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News & Types: Commercial, Competition & Trade Update

Fraudster and Victim Both Fail to Shift Loss

10/2/2017

Practices: Commercial, Competition & Trade, Litigation

Anyone faced with a claim or a loss will look for someone else to pay the claim or bear the loss. In an interesting decision from the 7th Circuit Court of Appeals, Judge Easterbrook declined to do so in three cases. The losses were caused by fraud and, ironically, both the perpetrator of the fraud and the victim failed in their efforts to shift their loss. *(Daniel J. Ratajczak, Jr., et al., v. Beazley Solutions Limited and Land O'Lakes, Inc. and First Mercury Insurance Company, et. al. v. Daniel J. Ratajczak, Jr., et. al., 7th Circuit Court of Appeals, No. 16-3418, August 31, 2017)*

Daniel J., Scott A., and Angela Ratajczak ("Ratajczaks") ran an apparently successful business called Packerland Whey Products, Inc. Packerland purportedly manufactured protein supplement from whey (the watery part of milk remaining after the removal of curds). But the Ratajczaks were not honest. They intentionally used deceitful methods to increase their profits by adding urea to adulterate the protein supplement. Protein levels are extrapolated by measuring nitrogen. By adding urea, rich in nitrogen and used in fertilizers, the protein level would read higher than it actually was. Since urea is cheaper than whey, Packerland saved money and increased its profits. The Ratajczaks were not caught before they were able to sell their business to Packerland Whey Intermediary Holding Co. in May, 2012 for apparently a substantial amount of money. The Ratajczaks continued as employees and, as employees, continued their fraudulent activity.

Things unraveled for the Ratajczaks soon after they sold their business. In November or December 2012, the buyer learned what they had been doing. The Ratajczaks were fired and litigation began. In December, 2012, the Ratajczaks settled for $10 million.

One of Packerland's customers was Land O'Lakes. Land O'Lakes unknowingly purchased the adulterated whey starting in 2006. Although Land O'Lakes developed suspicions about the quality of the whey they were purchasing, they accepted the excuses put forth by the Ratajczaks. But late in 2012, Land O'Lakes stopped buying whey from Packerland and filed suit, claiming a) breach of contract, b) fraud, and c) violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), a claim that could allow Land O'Lakes to claim triple damages and attorneys' fees. Although not stated in the decision, it appears that Land O'Lakes settled its breach of contract claim with Packerland. Land O'Lakes dropped the fraud claim. So Land O'Lakes was left with its RICO claim against the Ratajczaks. This claim had potential insurance coverage that Land O'Lakes tried to tap into.

There were two other claims that Judge Easterbrook had to deal with. In both claims, the Ratajczaks brazenly tried to shift their losses to their insurance carriers.

Claim 1: Land O'Lakes RICO Claim Against the Ratajczaks and Their Insurers

Recall that Land O'Lakes settled their breach of contract claim, apparently against Packerland. But Land O'Lakes wasn't done. It also had its RICO claim against the Ratajczaks which could entitle it to triple damages and attorneys' fees. So a lot was at stake.

The district court granted summary judgment for the insurers and the Ratajczaks, finding that Land O'Lakes failed to prove damages. Judge Easterbrook agreed.

As usual, Judge Easterbrook did not hold back on his view of the claims. He described eight different kinds of damages that Land O'Lakes might have suffered, but apparently did not even assert. For example, it could have claimed lost profits, losses from claims from customers purchasing the adulterated protein, recall expenses, or expenses incurred in investigating Packerland's products. Another way to measure the loss was for Land O'Lakes to purchase retroactive insurance to cover future claims against Land O'Lakes arising from Packerland's fraud. But Land O'Lakes failed to do this or even obtain a quote. Instead of itemizing its damages, Land O'Lakes offered what Judge Easterbrook scathingly referred to as "lawyers' talk."

Perhaps Land O'Lakes was made whole through the settlement on its breach of contract claim and Judge Easterbrook viewed the RICO claim as premature or even as an effort by Land O'Lakes to win a windfall from its misfortune. In any case, Land O'Lakes was stuck with the settlement it had already recovered and lost on its RICO claim.

Claim 2: Ratajczaks Claim Against Packerland's Insurers

Packerland had several insurance policies under which the Ratajczaks were additional insureds. But the insurance companies refused to defend or indemnify the Ratajczaks. The insurance policies covered "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." But the Ratajczaks' fraudulent adulteration of Packerland's whey protein concentrate could hardly be described as an "accident." Noted Judge Easterbrook, "Neither the behavior nor the consequence can be called an accident." So the Ratajczaks efforts to shift their loss to Packerland's insurance carrier was not successful.

Claim 3: Ratajczaks Claim Against the Representations and Warranties Insurer

The final claim was the Ratajczaks' claim against the representations and warranties insurer, Beazley Solutions, in the sale of their business. As background, it has become increasingly common to use representations and warranties insurance (R&W insurance) in merger and acquisition transactions. R&W insurance has many advantages to both an acquirer and a seller of a business. The acquirer has more viable recourse against an insurance company for breaches of representations and warranties compared to recourse against a seller, which may have already disposed of the proceeds, or to recourse to an escrow account that involves cumbersome procedures to actually obtain any funds. The seller can have assurance that the proceeds from the sale are secure and can limit or avoid placing any of the proceeds in an escrow account. However, as with any insurance policies, there are limits, requirements to make a claim, and notice procedures. So R&W insurance has some limitations.

The Ratajczaks used Beazley Solutions to procure R&W insurance in the sale of their business. But, in the end, it provided no benefit to the Ratajczaks.

As noted, in November or December, 2012, only 6 months after the sale of the business, the buyer learned of the Ratajczaks' fraud. Events moved quickly and the Ratajczaks agreed to pay $10 million to the buyer in December, 2012. They then tried to recoup their loss from Beazley Solutions, the insurer. The policy had a $10 million limit with a $1.5 million deductible.

One problem faced by the Ratajczaks was the same one faced in Claim 2. Their loss was not caused by accident or negligence, but by plain fraud. The insurance policy did not cover fraud.

The district court also concluded, and Judge Easterbrook agreed, that even if there was a breach of warranty subject to coverage, the terms of the policy and the agreement would have capped the damages at $1.5 million, matching the deductible that the Ratajczaks would be responsible for anyway.

There was still another reason why Beazley Solutions avoided coverage. It appears that the $10 million settlement and the $10 million limit of coverage was not a coincidence – the Ratajczaks seemed to have assumed the insurance company would step up. But this was a delusion. As explained in the opinion, the insurance company did not receive proper notice of the claim or the settlement. The Ratajczaks notified Beazley Solutions of the claim after the close of business on December 24, 2012. Unstated by the court, but obvious, this was literally the night before Christmas. The settlement was signed on December 28, 2012, after Beazley Solutions asked for more information on the settlement, but before the Ratajczaks bothered to respond. Said Judge Easterbrook, "By cutting Beazley out of the negotiations, the Ratajczaks prevented it from taking steps vital for self-protection."

The Ratajczaks claimed that Wisconsin law requires the insurer to show prejudice to avoid a claim based on inadequate notice. Judge Easterbrook said prejudice could probably be presumed in this situation, but it didn't matter. The policy was controlled by New York law, which permits insurers to insist on controlling settlements.

Facing a loss or claim, it is natural to look for someone else to bear the loss or cover the claim. In fact, insurance is made for this purpose. But these three claims illustrate the difficulties of shifting losses. Land O'Lakes, a victim of fraud, received some recovery although less than it hoped. For the Ratajczaks, the perpetrators of the fraud, Judge Easterbrook and his colleagues on the 7th Circuit, made sure they got what they deserved and did not get what they didn't deserve.