

Insurance Co. of the State of Pa. v HSBC Bank USA

2007 NY Slip Op 32715(U)

August 14, 2007

Supreme Court, New York County

Docket Number: 0600432/2004

Judge: Charles E. Ramos

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SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY
Charles Edward Ramos 53

PRESENT: _____
Justice

PART _____

Index Number : 600432/2004
INSURANCE CO OF THE STATE
vs
HSBC BANK USA
Sequence Number : 004
CONFIRM/REJECT REFEREE REPORT

INDEX NO. _____
MOTION DATE _____
MOTION SEQ. NO. _____
MOTION CAL. NO. _____

this motion to/for _____

PAPERS NUMBERED

Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...

Answering Affidavits — Exhibits _____

Replying Affidavits _____

Cross-Motion: Yes No

Upon the foregoing papers, it is ordered that this motion

FILED
AUG 31 2007
NEW YORK
COUNTY CLERK'S OFFICE

*decided in accord with the
attached decision.*

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE _____ FOR THE FOLLOWING REASON(S):

Dated: 8/14/07

HON. CHARLES E. RAMOS *J.S.C.*

Check one: FINAL DISPOSITION NON-FINAL DISPOSITION
Check if appropriate: DO NOT POST REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK:COMMERCIAL DIVISION
-----X
THE INSURANCE COMPANY OF THE STATE
OF PENNSYLVANIA,

Plaintiff,

-against-

HSBC BANK USA,

Defendant.

Index No.
600432/04

FILED

AUG 31 2007

NEW YORK
COUNTY CLERK'S OFFICE

Charles Edward Ramos, J.S.C.:

Plaintiff, The Insurance Company of the State of Pennsylvania ("ICSP"), moves pursuant to CPLR 4403 for an order confirming the report of Special Referee Walter Schackman dated November 15, 2006. Defendant HSBC Bank USA ("HSBC") cross-moves pursuant to CPLR 4403 to reject the Special Referee's report. Alternatively, HSBC moves pursuant to CPLR 2201 for a stay of additional proceedings until a decision has been reached by the Appellate Division on the issue of liability.

BACKGROUND

On February 19, 2004, plaintiff initiated this action alleging money had and received, unjust enrichment, constructive trust accounting and common law indemnity. ICSP commenced this action as a subrogee of the State of New York to collect unpaid cigarette tax stamp ("Unpaid Stamps") proceeds seized by HSBC during bankruptcy proceedings of its borrower. The Unpaid Stamps were purchased from the State of New York (the "State") by Herkimer Wholesale Company, Inc. ("Herkimer") during October and November 1997 and amounted to \$2.2 million. Herkimer was a non-operational food and beverage wholesaler which was a licensed

cigarette tax agent and is currently bankrupt. Herkimer's cash accounts were seized by HSBC during liquidation.

Herkimer purchased the cigarette tax stamps on thirty day credit terms and attached them to cigarette packages. They then collected the tax from retailers. As required by the State, Herkimer obtained a \$2.2 million bond (the "Bond") as security for Herkimer's obligation to pay for Unpaid Stamps. ICSP bonded Herkimer and named the State as an obligee.

HSBC was the principal lender to Herkimer, and thereby obtained a first priority blanket security interest in Herkimer's assets. On November 6, 1997, HSBC declared Herkimer to be in default in the amount of \$11 million. On November 10, 1997, certain of Herkimer's creditors (other than HSBC) commenced an involuntary Chapter 7 bankruptcy proceeding against Herkimer. Also on November 10, 1997, the State ceased selling cigarette tax stamps to Herkimer on credit.

The State has established that Herkimer failed to pay the State for \$2.2 million worth of cigarette tax stamps that were delivered to Herkimer between October 6 to November 7, 1997. On December 19, 1997, the State filed a proof of claim in the bankruptcy case. On January 6, 1998, the State made a claim on the bond to ICSP for the amount of \$2.2 million. On February 17, 1998, ~~ICSP filed a proof of claim in the bankruptcy case.~~ On February 24, 1998, the bankruptcy court lifted the automatic stay and authorized HSBC to exercise its rights against the collateral. On February 25, 1998, HSBC took possession of

Herkimer's assets.

By letter dated March 3, 1998, the State authorized HSBC to liquidate the cigarette inventory without license, so long as it complied with several conditions, including: (1) allowing the State to conduct an inventory of Herkimer's cigarette inventory; (2) returning all unaffixed cigarette tax stamps to the State; (3) selling the cigarette inventory to appropriately licensed parties only; and (4) provide information returns showing an accounting for the sale of the cigarette inventory. HSBC complied. After liquidation, HSBC received the proceeds of the sales of Unpaid Stamps by Herkimer from two sources as a result of the bankruptcy: (1) the funds deposited into a cash collateral account established during the bankruptcy and (2) the proceeds of accounts receivable. The proceeds were applied by HSBC to further reduce Herkimer's debt to HSBC.

On December 14, 2000, the State filed an action under the bond against ICSP in Albany County Supreme Court (Index NO. L-0075-00). On September 16, 1999, ICSP received \$1.4 million from a tobacco industry association alleged here as reimbursement for ICSP's anticipated loss on the bond. Finally, ICSP paid the State \$2.2 million in December 2003.

On February 19, 2004, ICSP brought this action against HSBC ~~to recover the money which it paid to the State, claiming HSBC~~ wrongfully foreclosed State trust property. ICSP alleged the Unpaid Stamps were held in cash in trust for the State by Herkimer and that HSBC seized these proceeds when they seized all

of Herkimer's cash accounts.

After summary judgment was granted in favor of ICSP on the issue of HSBC's liability in seizing State property, an accounting with respect to damages was ordered. Since ICSP has paid New York State the \$2.2 million maximum penal sum of the bond, it now seeks the equivalent reimbursement from HSBC. A Special Referee was appointed. This Court issued the Order of Reference directing the Special Referee to determine:

(1) Whether HSBC, through its submissions of January 26, 2006 and April 11, 2006, has met its burden, identified in the Court order of April 17, 2006, of identifying property of the state, i.e. proceeds of tax stamps which were affixed to cigarettes and for which the State never received payment ("Unpaid Stamps"), came into its possession as a result of its foreclosure upon the assets of Herkimer Wholesale Co., Inc., and of allocating the State's property between paid invoices and outstanding ones as of the date of foreclosure.

(2) As to those invoices which HSBC has successfully identified as representing State property and outstanding as of the date of foreclosure, whether HSBC has successfully identified the invoices which were not satisfied by HSBC's post-liquidation collection efforts.

In other words, whether HSBC has sufficiently accounted for the State's property in order to be able to identify the amount of Unpaid Stamps for which neither Herkimer nor HSBC ever received payment despite diligent collection efforts.

The Special Referee held hearings on July 20, 21, 31 and August 3, 2006 at which Michael Button, Herkimer's former president, testified as well as Robert J. Zwirecki, HSBC's Collateral Exam Manger. Mr. Button testified that cigarette sales comprised 80 to 85% of Herkimer's sales while Mr. Zwirecki testified using Herkimer's own financial records that no more than 54.7% of Herkimer's total sales were comprised of cigarette

sales. Mr. Zwirecki concluded that no more than \$600,672.41 of cash deposited into the cash collateral account was attributable to proceeds from unpaid tax stamps. With regard to post-liquidation accounts receivable in the amount of \$1,001,106, Zwirecki concluded that no more than \$75,538.25 of these proceeds are attributable to unpaid stamps. To arrive at this figure, HSBC used the inventory turnover rate used in the banking industry and by HSBC in the ordinary course of business of 34 days. Mr. Button speculated that the inventory turn-over rate was 10 to 15 days.¹

On November 15, 2006, Referee Schackman issued a report rejecting many of the assumptions HSBC used in its accounting to arrive at \$676,210. Principally, the report concluded HSBC's determination of the pre-liquidation receipts attributable to cigarette sales was based on erroneous calculations, and that HSBC multiplied the post-liquidation cash receipts by an unnecessary percentage to arrive at its total. The Referee concluded that HSBC had not sustained its burden in properly accounting for the State's property.

ICSP moved to confirm the Report of the Special Referee. HSBC cross-moved to reject the report, or, alternatively, to stay the proceedings until a decision is reached by the Appellate ~~Division on the issue of liability. HSBC maintains that it owes~~

¹ At his deposition in July 2001, Mr. Button could not estimate the inventory turn-over rate. However, in July 2006, Mr. Button testified that it was "probably around ten days" prior to November 10, 1997 and "probably... roughly ...fifteen days" after November 10, 1997. TR 367-368.

ICSP \$676,210, while ICSP seeks \$2.2 million, the amount it paid the State.

The appeal to the Appellate Division, First Department, of this court's decision was argued on October 7, 2005. The decision was issued on February 15, 2007, 37 AD3d 251, leave to appeal granted, 2007 NY App Div LEXIS 7890 (1st Dept 2007). The Appellate Division, First Department affirmed this Court's decision except that it granted defendant's motion to dismiss the fifth cause of action for common law indemnification. Therefore, the request for a stay is denied as moot.²

The Court confirms the Special Referee's report.

HSBC raises four objections: (1) the Referee failed to apply the proper burden of proof to HSBC and failed to shift the burden of proof to ICSP; (2) the Referee erroneously rejected HSBC's percentage of cigarettes sold of 54% since HSBC used unpaid tax stamps, not total sales; (3) the Referee abused his discretion by rejecting HSBC's methodology which is the fairest approximation in light of Herkimer's sloppy record-keeping practices rendering it impossible to accurately account in this action; and (4) Mr. Button's testimony is unreliable since ICSP agreed to indemnify Mr. Button, his wife, his brothers and their wives for the entire amount of \$3 million for which they are jointly and severally

liable.

Under CPLR 4320, the court may

² There has been no application to stay the action pending appeal to the Court of Appeals and this Court sees no reason to grant a stay.

"confirm or reject, in whole or in part . . . the report of a Referee to report; and may make new findings with or without taking additional testimony."

With regard to the burden of proof, HSBC was heard on this issue and the Court ruled on April 17, 2006 that HSBC rightfully has the burden to account for the state's property in its possession. HSBC chose to attempt to prove that the proper amount was \$676,210. The Referee concluded that HSBC failed and the Court has accepted the Referee's conclusion as well founded.

Unfortunately, this Court's reference was not as clear as it should have been and Confirming the Referee's report does not end this saga. The issue of how much HSBC owes to ICSP remains an open issue which this Court concludes is somewhere between \$676,210 and \$2 million, plus interest. The Court should have directed the Referee to calculate the amount of damages to be paid by HSBC to ICSP using the limited records available and making assumptions when necessary explaining the basis for those assumptions. Rejecting HSBC's proposal and assumptions is not sufficient. While 54% is not the correct figure for percentage of cigarettes sold, what should the Court use and why? While the Referee apparently credited Mr. Button's testimony, it is unclear what the inventory turn-over rate should be. Also left open by this Court's April 17, 2006 decision is whether AWMA's payment of ~~\$1.4 million to ICSP should be deducted from the damages in this~~ case.

The Court rejects HSBC's objection that the Referee abused his discretion by rejecting HSBC's methodology. Rather the

Referee was acting within the scope of the referral by not taking the next step of determining the fairest approximation in light of Herkimer's sloppy record keeping. The Special Referee has no power beyond that limited in the Order of Reference. *L.H. Feder Corp. v Bozkurtian*, 48 AD2d 701 (2d Dep't 1975). The Court now directs the Referee to conclude the reference by determining the amount HSBC should pay to ICSP.

Accordingly, it is

ORDERED, that the issue of damages is hereby referred to a Special Referee, who shall hear the evidence and report to the Court; and it is further

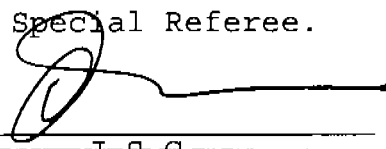
ORDERED, that the issue of damages are held in abeyance pending a hearing by a referee; and it is further

ORDERED, that this motion is held in abeyance pending receipt of the report and recommendations of the Special Referee regarding damages and a motion pursuant to CPLR 4403 or receipt of the determination of the Special Referee or the designated referee; and it is further

ORDERED that plaintiff shall serve a copy of this order with notice of entry on the Clerk of the Judicial Support Office (Room 311) to arrange a date for the reference to a Special Referee.

Dated: August 14, 2007

FILED
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J.S.C.
HON. CHARLES E. RAMOS

Counsel are hereby directed to obtain an accurate copy of this Court's opinion from the record room and not to rely on decisions obtained from the internet which have been altered in the scanning process.