that almost always exceed \$75,000. If the cedent prevails and obtains an award in excess of that amount, and assuming the parties are of diverse citizenship, a federal court would have subject matter jurisdiction to entertain a petition to confirm or vacate that award. But what if the arbitrators rule in favor of the reinsurer and award no monetary relief? If the reinsurer were to seek to have that award confirmed, and if the cedent did not seek to vacate the award, the federal court would not have subject matter jurisdiction if the *Hansen* decision were followed. This is probably a somewhat unusual factual situation, but it could occur if the reinsurer thought that the issue resolved by the arbitrators was important enough to warrant confirmation by a federal court. In that same example, if the cedent had sought to vacate the award so that it could continue to pursue its claims for damages in excess of \$75,000, the federal court would have subject matter jurisdiction under the *Hansen* decision. Although the recent U.S. Supreme Court decision of *Vaden v. Discover Bank*, 129 S. Ct. 1262 (U.S. 2009) addressed other issues, there is language in that decision discussing federal subject matter jurisdiction under the FAA which suggests that the Supreme Court may agree with the result in *Hansen*.

The importance of the *Hansen* decision is that parties to arbitrations need to be aware of limitations on their right to seek relief in federal court. Occasionally, parties to arbitration awards are citizens of the same state that eliminates diversity jurisdiction. The *Hansen* decision illustrates another limitation on federal jurisdiction: the failure to satisfy the amount in controversy requirement.

Beneficiary Of Surety Bonds Lacks Standing To Assert Direct Action Against Reinsurer

Jurupa Valley Spectrum LLC ("Jurupa") v. National Indemnity Co. ("NICO") and National Liability & Fire Ins. Co., 555 F.3d 87 (2nd Cir. N.Y., 2009)

In a claim by a beneficiary of surety bonds against the reinsurer of an insolvent bond issuer, the Second Circuit affirmed the District Court's dismissal of the claim for, *inter alia*, lack of contractual privity.

In *Jurupa Valley Spectrum LLC ("Jurupa") v. National Indemnity Co. ("NICO") and National Liability & Fire Ins. Co.*, 555 F.3d 87 (2nd Cir. N.Y., 2009), Jurupa entered into a construction contract with Aaron Management, Inc. ("Aaron") on February 1, 1999, for Aaron to build a movie theater. The parties secured the contract with two surety bonds, a performance bond and a payment bond, each in the amount of \$6,285,000. Frontier Insurance Company ("Frontier") executed the bonds with Aaron as principal and Jurupa as obligee. The bonds provided that if Aaron failed to perform according to the construction contract that Frontier would become liable for the immediate payment to Jurupa of all amounts due under the contract. Aaron defaulted under the contract on August 6, 1999. On January 26, 2000, Jurupa notified Frontier of Aaron's default and demanded immediate payment. No payment was made.

On June 6, 2000, the U.S. Treasury Department reported that Frontier lost its eligibility to provide surety bonds. Thereafter, Frontier and NICO entered into a \$490 million aggregate reinsurance agreement that provided that NICO would pay policyholders and other claimants *through the claims administrator*, on surety bonds issued by Frontier on or before December 31, 1999. The reinsurance agreement explicitly refrained from creating third party rights for those holding Frontier-issued bonds. On October 15, 2001, Frontier was put into rehabilitation. On January 1, 2004, NICO and Frontier amended their earlier agreement, now

providing that NICO would pay Frontier \$50 million and forgive \$140 million of Frontier's debt in exchange for a reduction in NICO's reinsurance obligations.

In 2006, Jurupa sued NICO in the U.S. District Court under the reinsurance agreement as well as New York Insurance Law Sections 1115 and 4118. New York Insurance Law limits a surety's ability to expose itself to certain significant risks without guaranteeing policyholder rights. Section 1115 prohibits an insurer from issuing a surety bond for an amount greater than 10% of its surplus to policyholders. Under section 4118, however, a bond insurer can exceed this 10% cap on surety risks if they secure reinsurance that protects bond holders by permitting them to sue the reinsurer directly *i.e.*, providing a cut-through for policyholders to the reinsurance in the event of the issuer's insolvency. The District Court dismissed the action, finding that Jurupa lacked standing to bring a direct cause of action under the reinsurance agreement and that neither sections 1115 and 4119, based on the facts, provided any relief.

In affirming the dismissal, the Second Circuit repeated the often-quoted rule that a party lacking contractual privity cannot sue a reinsurer directly to obtain payment. The agreement between Frontier and NICO made clear that there was no third-party beneficiary to the reinsurance agreement. The circuit court also confirmed that section 4119 did not apply because at the time of issuance the face value of bonds did not exceed 10% of Frontier's statutory surplus. Moreover, neither 1115 nor 4118 establishes an independent, statutory case of action in the event that a reinsurance agreement fails to contain a required cut through clause. Finally, the circuit court, agreed with the lower court that the agreement was one of indemnity and not assumption reinsurance.

The Insurance & Reinsurance Practice Group represents domestic and foreign insurance and reinsurance companies in reinsurance arbitrations and in litigation in state and federal courts. The Group also counsels insurers and reinsurers on a wide variety of issues, including coverage, claims, reserve adequacy, commutations, insolvency, contracts, regulatory matters and transactional matters.

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