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SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: JUSTICE RICHARD B. LOWE III Justice

PART 56

United States Fire

-v-

Nine Thirty

INDEX NO. 603284/09

MOTION DATE 9/14/10

MOTION SEQ. NO. 004

The following papers, numbered 1 to ____, were read on this motion to/for _____

Notice of Motion/Order to Show Cause — Affidavits — Exhibits _____ | No(s). _____

Answering Affidavits — Exhibits _____ | No(s). _____

Replying Affidavits _____ | No(s). _____

Upon the foregoing papers, it is ordered that this motion is

FILED

JUN 22 2011

NEW YORK
COUNTY CLERK'S OFFICE

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION

RECEIVED

JUN 20 2011

COUNTY CLERK'S OFFICE
NEW YORK COUNTY - CIVIL

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

Dated: 6/16/11

JUSTICE RICHARD B. LOWE III

_____, J.S.C.

1. CHECK ONE: ..... ☐ CASE DISPOSED ☒ NON-FINAL DISPOSITION

2. CHECK AS APPROPRIATE: .....MOTION IS: ☐ GRANTED ☐ DENIED ☒ GRANTED IN PART ☐ OTHER

3. CHECK IF APPROPRIATE: ..... ☐ SETTLE ORDER ☐ SUBMIT ORDER

☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 56

----------X

UNITED STATES FIRE INSURANCE COMPANY,

Plaintiff,

-against-

NINE THIRTY FEF INVESTMENTS, LLC and
NINE THIRTY VC INVESTMENTS, LLC,

Defendants.

----------X

Index No. 603284/09

Hon. Richard B. Lowe, III

In motion sequence 004, plaintiff United States Fire Insurance Company (U.S. Fire) moves, pursuant to CPLR 3212, for summary judgment in its favor on its complaint and as to defendants Nine Thirty FEF Investments, LLC (FEF) and Nine Thirty VC Investments, LLC's (VC) counterclaims. FEF and VC cross-move, pursuant to CPLR 3212, for summary judgment in their favor on their counterclaims and as to the complaint.

Background

This action arises out of U.S. Fire's denial of defendants' claims, under two Financial Institution Bonds (the Bonds) issued by U.S. Fire to FEF and VC, for losses defendants allegedly suffered as a result of the Ponzi scheme operated by Bernard L. Madoff (Bernard Madoff) and his firm, Bernard L. Madoff Investment Securities LLC (Madoff Securities).

FEF and VC are limited liability companies, formed to make investments for their owners. FEF and VC are advised by Nine Thirty Capital Management, LLC (Nine Thirty Capital), whose principal is Stuart J. Rabin. According to Mr. Rabin, Nine Thirty Capital creates

entities, such as FEF and VC, for its clients as investment entities, and then Nine Thirty Capital invests the entity's funds with outside advisors or money managers (*see* Notice of Defendants' Cross Motion for Summary Judgment, Exhibit T, Rabin Deposition at 6:17-8:16).

Mr. Rabin, after prior dealings with Bernard Madoff, recommended his services to FEF and VC. Rabin, on behalf of the FEF and VC, entered into Customer Agreements with Madoff Securities. The Customer Agreements refers to Madoff Securities as "the Broker" and the defendants as "the Customer," and states that "the Broker is acting as the Customer's agent" (Affidavit of John Riddle, Exhibits 24, 27). Rabin also entered into two Trading Authorizations, each authorizing Bernard Madoff to buy, sell, and trade in stocks, bonds, options, and any other risk securities on behalf of the defendants. The Trading Authorizations also gave Bernard Madoff the authorization to act for FEF and VC in respect to such purchases, sales, or trades and all other things in the furtherance or conduct of such and directed that Bernard Madoff's instructions, in regard to FEF and VC's accounts, were to be followed (Affidavit of John Riddle, Exhibits 22, 25).

Mr. Rabin was allegedly informed by Bernard Madoff that he would utilize his split-strike conversion strategy in making investment decisions for FEF and VC. Further, it was allegedly agreed that Bernard Madoff would arrange for the execution of his investments plan through Madoff Securities and that his fee for providing investment advice would be included in the 4-cent brokerage commission Madoff Securities would charge on each trade.

Over several years, both FEF and VC transferred money, by wire transfers, to an account in the name of Bernard Madoff maintained at Citibank (Affirmation of Sarah P. Kenney, Exhibit KK). These funds were allegedly commingled with the funds of Bernard Madoff's other

investment advisory clients. Each month FEF and VC received fictitious trade confirmations and monthly brokerage account statements from Madoff Securities showing their deposits and withdrawals for that month and purporting to show the transactions executed each month as well as dividends earned. When FEF or VC requested a withdrawal payment, it was allegedly honored within days by Madoff Securities. It was not until Bernard Madoff confessed to his scheme that withdrawal requests were denied. The last statements received by FEF and VC showed that FEF's account had a value of $9,232,811.70 and VC's account had a value of $5,536,493.

On December 11, 2008, the United States Securities and Exchange Commission filed a complaint against Bernard Madoff and Madoff Securities in the United States District Court for the Southern District of New York, charging them with securities fraud for a multi-billion dollar Ponzi scheme. In March 2009, Bernard Madoff was criminally charged with 11 felony counts, and that same month, pled guilty to all counts.

On December 12, 2008, FEF and VC, through their insurance broker, Frank Crystal & Company, notified U.S. Fire that they were asserting claims under the Bonds for the losses caused by Madoff Securities, as listed as an Outside Investment Advisor on Rider #9 of the Bonds (Rider 9). On June 9, 2009, FEF and VC submitted their Proofs of Loss to U.S. Fire, claiming losses of $9,232,811.71 and $5,536,493, and seeking indemnification for the full amount of these alleged losses, plus an additional $25,000 each in claims expenses. By letter dated October 28, 2009, U.S. Fire notified FEF and VC that the Bonds were void ab initio and had been rescinded due to their misrepresentations and incorrect statements of material facts in connection with their applications and purchase of the Bonds.

On that same day, U.S. Fire filed this action seeking a judgment that (1) the Bonds were void ab initio and rescinded; (2) the Bonds were rescinded under Rider #5 of the Bonds; (3) FEF and VC's claims are not covered under Rider 9 of the Bonds; (4) Exclusion (x) of the Bonds excludes coverage for FEF and VC's claimed losses; and (5) in the alternative, FEF and VC's losses are limited to the net amount of the monies that they actually paid to Bernard Madoff and Madoff Securities, after deducting all withdrawals made. FEF and VC allege counterclaims against U.S. Fire seeking denial of U.S. Fire's request for declaratory judgment and for enforcement of the Bonds. All parties now seek summary judgment in their respective favors as to the relief requested in their respective pleadings.

Analysis

The issue in this case is whether FEF and VC's losses, as a result of Bernard Madoff's dishonest acts, are covered under the Bonds. All parties focus their main arguments on an Insuring Agreement, known as Rider 9, which was added to the Bonds. Rider 9 states, in part,

> 1. The following Insuring Agreement will be added to the Policy:
>
> **Outside Investment Advisor**
>
> Loss resulting directly from the dishonest acts of any Outside Investment Advisor, named in the Schedule below, solely for their duties as an Outside Investment Advisor, on behalf of the Insured, such loss limited to the Insured's investment interest, committed alone or in collusion with others, except a director or trustee of the Insured who is not an Employee, provided howev er the Insured shall first establish that the loss was directly caused by dishonest acts of any Outside Investment Advisor which results in improper financial gain to such Outside Investment Advisor and which acts were committed with the intent to cause the Insured to sustain such loss.

Rider 9 defines Outside Investment Advisor as any firm, corporation, or individual named in the Schedule of Rider 9 and an employee, officer, or partner of such Outside Investment Advisor.

Madoff Securities is listed as an Outside Investment Advisor in the Schedule. There is no dispute that Bernard Madoff is included under the definition of Outside Investment Advisor.

U.S. Fire argues that there is no coverage under the Bonds, because FEF and VC's losses were not caused by Bernard Madoff and Madoff Securities acting solely as an outside investment advisor as required by Rider 9. U.S. Fire asserts that Madoff acted primarily as a securities broker for FEF and VC, and thus, his dishonest acts would not be covered.

FEF and VC, however, argue that Rider 9 states, "solely for their duties as an Outside Investment Advisor," and "Outside Investment Advisor" is a defined term with specific meaning. They argue that U.S. Fire is not interpreting the language as the defined term "Outside Investment Advisor," but rather as the generic term outside investment advisor. FEF and VC assert that Rider 9 makes no effort to set out any duties of the firms and/or persons listed as Outside Investment Advisors, and it was their understanding that any firm listed as an Outside Investment Advisor would be covered under the policy, even if they performed other duties in addition to investment advising.

"The interpretation of written contracts which are clear and explicit is a matter for the courts to resolve" (*Eden Music Corp. v Times Square Music Publications Co.*, 127 AD2d 161, 164 [1st Dept 1987], citing *Mallad Constr. Corp. v County Fed. Sav. & Loan Assn*, 32 NY2d 285, 291 [1973]). A contract is unambiguous if the language it uses has a definite and precise meaning (*Greenfield v Philles Records*, 98 NY2d 562, 569 [2002]). "[I]f the agreement on its face is reasonably susceptible of only one meaning, a court is not free to alter the contract to reflect its personal notions of fairness and equity" *Greenfield v Philles Records*, 98 NY2d at 569-570 [2002]).

The language of Rider 9 has a definite and precise meaning, and thus, is unambiguous. In its clear and plain language, Rider 9 limits coverage to losses as a result of dishonest acts as an Outside Investment Advisor. As stated above, Rider 9 defines an "Outside Investment Advisor" as any firm, corporation, or individual named in the Schedule, including an employee, officer, or partner of such firm, corporation, or individual, and Madoff Securities is clearly listed as one of the 25 Outside Investment Advisors in the Schedule. Rider 9 does not, as U.S. Fire asserts, require that those entities listed must only be investment advisors; rather, the Rider limits the losses covered to those occurring out of the duties of an Outside Investment Advisor. If losses were suffered as a result of dishonest acts committed by Madoff in his duty as an Outside Investment Advisor, those losses are covered.

However, while the language of Rider 9 is clear, an ambiguity exists when read with Exclusion (x). Section 2, Exclusion (x) states, in part,

> This bond does not cover:
> (x) loss resulting directly or indirectly from any dishonest or fraudulent act or acts committed by any non-Employee [of FEF or VC] who is a securities...broker...

While this exclusion provides that losses as a result of any dishonest act committed by a securities brokers are not covered, its meaning is unclear when read with Rider 9. This creates an ambiguity that must be resolved by a trier of fact.

Madoff is clearly included as an Outside Investment Advisor on Rider 9; however, he was admittedly a registered securities broker. Although Exclusion (x) does not cover losses as a result of dishonest acts by a securities broker, it is not clear, when read with Rider 9, whether losses from dishonest acts by Madoff, acting as an Outside Investment Advisor. The issue is whether these losses, if any, are precluded by Exclusion (x) because Madoff is also a registered

securities broker. This ambiguity presents a question of fact which cannot be resolved on these motions for summary judgment.

U.S. Fire seeks to also rescind the Bonds as a result of FEF and VC's alleged material misrepresentations on the applications for the Bonds. U.S. Fire alleges that FEF and VC incorrectly stated that: (1) FEF and VC suffered no losses; (2) as of December 31, 2006, Madoff Securities was holding T-Bills valued at $6,565,612 for FEF and $6,318,784 for VC; (3) FEF had total assets under management of $50,254,819 as of December 31, 2006, $55,000,000 as of June 30, 2007, and $63,000,000 as of December 31, 2007; and (4) VC had total assets under management of $67,199,515 as of December 31, 2006, $68,000,000 as of June 30, 2007 and December 31, 2007. U.S. Fire also alleges that FEF and VC misrepresented that their accounts were not insured by Securities Investor Protection Corporation (SIPC), thus indicating that Madoff Securities was not a securities broker, when defendants allegedly knew it was.

The Bonds originally provided,

> REPRESENTATION OF INSURED
>
> D. The Insured represents that the information furnished in the application for this bond is complete, true and correct. Such application constitutes part of this bond.
>
> Any misrepresentation, omission, concealment or incorrect statement of a material fact, in the
> application or otherwise, shall be grounds for the rescission of the bond. (General Agreement Provision D)

However, General Agreement Provision D is expressly deleted by Rider # 5 (Rider 5). Rider 5 states, in relevant part,

> (INTENTIONAL MISREPRESENTATION OF INSURED RIDER)
>
> It is agreed that:

> 1. General Agreement D, REPRESENTATION OF INSURED, of the attached bond is deleted in its entirety and replaced by the following:
>
> "REPRESENTATION OF INSURED"
>
> 5. The Insured represents that the information furnished in the application for this bond is complete, true and correct. Such application constitutes part of this bond.
>
> Any intentional misrepresentation, omission, concealment or any incorrect statement of a material fact, in the application or otherwise, shall be grounds for rescission of this bond.

U.S. Fire argues that it is entitled, under Rider 5 and New York Insurance Law § 3105, to rescind the Bonds as a result of FEF and VC's alleged material misrepresentations, even if they were made innocently. The court disagrees.

While New York Insurance Law § 3105 does permit an insurer to rescind a policy based upon even an innocent or unintentional material omission, Rider 5 limits this right of the insurer to intentional misrepresentations, omissions, concealment, or incorrect statements. Rider 5 clearly requires that any misrepresentations, omissions, concealment, or incorrect statements must be made intentionally. Rider 5 deletes General Agreement Provision D, which did not require the intentional element. Further, Rider 5 clearly states that it is an "Intentional Misrepresentation of Insured Rider."

U.S. Fire argues that the language of Rider 5 permits rescission for either intentional misrepresentations, omission, or concealment, *or* an incorrect statement of material fact, whether intentional or not. However, reading the plain language of Rider 5, in conjunction with General Agreement Provision D, it is clear that misrepresentations, omissions, concealment and incorrect statements all must be intentional. Therefore, U.S. Fire cannot void the policy unless the material misrepresentations were proved to be intentional.

U.S. Fire submits no proof that FEF and VC intentionally misrepresented that (1) FEF and VC suffered no losses; (2) as of December 31, 2006, Madoff Securities was holding T-Bills valued at $6,565,612 for FEF and $6,318,784 for VC; (3) FEF had total assets under management of $50,254,819 as of December 31, 2006, $55,000,000 as of June 30, 2007, and $63,000,000 as of December 31, 2007; and (4) VC had total assets under management of $67,199,515 as of December 31, 2006, $68,000,000 as of June 30, 2007 and December 31, 2007. Thus, it cannot seek rescission based on these alleged misrepresentations.

U.S. Fire also alleges that FEF and VC intentionally misrepresented that their accounts were not insured by SIPC, indicating that Madoff Securities was not a securities broker, when they knew it was, and seeks to rescind the Bonds on this alleged intentional misrepresentation. However, there is an issue of fact here as to whether FEF and VC intentionally misrepresented that their accounts were not insured by SIPC on the application. It is disputed whether FEF and VC understood that the question on the application in regard to SIPC coverage applied to accounts held by themselves or by a third party, such as Madoff.

However, even if this alleged misrepresentation was intentional, U.S. Fire has not established that it was material as a matter of law (*see Albany Insurance Company v Fashion Avenue Knits, Inc.*, 209 AD2d 194 [1st Dept 1994]). To establish materiality as a matter of law, "the insurer must present documentation concerning its underwriting practices, such as underwriting manuals, bulletins or rules pertaining to similar risks, to establish that it would not have issued the same policy if the correct information had been disclosed in the application" (*Curanovic v New York Cent. Mut. Fire Ins. Co.*, 307 AD2d 435, 437 [3rd Dept 2003] [citations omitted]).

Here, U.S. Fire relies on Mr. Ovalle's affidavit in which he affirms that, if FEF and VC had affirmatively answered that their accounts were insured by SIPC, he would have made further inquires, which would have led him to the discovery that Madoff Securities was a broker. Mr. Ovalle states that had he learned that Madoff Securities was a broker, he would have refused to renew coverage of the Bonds or he would not have included Madoff Securities on the list of Outside Investment Advisors on Rider 9. However, U.S. Fire presents no documentation supporting Ovalle's claims that he would have denied coverage and why he would have denied coverage. "Conclusory statements by insurance company employees, unsupported by documentary evidence, are insufficient to establish materiality as a matter of law" (*Curanovic v New York Cent. Mut. Fire Ins. Co.*, 307 AD2d at 437 [citations omitted]). Thus, the court cannot grant summary judgment declaring that the Bonds are rescinded for an alleged intentional misrepresentation.

In the event that complete summary judgment is not granted in its favor, U.S. Fire seeks partial summary judgment limiting any recovery by FEF and VC to actual out-of-pocket losses, and denying FEF and VC's request for attorneys' fees and consequential damages for lost investment opportunities and returns.

Rider 9 covers losses resulting directly from the dishonest acts of an Outside Investment Advisor and limits such loss to the Insured's "investment interest." FEF and VC argue that the language of Rider 9 is ambiguous, because the terms "loss" and "investment interest" are not defined. U.S. Fire, on the other hand, argues that losses are limited to the amount FEF and VC actually paid to Madoff Securities, less the amount repaid to them by Madoff, which is clearly what Rider 9 provides.

In order for FEF and VC to prevail on the theory that Rider 9 is ambiguous, in regard to what losses they can recover, they must show that their interpretations of the language are reasonable (*Foot Locker, Inc. v Omni Funding Corp. of America*, 78 AD3d at 515). FEF and VC argue that given the purpose of Bonds, and the manner in which the premiums were calculated, it is a reasonable interpretation to view losses covered under Rider 9 as the investments held by Madoff. The court disagrees.

The plain language of Rider 9 is clear as to what losses are covered for dishonest acts by Madoff Securities and Bernard Madoff. Rider 9 provides coverage for only direct losses resulting from Madoff's dishonest acts and limits such losses to what FEF and VC invested with Madoff and Madoff Securities, i.e., their investment interest. Rider 9 cannot reasonably be interpreted as extending FEF and VC's investment interest to fictitious losses of monies FEF and VC never had as a result of Madoff's fraud.

Further, Rider 9 only provides coverage for "Loss resulting directly from the dishonest acts of [Madoff Securities]." This covers a direct loss resulting from Madoff's dishonest acts (*see Horowitz v American International Group, Inc.*, 2010 WL 3825737, 2010 US Dist LEXIS 103489, *19 [SD NY 2010]). FEF and VC's direct loss as result of Madoff's dishonest acts was only what they invested, minus moneys paid out to them by Madoff. They did not suffer a direct loss by not receiving the money reflected in the November 2008 statement, as that money never belonged to them. In fact, the money never existed. FEF and VC argue that they could have withdrawn that money before the fraud was exposed; however as held by the United States District Court, Southern District of New York, this argument is speculative and short-sighted (*Horowitz v American International Group, Inc.*, 2010 WL 3825737, 2010 US Dist LEXIS

103489, *25 [SD NY 2010]). Therefore, if it is found that Bernard Madoff's dishonest acts are covered under the Bonds, FEF and VC are entitled to only actual losses.

FEF and VC also seek consequential damages for lost investment opportunities and returns as a result of the alleged bad faith breach by U.S. Fire of its obligations under the Bonds, as well as attorneys' fees. "[C]onsequential damages resulting from a breach of the covenant of good faith and fair dealing may be asserted in an insurance contract context, so long as the damages were within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting" (*Panasia Estates, Inc. v Hudson Ins. Co.*, 10 NY3d 200, 203 [2008] [internal citations and quotation marks omitted]).

In determining whether consequential damages were reasonably contemplated, "courts must look to the nature, purpose and particular circumstances of the contract known by the parties ... as well as what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made" (*Bi-Economy Mkt., Inc. v Harleysville Ins. Co. of N.Y.*, 10 NY3d 187, 193 [2008] [internal citations and quotation marks omitted]). Proof of consequential damages cannot be speculative. *Id.* FEF and VC assert that U.S. Fire cannot contend that it did not know, at the time the Bonds were issued, that FEF and VC were in the business in investing, and that U.S. Fire's failure to timely make payment under the Bonds reduced the amount of capital that FEF and VC had to invest. Thus, FEF and VC assert that U.S. Fire knew it was probable that its refusal to make payment under the Bonds reduced the amounts that FEF and VC could invest.

First, this argument is speculative. FEF and VC did not prove with reasonable certainty that U.S. Fire could foreseeably contemplate this loss. Second, the consequential damages that

FEF and VC allege are no other than a loss of the use of money, which is what prejudgment interest is designed to compensate. Thus, FEF and VC's claims for consequential damages are dismissed.

With regard to attorneys' fees, an insured can recover the costs of litigation, including attorneys' fees, where an insurer refuses to pay a claim in bad faith (*Sukup v State of New York*, 19 NY2d 519 [1967]). Here, U.S. Fire and defendants both have an arguable basis for their positions in regard to payment under the Bonds, and therefore, attorneys' fees are not warranted (*see Greenburgh Eleven Union Free School Dist. v National Union Fire Ins. Co. of Pittsburgh, PA*, 304 AD2d 334 [1st Dept 2003]).

Finally, U.S. Fire seeks dismissal of FEF's defense that U.S. Fire waived its rescission claim on the FEF Bond. In February 2009, U.S. Fire extended the FEF Bond for 59 days, because U.S. Fire's notice to FEF of non-renewal was admittedly untimely, and thus, ineffective under New York law. FEF asserts that U.S. Fire's acceptance of premiums for the extension of the FEF Bond was a waiver of any claims to rescind the FEF Bond.

It is well settled that "[w]here an insurer accepts premiums after learning of an event allowing for cancellation of the policy, the insurer has waived the right to cancel or rescind" (*Continental Ins. Co. v Helmsley Enters.*, 211 AD2d 589 [1st Dept 1995]). Although U.S. Fire argues that it was legally obligated to provide the extension, just "as rescission of an insurance contract voids that contract ab initio, so too rescission would void an obligation to provide extended coverage in connection with such a contract" (*Chicago Ins. Co. v Kreitzer & Vogelman*, 2000 WL 16949, * 9 [SD NY 2000]). Therefore, U.S. Fire could have sought to rescind the extension based upon the alleged intentional misrepresentations by FEF and VC.

There is, however, an issue of fact as to whether U.S. Fire knew all the facts supporting the rescission claim now brought when it extended the Bonds. Thus, while the court will not dismiss FEF's defense of waiver, summary judgment cannot be granted in favor of FEF in regard to the rescission claim based on this defense.

Conclusion

Accordingly, it is

ORDERED that United States Fire Insurance Company's motion for summary judgment is granted only to the extent that any recovery by FEF and VC is limited to actual out-of-pocket losses, and FEF and VC's claims for attorneys' fees and consequential damages for lost investment opportunities and returns are dismissed; and it is further

ORDERED that Nine Thirty FEF Investments, LLC and Nine Thirty VC Investments, LLC's cross motion for summary judgment is denied.

Dated: June 16, 2011

JUSTICE RICHARD B. LOWE III
J.S.C.