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8 **UNITED STATES DISTRICT COURT**  
 9 **FOR THE NORTHERN DISTRICT OF CALIFORNIA**  
 10 **SAN JOSE DIVISION**

11 UNITED STATES FIRE INSURANCE  
 COMPANY, a corporation,

12 Plaintiff,

13 vs.

14 VESTA STRATEGIES, LLC, a limited liability  
 company; SAMUEL W. HENKA, an individual,

15 Defendants.

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17 SAMUEL W. HENKA, et al.,

18 Counter-Claimants,

19 vs.

20 UNITED STATES FIRE INSURANCE  
 COMPANY, a corporation.

21 Counter-Defendants.

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23 SAMUEL W. HENKA, et al.,

24 Cross-Claimants,

25 vs.

26 VESTA STRATEGIES, LLC, a limited liability  
 company; et al.,

27 Cross-Defendants.

**Case No.: C0902388 JW PVT**

**HENKA PLAINTIFFS' OPPOSITION  
 TO MOTION TO DISMISS FILED BY  
 CONTINENTAL CASUALTY  
 COMPANY**

**Hearing Date: March 22, 2010**  
**Time: 9:00a.m.**  
**Location: Dept. 8, 4th Floor**  
**Judge: Hon. James Ware**

**Filed concurrently herewith:**

**Opposition to U.S. Fire's Motion for  
 Judgment on the Pleadings**

**Opposition to Liberty Mutual's  
 Motion to Dismiss**

**Request for Judicial Notice in  
 Support of Oppositions**

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1 Counter-Claimants and Cross-Claimants Samuel M. Henka, et. al. (the “Henka  
2 Plaintiffs”) hereby submit their Lead Brief in opposition to the motion brought by Continental  
3 Casualty Company (“Continental”) to dismiss the Cross-Complaint (“Complaint”) pursuant to  
4 Fed. R. Civ. P. 12(b)(6).<sup>1</sup>

5 **I. SUMMARY OF ARGUMENTS**

6 In this case, the Court is being asked to interpret standard commercial crime insurance  
7 policies that were modified and expanded by several 1031 tax-deferred exchange  
8 endorsements. The enhanced crime policies were issued by Continental to its named insureds  
9 Vesta Strategies, LLC (“Vesta”) and Excalibur 1031 Group, LLC (“Excalibur”), both qualified  
10 intermediaries (“QIs”) handling “like-kind” exchanges of real property for clients  
11 (“Exchangers”). Endorsement No. 3 created a different type of insurance than that ordinarily  
12 encountered in crime policies, it created a surety contract with Continental acting as the surety  
13 and the insured QIs acting as obligors. The Exchangers, as obligees, are third party  
14 beneficiaries of the surety relationship. The Henka Plaintiffs are Exchangers that deposited  
15 funds with the insured QIs and lost their funds at the hands of John D. Terzakis (“Terzakis”)  
16 and Robert Estupinian (“Estupinian”), the owners of the QIs who were running them together  
17 as a Ponzi-scheme. The Henka Plaintiffs are equitable subrogees of the prior Exchangers doing  
18 business with Vesta and Excalibur and may currently enforce their insurance rights which  
19 vested as to the various Continental policies during the applicable policy periods. The  
20 expanded crime policies contained a loss discovery clause, which, as drafted, was complied  
21 with because the named insureds, Vesta and Excalibur, knew of the thefts committed by  
22 Terzakis and Estupinian when they were occurring during each policy period. Vesta and

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23  
24 <sup>1</sup> United States Fire Insurance Company (“U.S. Fire”) and Liberty Mutual Insurance Company  
25 (“Liberty”) have brought similar motions to dismiss. U.S. Fire’s motion is framed as a motion for  
26 judgment on the pleadings pursuant to Fed. R. Civ. P. 12(c). The issues raised in all three  
27 motions are substantially similar. The Court consolidated the hearing dates for the three motions  
28 as their “Lead Brief” in opposition to all three motions. The Henka Plaintiffs have filed separate  
oppositions in response to the motions brought by U.S. Fire and Liberty, however, those  
oppositions refer to and incorporate many of the facts and arguments raised in this Lead Brief.

1 Excalibur made their claims against Continental “as soon as possible” following Thomas  
2 Dillon’s appointment as Receiver, which satisfies the notice clause. Continental was aware of  
3 the QI insurance fraud by August 2006, but elected to continue as the insurer because of the  
4 \$800,000 per year it received in premiums with no claims being made. Continental should  
5 suffer the burdens caused by its election to assume the benefits of a fraud.

6 Either Continental is a surety and the Henka Plaintiffs are the third-party beneficiaries  
7 (obligees) of the insurance contracts providing protection to Exchange Funds from theft by  
8 Vesta and Excalibur or, Continental provided financial protection to Vesta and Excalibur in the  
9 event they stole their clients’ Exchange Funds, thereby making Continental an accessory to the  
10 crime of the theft of Exchange Funds.

## 11 **II. INTRODUCTION**

12 This is an insurance case of first impression. There are no reported decisions  
13 interpreting the unique insurance issues in dispute. The cases cited by Continental apply only  
14 to employee theft and do not apply to situations involving theft by the named insured. The  
15 insurance protection sold by Continental was developed recently, within the last decade, to  
16 meet the needs of an emerging growth industry, namely QIs handling “like-kind” exchanges of  
17 real property for Exchangers seeking to defer the payment of capital gains taxes pursuant to  
18 Section 1031 of the Internal Revenue Code. Complaint ¶¶ 5-8 and 108-109. The nature of a  
19 QI’s business is to hold its clients money (“Exchange Funds”), received from the sale of  
20 relinquished property, in trust for 1 to 180 days, while the Exchangers locate and purchase  
21 “like-kind” replacement property. *Id.* ¶¶ 5-7. The QI’s sole purpose is to act as a fiduciary for  
22 its clients, preserving and protecting the safety of their Exchange Funds so that the money will  
23 be available to close each Exchanger’s purchase of replacement property. *Id.* Before deciding  
24 to do business with a QI, prospective Exchangers need to know the Exchange Funds they  
25 deposit will remain safe during the 1-180 day exchange period. *Id.* ¶¶ 110-119.

26 The Federation of Exchange Accommodators (“FEA”) is a trade organization  
27 established to promote the financial and business interests of QIs. Complaint ¶ 108. The FEA  
28 recognized that to effectively compete with regulated banks and title insurance companies for

1 1031 exchange business, the Exchange Funds on deposit with its “unregulated” QI members  
2 needed to be “bonded” against theft by the QI or its principals, who had unfettered access to  
3 the money. *Id.* Continental, together with Willis (and later Lockton), in conjunction with the  
4 FEA, developed the subject insurance which was ostensibly designed to provide protection  
5 from QI theft and thereby boost consumer confidence in using the unregulated QIs. *Id.* The  
6 program involved the modification of a standard commercial crime policy by means of three  
7 tax-deferred exchange endorsements. *Id.* ¶¶ 108-109. The key endorsement for the Henka  
8 Plaintiffs, Endorsement No. 3, expanded the scope of coverage to include the theft of Exchange  
9 Funds by the QI (the named insured) or theft by owners or partners of the QI. The expanded  
10 coverage granted by Endorsement No. 3 allowed QIs to advertise to the public the existence of  
11 a financial guarantee regarding the protection and the safety of their Exchange Funds. *Id.* ¶¶  
12 110 and 113-115.

13 A standard commercial crime policy protects the named insured against theft by a  
14 dishonest employee. Complaint ¶ 109. Generally, the source of the funds at risk of being  
15 stolen belong to the first party, the named insured, who will naturally attempt to protect his/her  
16 own funds. The insurance protects the insured against the unintended risk that the insured’s  
17 money might be stolen by a dishonest employee. If a loss is sustained, the loss is sustained by  
18 the named insured, and the policy pays benefits to the named insured accordingly.

19 In the QI context, the situation is entirely different. Because the QI is in the business  
20 of holding other people’s money, the source of funds at risk of being stolen do not belong to  
21 the first party, the named insured. Instead the funds at risk (Exchange Funds) belong to the  
22 Exchangers who have no ability to protect those funds once transferred to the control of the QI.  
23 While on deposit at the QI, the Exchange Funds are at risk of being stolen not just by dishonest  
24 employees at the QI, but more so by others having unfettered access to the Exchange Funds,  
25 namely the owners of the QI and the QI itself. If Exchange Funds are stolen either because of a  
26 dishonest employee, or the intended theft by the named insured, the loss is not sustained by the  
27 named insured, but is suffered by the client whose Exchange Funds were stolen. See *In re The*  
28 *1031 Tax Group*, 420 B.R. 178 (Dec. 2009) where the court concluded that the loss of

1 Exchange Funds due to theft by the owner of the QI is a loss suffered by the Exchangers, and  
2 not the QI.

3 In recognition of this fundamental difference in the risk posed by QIs entrusted with  
4 handling the Exchange Funds of others, the FEA insurance program modified a standard  
5 commercial crime policy and expanded the scope of coverage so that Exchange Funds were  
6 protected against theft by: (i) an errant employee and (ii) the intentional theft by the named  
7 insured, the QI, and/or the QI's owners and partners. Complaint ¶ 109. **The second**  
8 **component of coverage necessarily converted a two-party insurance contract into a three-**  
9 **party surety bond, because the insurance provided protection for the intentional theft of**  
10 **other peoples' money by the named insured.** *Id.* Continental, and the other carriers and  
11 brokers involved with providing the new expanded crime coverage, promoted and marketed it  
12 as a guarantee that Exchange Funds on deposit with the QI would be safe from theft by the QI  
13 and the owners or partners of the QI. *Id.* ¶¶ 115-119. The QIs purchasing the coverage in turn  
14 began advertising, and the public (including the Henka Plaintiffs) began reasonably construing,  
15 the crime policies to be three-party surety bonds that guaranteed the fidelity of the QI. *Id.* ¶¶  
16 110 and 113-119. With full awareness and knowledge of the public's perception of the scope of  
17 coverage, Continental continued to issue policies for the expanded crime coverage to collect  
18 \$800,000 in annual premiums (with no history of claims) from its insured QIs. *Id.* ¶ 119 and  
19 Exhibit B to the Complaint.

20 The real estate market peaked in late 2006 and collapsed in the summer of 2008. Along  
21 with this bursting bubble, a number of QIs that were being run as Ponzi-schemes failed,  
22 triggering claims by Exchangers against Continental and the other carriers that issued the  
23 enhanced crime coverage.<sup>2</sup> In response to the onslaught of claims, Continental recoiled and  
24 begin denying that third party coverage ever existed, even though it knew the insurance was

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25  
26 <sup>2</sup> *In Re: Edward H. Okun Internal Revenue Service § 1031 Tax Deferred Exchange Litigation*,  
27 MDL No. 2028, pending in the United States District Court for the Northern District of  
28 California, Case No. 07-cv-2795-JW (hereinafter "*Hunter P*"); and *SCCAA Holdings, LLC, et al.*  
*v. Brown & Brown, et al.*, United States District Court for the District of Nevada Case No. 2:07-  
CV-00536-RCJ-LRL ("*SCCAA v. Brown & Brown*").

1 marketed as such during the decade before claims were made. Continental, turning 180 degrees  
2 from its marketing strategy, now insists the modified crime policies were in reality “first-party”  
3 insurance contracts providing “protection” only to the thieving QIs. However, if this were the  
4 case, then Continental has been caught committing insurance fraud, or worse, it is an accessory  
5 to a crime. If Exchangers are not protected, Endorsement No. 3 did nothing more than provide  
6 financial protection to the QIs for their own intentional acts of stealing client money. Public  
7 policy precludes a person from purchasing insurance to benefit himself for committing  
8 intentional acts which injure others, such as stealing someone’s money and the criminal law  
9 imposes sanctions on those who encourage, aid, abet, promote, endorse or financially protect  
10 criminal behavior. Cal. Pen.Code § 31.

11 The Henka Plaintiffs’ Complaint sets forth four causes of action against Continental:  
12 Declaratory Judgment (Seventh Cause of Action); Breach of Contract (Eighth Cause of  
13 Action); Appointment of a Receiver (Ninth Cause of Action); and Aiding and Abetting Fraud  
14 (Eleventh Cause of Action).<sup>3</sup> Plaintiffs’ breach of contract and declaratory judgment causes of  
15 action are based in part on their status as subrogees of the third party beneficiaries of the  
16 enhanced crime policies that Continental sold to Vesta and Excalibur. Continental’s  
17 fundamental argument is that none of the Exchangers can be third party beneficiaries because  
18 there is a clear and express disclaimer in Endorsement No. 1 denying any third party rights. In  
19 making this argument, Continental ignores Endorsement No. 3 which for obvious reasons does  
20 not have the disclaimer.

21 Endorsement No. 3 (expanding coverage to encompass the theft of Exchange Funds by  
22 the QI or its principals) must be for the intended benefit of the Exchangers; or: (i) it is void as  
23 against public policy and (ii) Continental is an accessory to a crime. The exclusion of the  
24 \_\_\_\_\_

25 <sup>3</sup> The Henka Plaintiffs’ primary causes of action against Continental are set forth in their Eighth  
26 Cause of Action for Breach of Contract and in their Eleventh Cause of Action for Aiding and  
27 Abetting Fraud. Plaintiffs’ Seventh Cause of Action for Declaratory Relief is grounded on the  
28 same facts and circumstances as their breach of contract claim. Plaintiff’s Ninth Cause of Action  
seeking Appointment of a Receiver is moot as a result of the Court’s order appointing Thomas  
Dillon as the Receiver for Vesta and Excalibur dated December 16, 2009, Docket No.123.

1 Exchangers as intended beneficiaries in Endorsement No. 1 must be limited to situations  
 2 involving employee theft of Exchange Funds as contrasted to QI theft which is the subject  
 3 matter of Endorsement No. 3.

4 The aiding and abetting insurance fraud claim against Continental is viable as the  
 5 current roster of Henka Plaintiffs relied on Vesta's ongoing representations that their Exchange  
 6 Funds were protected by fidelity bonds issued by "one of the nation's highest levels of  
 7 coverage available in the industry." The Henka Plaintiffs are also equitably subrogated to the  
 8 rights of earlier Exchangers doing business with Vesta and Excalibur who parted with their  
 9 money in reliance on the claim of insurance protection, because the Henka Plaintiffs' Exchange  
 10 Funds were then used to pay off the earlier escrows pending at Vesta and Excalibur. If the  
 11 Court concludes that the Continental crime policy was a two party insurance contract intended  
 12 to solely benefit Vesta and Excalibur (the thieves), Plaintiffs request leave to allege conspiracy.

13 As presently alleged, Vesta and Excalibur were operated together as a Ponzi scheme,  
 14 whereby newly deposited Exchange Funds were used to fund older Exchanges because the  
 15 prior deposits had been looted. Plaintiffs' money was used to pay off escrows at Vesta and  
 16 Excalibur which should have been paid off by Continental, pursuant to the various insurance  
 17 policies issued by Continental. As equitable subrogees, the Plaintiffs may enforce the rights of  
 18 prior Exchangers including the right to sue Continental for insurance fraud and for breaching  
 19 the contracts issued to Vesta in 2004, and to Excalibur for 2005, 2006 and 2007. The success  
 20 of an ongoing Ponzi scheme should not inure to the benefit of Continental.

### 21 **III. STANDARD OF REVIEW**

22 A complaint may be dismissed for failure to state a claim upon which relief can be  
 23 granted. Fed. R. Civ. P. 12(b)(6). A claim may be dismissed as a matter of law for: "(1) lack of  
 24 a cognizable legal theory or (2) insufficient facts under a cognizable legal claim." *Robertson v.*  
 25 *Dean Witter Reynolds, Co.*, 749 F.2d 530, 534 (9th Cir. 1984). "A complaint should not be  
 26 dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove  
 27 no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355  
 28 U.S. 41, 45-46, 2 L. Ed. 2d 80, 78 S. Ct. 99 (1957). The Court "must presume all factual

1 allegations of the complaint to be true and draw all reasonable inferences in favor of the  
2 nonmoving party." *Usher v. City of Los Angeles*, 828 F.2d 556, 561 (9th Cir. 1987).

#### 3 **IV. ANALYSIS OF THE CONTINENTAL CRIME POLICIES**

##### 4 **1. Background**

5 Plaintiffs represent a group of former customers of Vesta and Excalibur, who lost their  
6 Exchange Funds on deposit at Vesta. Complaint ¶¶ 1 and 9-14. Defendants Terzakis  
7 Estupinian<sup>4</sup> organized Vesta in January 2004, to act as a QI for purposes of 1031 exchanges,  
8 but in reality to operate as a front enabling Terzakis and Estupinian to perpetuate a Ponzi-  
9 scheme involving the misappropriation of client trust assets dating back to at least 2002. *Id.* ¶¶  
10 1 and 93-107. In September 2004, several months after forming Vesta, Terzakis and  
11 Estupinian, together with several additional partners, formed Excalibur, another QI, to act as a  
12 marketing sub-brand for Vesta, whereby Vesta, through Excalibur, could broaden its business  
13 presence in the northeastern portion of the United States. *Id.* ¶ 37-38.

14 Terzakis and Estupinian operated Vesta and Excalibur together as a partnership,<sup>5</sup>  
15 utilizing the same employees, commingling client Exchange Funds, sharing joint bank  
16 accounts, and splitting company profits. All Exchange Funds, regardless of whether they  
17 originated from Vesta's clients or Excalibur's clients, were deposited into bank accounts held  
18 in Vesta's name. As a result their common ownership, and the commingling of Exchange  
19 Funds, Excalibur obtained access to the Exchange Funds of Vesta's clients (Complaint ¶ 39),  
20 and Vesta obtained access to the Exchange Funds of Excalibur's clients. As partners, Vesta and  
21 Excalibur became co-obligors of the contractual and fiduciary obligations they both owed to  
22 their respective clients. *Id.* ¶ 39. Pursuant to the Ponzi scheme, Vesta Exchange Funds  
23

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24  
25 <sup>4</sup> Terzakis and Estupinian have now been indicted. See *United States of America v. John D.*  
26 *Terzakis and Robert E. Estupinian*, Criminal Case No. 5:09-CR-1212-JF, pending in the Federal  
District Court for the Northern District of California, San Jose Division.

27 <sup>5</sup> Plaintiffs request the Court to take judicial notice of Estupinian's First Amended Counter-  
28 Claim against Terzakis and others, in *Vesta Strategies, LLC v. Estupinian, et al.* Case No. 5:07-  
CV-06216-JW (Docket No. 44), wherein Estupinian alleges that Excalibur and Vesta were joint  
venture partners. See Exhibit 1 to the Henka Plaintiffs Request for Judicial Notice, at ¶ 35, p. 9.

1 deposited by Exchangers doing business with Vesta were used to pay off older exchanges at  
 2 Excalibur because the Exchange Funds of Excalibur’s clients had been looted. *Id.* ¶¶ 126-127.  
 3 The total amount of commingled Exchange Funds clients of both Vesta and Excalibur  
 4 deposited with Vesta and had stolen by Terzakis and Estupinian approximates \$25,000,000.<sup>6</sup>

5 Continental issued Crime Policy No. 267920538 to Vesta for the policy period  
 6 beginning January 2004 through August 15, 2004. Complaint ¶ 111(a). Continental issued  
 7 Crime Policy No. 268100958 to Excalibur, for three consecutive policy periods beginning  
 8 April 22, 2005 and ending August 15, 2007. *Id.* ¶ 112(a), (b) and (c). The Vesta Crime Policy  
 9 and the Excalibur Crime Policies are collectively referred to herein as the “Continental Crime  
 10 Policies.” Representative examples of looted Exchange Funds during the periods of each  
 11 policy is set forth below:

Applicable Policy Period	Evidence of Looting
January 2004 - August 15, 2004	<b>June 7, 2004</b> - Estupinian transferred \$1,256,150 in Exchange Funds to purchase his residence for cash at closing;
April 22, 2005-August 2005	<b>May 4, 2005</b> – Terzakis and Estupinain transferred \$148,000 in commingled Exchange Funds to pay obligations of their other QI entity, Investment Advantage Group, LLC;  <b>May 24, 2005</b> – Terzakis transferred \$200,000 in commingled Exchange Funds to pay his entity Single Site Solutions Corp.
August 2005 – August 2006	<b>July 5, 2006</b> – Estupinian transferred \$910,000 in commingled Exchange Funds to a high-risk mezzanine financing scheme;
August 2006 – August 2007	<b>January 22, 2007</b> – Terzakis transferred \$2,000,000 in commingled Exchange Funds to fund his multiple personal business ventures in the Chicago area.

23  
 24 <sup>6</sup> Plaintiffs bring their action as representatives of a putative class. The class is defined as  
 25 follows: “All persons who entered into an Exchange Agreement with Vesta Strategies, LLC,  
 26 deposited funds with Vesta Strategies, LLC, or had their 1031 Exchange Funds deposited with  
 27 Vesta Strategies, LLC, and have been deprived of the access to those funds held in trust.”  
 28 Complaint ¶ 134. Plaintiffs assert the class includes Excalibur Exchangers who had their  
 Exchange Funds deposited with Vesta. If necessary, Plaintiffs will amend their Complaint to  
 develop in more detail the facts and circumstances surrounding the operation of Vesta and  
 Excalibur together as a partnership, as well as to specifically name as Plaintiffs and incorporate  
 the exchange clients of Excalibur into the class definition.

1 The Continental Crime Policies were standard commercial crime policies modified by  
2 means of three 1031 tax-deferred exchange endorsements.<sup>7</sup> The critical endorsement granting  
3 coverage to Exchangers for the theft of Exchange Funds by (i) the QI, (ii) the owners of the QI,  
4 or (iii) the partners of the QI is Endorsement No. 3. Vesta was a partner of Excalibur and  
5 Excalibur was a partner of Vesta, so the theft by each is covered under the respective policies  
6 issued to the two QIs. Endorsement No. 3 does not exclude third party beneficiary status to  
7 Exchangers doing business with Vesta or Excalibur (because it logically cannot) and it is set  
8 out in its entirety below for the Court to read and study.

9 **ENDORSEMENT NO. 3**

10 **THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY**

11 **INCLUDE OWNERS AND PARTNERS**

12 **FOR LOSSES INVOLVING CLIENT PROPERTY**

13 **PROVISIONS:**

- 14 **1. GENERAL EXCLUSION A. 1.** Acts Committed by **You or Your Partners** will not apply to  
15 losses involving the funds of client/exchangors while the Insured is acting as a qualified  
16 intermediary in a tax-deferred exchange of property intended to qualify under Internal Revenue  
Code 1031. (Emphasis added)
- 17 **2.** In addition to any other rights we have under the law or this policy, it is understood and agreed  
18 that any loss paid as well as any fees, costs or expenses incurred by us as a result of the  
extension of coverage in Provision 1, above, will be subject to all rights of recovery that we, as  
**surety** in this undertaking of Employee Dishonesty coverage, may have against you and your  
19 partners. (Emphasis added)

20 Continental is absolutely correct that a standard commercial crime policy provides  
21 “first-party” coverage to the named insured for losses sustained as a result of employee

22  
23 <sup>7</sup> Plaintiffs did not attach the Continental Crime Policies, including Endorsements Nos. 1, 2 and  
24 3, to their Complaint. Instead, Plaintiffs chose to describe the factual context surrounding  
25 development of the policies and provide a summary of policies’ legal effect. The court may  
26 consider a document not attached to the complaint if the complaint specifically refers to it and its  
27 authenticity is not questioned. Fed. R. Evid. 201(f); *Townsend v. Columbia Operations*, 667 F.2d  
28 844, 848-49 (9th Cir. 1982). Continental, in its motion to dismiss, offers what it purports to be  
true and correct copies of the Continental Crime Policies, including all forms, provisions and  
endorsements that could be located. Plaintiffs have no basis for disputing the authenticity of the  
documents Continental submits, and refers to the documents accordingly.

1 dishonesty and third parties are excluded as beneficiaries.<sup>8</sup> The insurance is “first-party” in  
 2 the sense that it involves a contract between the insurance carrier and the named insured  
 3 protecting an insurable interest of the insured against losses sustained by the insured at the  
 4 hands of a dishonest employee. The insurance is triggered when a covered employee steals  
 5 money or other assets belonging to or possessed by the named insured. In the standard “first-  
 6 party” commercial crime context, there are no third parties whose money is protected against  
 7 theft committed by the named insured.

8 The Continental Crime Policies at issue in this litigation were not standard “first-party”  
 9 commercial crime policies - they were “enhanced” commercial crime policies modified by tax-  
 10 deferred exchange endorsements drafted at the behest of the FEA which expanded coverage to  
 11 protect Exchange Funds from theft by the QI, the named insured. The insured risk was not  
 12 limited to the situation where an errant employee penetrated the financial protections  
 13 implemented by the employer to protect his own money or money owed to others.  
 14 Endorsement No. 3 expanded the scope of coverage to include protection of Exchange Funds  
 15 belonging to clients of the QI from the intentional acts of theft and embezzlement by the QI  
 16 itself, and by those persons in control of the QI including its owners and partners. The three  
 17 fundamental differences between a standard “first-party” commercial crime policy (and the  
 18 cases interpreting it) and the enhanced Continental Crime Policies at issue in this litigation are:  
 19 (i) the ownership of the funds at risk of theft; (ii) the party exposed to the loss in the event of  
 20 theft; and (iii) the identity of the thief whose intentional conduct is insured against by  
 21 Continental.

## 22 **2. The Tax-Deferred Exchange Endorsements**

23 The Continental Crime Policies were issued with three separate tax-deferred exchange  
 24

25 <sup>8</sup> “First-party” coverages protect against loss or damage sustained by the named insured.  
 26 *Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.* 10 Cal App 4<sup>th</sup> 645, 663 (1995). “Third-  
 27 party” coverages protect the insured against liability to another based on the insured’s acts.  
 28 *Garvey v. State Farm Fire & Cas. Co.* 48 Cal 3d 395, 399 (1989). And a surety bond protects a  
 third person against loss resulting from its dealings with the insured. Cal. Civ. Code §2787;  
*Cates Construction, Inc. v. Talbot Partners* 21 Cal 4<sup>th</sup> 28, 38 (1999).

1 endorsements.<sup>9</sup> While the language of the endorsements is slightly different for the 2006 and  
 2 2007 Excalibur Policies, there is no material difference in the language of any of the relevant  
 3 endorsements. A fundamental understanding of how these endorsements modified the standard  
 4 commercial crime policy is needed to understand the surety nature of the coverage provided  
 5 and Plaintiffs' standing to sue as third party beneficiaries or subrogees of third party  
 6 beneficiaries. The tax-deferred exchange endorsements effectively converted a standard "first  
 7 party" insurance contract into a three-party surety bond by doing all of the following: (i)  
 8 expanding the scope of coverage to apply to the funds of an insured QI's client on deposit with  
 9 the insured for purposes of 1031 exchanges;<sup>10</sup> (ii) dramatically expanding coverage to include  
 10 the intentional theft of Exchange Funds committed by the named insured (the QI), its owners  
 11 and partners;<sup>11</sup> and (iii) providing the insurer with the right to sue the insured QI for  
 12 subrogation in the event a loss was paid as the result of a theft by the insured QI.<sup>12</sup>

13 The third endorsement (which **"INCLUDES OWNERS AND PARTNERS FOR**  
 14 **LOSSES INVOLVING CLIENT PROPERTY"**) grants coverage for "any loss resulting  
 15 from any dishonest or criminal act committed by you or any of your partners . . ." <sup>13</sup> The terms  
 16 "you " and "your " refer to the named insureds, Vesta and Excalibur.<sup>14</sup> There can be no loss of  
 17 an insurable interest owned by Vesta or Excalibur for thefts committed by Vesta or Excalibur.  
 18 It is absolutely fundamental in all states of the United States that a person may not purchase  
 19  
 20  
 21

22 <sup>9</sup> See Exhibits A, B, C and D to Faas Declaration, offered in support of Continental's motion.

23 <sup>10</sup> Endorsement No. 1.

24 <sup>11</sup> Endorsement No. 3.

25 <sup>12</sup> Endorsement No. 3.

26 <sup>13</sup> See Endorsement No. 3.

27 <sup>14</sup> See General Crime Provisions.  
 28

1 insurance to cover losses sustained by others as a result of the insured's own intentional theft.<sup>15</sup>  
2 Endorsement No. 3 expands coverage to include acts of theft committed by the named insured,  
3 including any of its owners and partners. The expansive grant of coverage only makes sense if  
4 the source of funds (the insurable interest) at risk of loss belong to a third person (not the  
5 named insured), and the third person's funds are insured for the theft committed by the named  
6 insured.

7 When a third person's funds are insured for theft by the named insured, the third  
8 persons are necessarily intended beneficiaries of the policy, as set out in Cal. Civ. Code § 1559,  
9 because the thieves, by law, cannot be the beneficiaries. Insuring against acts of theft  
10 committed by the named insured has the legal effect of providing a grant of coverage  
11 protecting Exchangers depositing Exchange Funds with the insured from theft by the insured.  
12 There is no other way to interpret Endorsement No. 3 and Continental knew this was the  
13 interpretation before claims were made. The law is clear, as Vesta and Excalibur may not buy  
14 insurance, steal Exchange Funds, and then submit a claim to Continental for payment to Vesta  
15 and Excalibur for the amount of Exchange Funds they have stolen. Providing economic  
16 incentives to thieves to encourage them to steal would make Continental an accessory to crime.  
17 Cal. Pen. Code § 31.

18 Adam McDonough, a drafter of Endorsement No. 3, testified in *SCCAA v. Brown &*  
19 *Brown*, that the Exchangers were the express intended beneficiaries of Endorsement No. 3  
20 contained in the policies sold by Continental to Vesta and Excalibur:

21  
22  
23  
24  
25 <sup>15</sup> Insurance Code §533 provides that an insurer is not liable to indemnify an insured for losses  
26 caused by the willful or intentional acts of the insured. The statute was enacted for public policy  
27 reasons to discourage willful torts. The language in the statute is an implied exclusionary  
28 provision which is to be read into all insurance policies. *J.C. Penny Cas. Ins. Co. v. M.K.*, 52 Cal  
3d 1009, 1019 (1991). Therefore, Vesta and Excalibur may not insure themselves for their own  
willful theft of Exchange Funds. They cannot be beneficiaries of the policy for their own theft,  
leaving of the Exchangers as the only possible beneficiaries for QI theft of Exchange Funds.



1 The only possible beneficiaries of Endorsement No. 3 are the Exchangers doing  
 2 business with Vesta and Excalibur, because Continental has the right to recover stolen client  
 3 funds directly from “you”, which is Vesta or Excalibur, if Vesta or Excalibur (as contrasted to  
 4 an employee) stole the funds.

5 Assume a theft by the QI of \$100,000 in Exchange Funds and follow the flow of money  
 6 under Continental’s interpretation versus the Henka Plaintiffs’ interpretation. Under  
 7 Continental’s astute insurance analysis (it is an insurance company), Vesta steals \$100,000,  
 8 submits a claim for \$100,000, and is paid \$100,000 as an incentive, for a total take of  
 9 \$200,000. Under the Henka Plaintiffs’ analysis, Vesta steals \$100,000, Continental pays the  
 10 Exchanger the \$100,000, and pursues Vesta to recover the \$100,000 if it can. Plaintiffs’  
 11 interpretation gives no benefit to the thief as required per the law of insurance, and no  
 12 inducement to Vesta to steal Exchange Funds.

13 Chris Barr, the underwriter at U.S. Fire, testified in *SCCAA v. Brown & Brown* that the  
 14 goal of Endorsement No. 3 was to benefit the Exchangers, and not the thieving QIs. If U.S.  
 15 Fire paid for the theft of client funds by the QI, the insurer, as surety, could sue Vesta or  
 16 Excalibur to recover, but Exchange Funds on deposit at the QIs would be protected from the  
 17 insurer’s subrogation rights under the policy. Chris Barr’s testimony on the insurer’s  
 18 subrogation rights is quoted below:

19 **Deposition Testimony of Chris Barr**

20 **Question by Brace:** Well, tell me your understanding of how [the surety  
 21 subrogation clause] would work if the owner steals some client funds.

22 **Answer by Barr:** If a loss occurs that is covered . . . we would have the  
 23 right, which we under many circumstances would not have, **to seek**  
**recovery against our own insured.** (Emphasis added.)

24 **Q.** So if [the QI] steals \$100,000, and you have to pay \$100,000, you get  
 25 to go after [the QI] for the \$100,000?

26 **A.** If they had \$100,000, we have the right to try and get it.

27 **Q.** But that would not include going after trust assets [in the possession  
 28 of the QI], which are the assets of the other depositors, isn’t that right?

1 A. That's true.

2 Q. So [the QI] steals \$100,000, and makes a claim under the policy.  
3 Your check from U.S. Fire goes into [the QI] general account or goes  
4 directly to the client [Exchanger] or goes where?

5 A. That's a hypothetical I cannot answer . . . There are obviously some  
6 steps that have to be taken to make sure that we're not essentially paying  
7 the loss to the guy who stole the money in the first place.

8 Q. . . . And so the goal of U.S. Fire would not be to pay the thieving  
9 party?

10 A. Exactly.

(Barr Depo. p. 163:11 – 165:23).

11 Endorsement No. 3 subjects the QI to liability back to the insurer who pays for the theft  
12 by the QI of Exchange Funds. The right of the surety to seek subrogation back against the  
13 principal obligor creates a detriment to the named insured and a disincentive to steal. It is  
14 inconceivable to say that the Exchangers, as obligees, doing business with Vesta and Excalibur  
15 were not intended to be the sole beneficiaries of the promise made by Continental to pay for  
16 the theft of Exchange Funds by the named insured.

17 Exchange Funds belong to the Exchangers. If Vesta or Excalibur engage in stealing  
18 Exchange Funds, Continental must pay for the loss. The payment from Continental must go to  
19 the Exchangers whose funds were stolen. The payments cannot go to Vesta or Excalibur (the  
20 QIs who stole the money) to be deposited into their general accounts after payment.  
21 Continental, as surety, may then seek subrogation against Vesta and Excalibur. Continental's  
22 right to seek subrogation would not include access to Exchange Funds as a source of  
23 repayment. In this scenario, Continental is a surety, Vesta and Excalibur are the primary  
24 obligors, and the Exchangers are the obligees in the 3-party surety relationship. As such, the  
25 Exchangers, as obligees, must be third party beneficiaries.

26 **3. The Disclaimer Regarding Third Party Beneficiaries**

27 Continental now insists the policies it issued Vesta and Excalibur were "first-party"  
28 insurance contracts executed only for the sole economic benefit of the named insured, to pay

1 benefits to the named insured. In making this argument, Continental ignores the principle that  
2 insurance cannot be purchased to benefit the party that perpetrates a theft but sustains no loss.  
3 In addition, Continental dismisses the context in which the policies were developed, and the  
4 language in Endorsement No. 3 which confirms Continental's role as a surety. Instead,  
5 Continental relies exclusively on a single sentence in Endorsement No.1 which reads:  
6 **"However, this insurance is for [Vesta's and Excalibur's] benefit only. It provides no rights**  
7 **or benefits to any other person or organization."** (emphasis added).

8 The non-third party beneficiary ("TPB") disclaimer Continental relies upon is a  
9 provision commonly found in standard "first-party" commercial crime policies. The disclaimer  
10 makes good sense in the "first-party" insurance context, where the insurance is intended to  
11 protect against theft by a dishonest employee of the insured. However, the disclaimer makes no  
12 sense in the QI context where the risk of theft is by the insured, and is not found in  
13 Endorsement No. 3. If the TPB disclaimer contained in Endorsement No. 1 is interpreted as  
14 denying benefits to the actual owners of the Exchange Funds, then the effect of the  
15 endorsements combined would be to provide QIs incentive insurance for their intentional acts  
16 of stealing other people's money, which is against public policy and against the law. In *Foster*  
17 *v. National Union Fire Ins. Co.*, 902 F. 2d 1316 (8<sup>th</sup> Cir. 1990), the court allowed third party  
18 investors to enforce a fidelity bond issued by National Union, even though it expressly  
19 excluded coverage for third parties, as is the case with the Continental policies. The court  
20 granted the third parties standing to sue, despite the anti-TPB clause for reasons of public  
21 policy.

22 Ambiguity in an insurance contract may result from contradictory or necessarily  
23 inconsistent language found in different portions of the policy. *Delgado v. Heritage Life Ins.*  
24 *Co.*, 157 Cal. App. 3d 262, 271 (1984); *Smith Kandal Real Estate v. Continental Casualty Co.*  
25 67 Cal. App. 4th 406, 416 (1988). The disclaimer of third party beneficiaries found in  
26 Endorsement No.1 is in direct conflict with the expanded coverage provided by Endorsement  
27 No. 3. This ambiguity is apparent from the policy language itself when read in context, as well  
28 as the circumstances of the case, and common sense. A policy provision will be considered

1 ambiguous if it is capable of two or more constructions, both of which are  
 2 reasonable. *MacKinnon v. Truck Ins. Exch.*, 31 Cal. 4th 635, 648 (2003); *see also Nava v.*  
 3 *Mercury Casualty Co.*, 118 Cal. App. 4th 803, 805 (2004); *Shell Oil Co. v. Winterthur Swiss*  
 4 *Ins. Co.*, 12 Cal. App. 4th 715, 737 (1993); *see also Titan Corp. v. Aetna Cas. & Sur. Co.*, 22  
 5 Cal. App. 4th 457, 469 (1994) (predicate to interpreting ambiguities in favor of coverage is that  
 6 policy be *reasonably* susceptible to more than one interpretation).

7 The anti-TPB language contained in Endorsement No. 1 is in direct conflict with the  
 8 coverage for QI theft and surety language in Endorsement No. 3. There is no plain and clear  
 9 meaning which can reconcile the patent inconsistency. As such, extrinsic evidence is  
 10 admissible to establish the parties' intent.<sup>16</sup> What the QIs participating in the FEA program  
 11 could reasonably expect in terms of coverage is what they were advertising to the public  
 12 through representations on their websites and in printed promotional materials. Vesta  
 13 advertised to the Henka Plaintiffs that the insurance was:

14 **"To provide our clients with peace of mind, Vesta automatically**  
 15 **provides Fidelity Bonds coverage for every individual exchange.**  
 16 **This policy is underwritten by one of the nation's largest insurance**  
 17 **companies and offers one of the highest levels of coverage available**  
 18 **in the industry. There is no additional cost to our clients for this**  
 19 **valuable protection."** Complaint ¶ 113.

20 Excalibur made virtually identical statements on its website and in its printed promotional  
 21 materials representing that clients' funds were "bonded" against QI theft. Complaint ¶ 114.  
 22 Vesta and Excalibur's representations were consistent with the description of coverage  
 23 described in the Evidences of Insurance ("EOIs") issued by Lockton, the insurance broker who  
 24 procured the Continental Crime Policies for both Vesta and Excalibur. *Id.* ¶ 115. The EOIs  
 25 unambiguously stated without disclaimer, reservation or hesitation that the clients of Vesta and  
 26 Excalibur were protected by a:

27 <sup>16</sup> When the terms of an insurance policy are ambiguous, extrinsic evidence is generally  
 28 admissible to establish the parties' intent. *MacKinnon v. Truck Ins. Exch.* 31 Cal 4<sup>th</sup> 635, 651  
 (2003).

1           **“Fidelity Bond [which] insures against losses resulting from**  
2           **dishonest acts, such as embezzlement, conversion, fraud, theft,**  
3           **etc., by. . . the insured’s employees, partners and owners against**  
          **the insured’s clients.”** Complaint ¶ 116.

4           The EOIs and website representations alleged by Plaintiffs in their Complaint are  
5 consistent with the Plaintiffs’ interpretation of the terms of coverage granting Exchangers  
6 standing as obligees of a surety relationship. They should be viewed by this Court as  
7 supporting the only reasonable interpretation.

8           In *American United Logistics, Inc. v. Catellus Development Corp.*, 319 F.3d 921 (7<sup>th</sup>  
9 Cir. 2003); a lease contract stated that “nothing herein is intended to create any third party  
10 benefit.” A third party (“AUL”) brought suit claiming to be a third party beneficiary of the  
11 lease contract notwithstanding the express disclaimer. The court concluded that AUL was  
12 indeed an intended third party beneficiary because the clear intent articulated in the contract  
13 was to benefit AUL. The same rule of contract interpretation applies here. Plaintiffs, as  
14 obligees, are either viewed as intended third party beneficiaries of the Continental Crime  
15 Policies, or the entire FEA insurance program was a scam and Continental was providing  
16 economic incentives for QIs to steal money.

17           Continental must do one of two things: (i) it must admit it was a knowing participant in  
18 a national insurance scam and a co-conspirator of the theft of Exchange Funds; or (ii) it must  
19 adopt the interpretation that Plaintiffs, as obligees, have standing to assert claims against  
20 Continental, as a surety, under the policies issued to Vesta and Excalibur, the obligors. As set  
21 out in Exhibit B to Plaintiffs’ complaint, on August 11, 2006, Kevin Donahue (of Continental)  
22 wrote an email to Daniel Auslander (of Continental) about serious concerns Continental had  
23 regarding renewal of the FEA program on August 15, 2006, because QIs were using the  
24 insurance to defraud Exchangers.<sup>17</sup> In this email, Continental, through its employee, states:

25  
26  
27  
28           <sup>17</sup> See Continental’s August 11, 2006 email, attached as Exhibit 3 to the Henka Plaintiffs’  
Request for Judicial Notice.

- 1 1. The [above] captioned [insurance] is one of the Lockton “Fed’l Exchange  
2 Accommodator” crime accounts which account for about **\$800k in annual  
3 premium** for Lisa [Continental] (emphasis added).
- 4 2. There has never been a claim on any of these accounts, and Lockton is  
5 becoming very impatient with my trying to alleviate some concerns I have  
6 on the program.
- 7 3. Can I get your advice on the following major concern I have:  
8 **My concern is the large Fidelity programs are really a marketing ploy  
9 to give their clients the false impression our policy is somehow  
10 guaranteeing the safety of the clients “investment” with insured.**  
11 (emphasis added).
- 12 4. I’m not sure whether they [Continental] approved this wording on this  
13 “Evidence of Insurance” Ms. Porras of Lockton provides to the insureds.
- 14 5. It’s clear that the Fidelity Coverage description [contained in the EOIs]  
15 would never pass CNA Legal review.

16 In substance, on August 11, 2006, Continental admits that (i) it has been making  
17 \$800,000 per year on an insurance program which had not suffered any claims; (ii) the EOIs  
18 issued by Continental’s broker would never be approved by Continental’s lawyers; and (iii)  
19 the QIs buying the “enhanced” insurance are doing so to give their client Exchangers the false  
20 impression that Continental’s policy “somehow” guarantees the safety of Exchangers’  
21 Exchange Funds deposited with the insured QIs. **What does Continental do with this  
22 information?** Four days later, Continental reissued its enhanced policies with the surety  
23 component in Endorsement No. 3 to the QI members of the FEA to make another \$800,000 in  
24 premium on a program that had suffered no claims. Included in the renewal was the  
25 \$2,500,000 policy for 2006-2007 reissued to Excalibur.

26 The Henka Plaintiffs request the Court take judicial notice of the First Amended  
27 Complaint in *In Re: Edward H. Okun Internal Revenue Service § 1031 Tax Deferred  
28 Exchange Litigation*, MDL. No. 2028, pending in the United States District Court for the  
Northern District of California, Case No. 07-cv-2795-JW (hereinafter “*Hunter P*”) (Docket

1 No. 76).<sup>18</sup> As noted on page 37 in the *Hunter I* First Amended Complaint, Continental issued  
 2 the same policies on August 15, 2006 to Edward Okun's 1031 Advance, SOS, IXG and  
 3 REES, and issued another policy to The 1031 Tax Group LLC on November 11, 2006.

4 Continental's knowing behavior in August of 2006 creates two alternative theories of  
 5 legal liability to the Exchangers doing business with Vesta and Excalibur, the QIs advertising  
 6 the coverage. By reissuing the policies in the FEA program, knowing about the accepted and  
 7 advertised interpretation as a financial guarantee to protect Exchangers from QI theft of  
 8 Exchange Funds, Continental adopted this interpretation as being true and accurate. As such,  
 9 the Court may view this as sufficient extrinsic evidence of Continental's intent when  
 10 attempting to reconcile Endorsement No. 1 with Endorsement No. 3 to determine if Plaintiffs  
 11 have standing to sue. The Court should keep in mind that Continental's adoption of Plaintiffs'  
 12 interpretation in August of 2006 is before the onslaught of Exchanger claims which arose  
 13 upon the collapse of the real estate bubble. Contemporaneous exposition is generally the best  
 14 evidence to determine intent. Cal. Civ. Code § 3535.

15 In the alternative, Plaintiffs have included a fraud claim against Continental. If  
 16 Continental knew that QIs were using the Continental enhanced crime policies to give the  
 17 false impression that Exchange Funds were protected, to induce Exchangers to part with their  
 18 money, and Continental reissued the policies with knowledge of the fraud being perpetrated, it  
 19 is liable for aiding and abetting the fraud for pecuniary gain (\$800,000 annually). Fraud at this  
 20 level committed by Continental is on par with the crimes committed by Terzakis and  
 21 Estupinian; or Okun, who was sentenced to 100 years in prison.

22 **V. THE HENKA PLAINTIFFS HAVE THE RIGHT TO STAND IN THE SHOES**  
 23 **OF EARLIER EXCHANGERS WHOSE EXCHANGE FUNDS WERE**  
 24 **STOLEN DURING THE EARLIER POLICY PERIODS**

25 Terzakis and Estupinian were using Vesta and Excalibur to steal client trust money  
 26 deposited with Vesta during the policy periods that the Continental Crime Policies were in

27 <sup>18</sup> See Exhibit 2 to the Henka Plaintiffs' Request for Judicial Notice.  
 28

1 effect. Complaint ¶¶ 125-127. Terzakis and Estupinian concealed their theft by using the  
2 Exchange Funds of more recent clients to pay the close of escrows on replacement properties  
3 of earlier clients. *Id.* ¶ 127. Terzakis and Estupinian used the Henka Plaintiffs' money, and the  
4 money of Exchangers before them, without their consent, to cover up earlier thefts dating back  
5 to 2004. *Id.* ¶ 127. This pattern occurred repeatedly and continuously during each of the policy  
6 periods covering both Vesta and Excalibur. *Id.* ¶ 127. The Henka Plaintiffs, as the involuntary  
7 payors of the insurance obligations Continental owed to earlier Exchangers doing business with  
8 Vesta and Excalibur, are subrogated to, and have the same rights against Continental as the  
9 earlier Exchangers had when their money was stolen during the relevant policy periods. *Id.* ¶  
10 127. Continental cannot claim that the success of the Ponzi scheme inures to its benefit.

11 Subrogation may be applied where a person who is not a volunteer pays a debt for  
12 which another is primarily answerable, and which, in equity and good conscience, should have  
13 been discharged by the latter. Complaint ¶ 128; *Stein v. Simpson* 37 Cal. 2d 79, 83 (1951);  
14 *Offer v. Superior Court* 194 Cal. 114, 118 (1924). In such cases, the payor steps into the shoes  
15 of the party receiving benefit for the payment, succeeding to the rights of the other in relation  
16 to the debt or claim. *Id.* ¶ 128; *Transit Cas. Co. v. Spink Corp.* 94 Cal. App. 3d 124, 132  
17 (1979). Actual loss to the subrogor (earlier exchange client) is not a prerequisite to equitable  
18 subrogation; all that is required is that the subrogor would have suffered loss had not the  
19 subrogee (the Henka Plaintiffs) discharged the liability or paid the loss on the wrongdoer's  
20 behalf. *Id.* ¶ 128; *Northwestern Mut. Ins. Co. v. Farmers' Ins. Group* 76 Cal. App. 3d 1031,  
21 1044 (1978). It makes no difference that the Henka Plaintiffs' money was stolen after the  
22 Continental Crime Policies had lapsed. *Id.* ¶ 128. The Henka Plaintiffs' money was used to  
23 cover up and conceal prior losses dating back to the earlier policy periods. *Id.* ¶ 128. Because  
24 of this, the Henka Plaintiffs must be allowed to step into the shoes, and be subrogated to the  
25 rights of the earlier Exchangers, who were third-party beneficiaries of the modified crime  
26 policies issued by Continental to Vesta and Excalibur. *Id.* ¶ 128.

27 A contrary result would allow Continental to be unjustly enriched by the success of the  
28 fraud perpetrated on the Henka Plaintiffs by Terzakis and Estupinian. Continental collected

1 policy premiums from Vesta and Excalibur for 2004, 2005, 2006 and 2007. Exchange Funds  
2 were stolen by Vesta, through Terzakis and Estupinian, in 2004. Exchange Funds were stolen  
3 by Excalibur and Vesta, through Terzakis and Estupinian, in 2005, 2006 and 2007. No claims  
4 were asserted against Continental by these earlier Exchangers because the Henka Plaintiffs  
5 involuntarily paid the claims which should have been asserted against Continental. As  
6 equitable subrogees of these earlier Exchangers, the Henka Plaintiffs are now asserting these  
7 claims and have the right to do so.

8 **VI. THE LOSS DISCOVERY PROVISION HAS BEEN COMPLIED WITH AND**  
9 **THE NOTICE OF CLAIM REQUIREMENT HAS BEEN TOLLED BY THE**  
10 **ADVERSE DOMINATION OF VESTA AND EXCALIBUR BY TERZAKIS**  
11 **AND ESTUPINIAN.**

12 The Continental Crime Policies require that a loss giving rise to a claim must be  
13 discovered either (i) during the policy period, or (ii) during the period for extended discovery,  
14 which generally is 60 days beyond the cancellation or termination date of the policy.<sup>19</sup> The  
15 policies state that “discovery” occurs “when you [the named insured] first become aware of  
16 facts which would cause a reasonable person to assume that a loss covered by this insurance  
17 has been or will be incurred[.]”<sup>20</sup> After the insured discovers the loss, he must notify  
18 Continental “as soon as possible”.<sup>21</sup>

19 Continental claims that the Henka Plaintiffs (as well as all other Vesta and Excalibur  
20 Exchangers) are not insureds under the policies and are not intended third party beneficiaries.  
21 Continental then turns 180 degrees and argues that the Henka Plaintiffs failed to comply with  
22 the loss discovery clause because “they” discovered their losses after the various policies  
23 expired. However, the loss discovery clause is limited by definition to discovery by “you”,

24 <sup>19</sup> The only exception is the Excalibur policy in effect from August 15, 2005 to August 15,  
25 2006, which provides for a loss discovery period extending “one year from the end of the policy  
26 period” or to August 15, 2007.

27 <sup>20</sup> Section B.4 of Continental Crime Policies Nos. 267920538 and 268100958.

28 <sup>21</sup> Section B.5 of Continental Crime Policies Nos. 267920538 and 268100958.

1 and “you” is defined as Vesta and Excalibur. Vesta and Excalibur discovered the theft loss the  
 2 moment the owners of these named insureds (Terzakis and Estupinian) were stealing the  
 3 money. Therefore, the thefts committed by the owners and partners of the named insureds  
 4 were discovered by the named insureds during each policy period in which the thefts occurred,  
 5 satisfying the terms of the applicable loss discovery clause.

6 As to the notice requirement, Thomas Dillon, the court-appointed Receiver for Vesta  
 7 and Excalibur has now made claims on behalf of Vesta and Excalibur.<sup>22</sup> Mr. Dillon’s claim  
 8 notice to Continental was made on February 13, 2010, “as soon as possible” after his  
 9 appointment, satisfying the terms of the applicable claim notice provision.

10 In addition, the law governing insurance contracts allows the time for making a claim to  
 11 be equitably tolled during the period that an insured is adversely dominated by its owners.  
 12 Complaint ¶ 130. Adverse domination is a tolling doctrine, and was originally developed to toll  
 13 the statues of limitation applicable to a corporation’s claims against its officers and directors.  
 14 The doctrine is based on the recognition that a defalcating officer or director cannot be  
 15 expected to protect the interests of the corporation. See *Resolution Trust Corp. v. Gardner*, 798  
 16 F. Supp. 790, 795 (D.D.C. 1992) (discussing the rationale underlying the doctrine). The theory  
 17 has been applied to discovery provisions in insurance policies, specifically including contracts  
 18 of fidelity insurance. See *Admiralty Fund v. Peerless Insurance Company*, 143 Cal. App. 3d  
 19 379 (1983). The theory applies here to toll the loss discovery and notice of claim provisions,  
 20 including the period for Vesta and Excalibur, and/or their client Exchangers, to make a claim.

21 **VII. PLAINTIFFS HAVE A WELL PLEAD CAUSE OF ACTION AGAINST**  
 22 **CONTINENTAL FOR AIDING AND ABETTING THE FRAUD COMMITTED**  
 23 **BY VESTA AND EXCALIBUR.**

24 **1. Summary of Plaintiffs’ Aiding and Abetting Theory**

25 Persons who aid and abet another in the commission of a fraud may be liable for that fraud (1)  
 26 if the plaintiff alleges and proves in addition to the perpetration of the underlying fraud that there

27 <sup>22</sup> Thomas Dillon’s insurance claim letters are attached as Exhibit 4 to the Henka Plaintiffs’  
 28 Request for Judicial Notice.

1 was knowledge of this fraud on the part of the aider and abettor, and substantial assistance by the  
 2 aider and abettor in achievement of the fraud; and (2) that damages to the plaintiff were  
 3 proximately caused thereby. Plaintiffs must at least demonstrate some measure of “active  
 4 participation” and knowing provision of substantial assistance by the defendant to the principal’s  
 5 alleged fraud. 37 Am. Jur. 2d Fraud and Deceit § 302 (2002).

6 Terzakis and Estupinian were operating a RICO enterprise configured as a 1031  
 7 Exchange Ponzi scheme.<sup>23</sup> Complaint ¶¶ 1, 93-107 and 125-127. As part of their fraud, Terzakis  
 8 and Estupinian needed to induce new Exchangers to deposit additional Exchange Funds so they  
 9 advertised that Vesta and Excalibur were insured by a policy which guaranteed the protection of  
 10 Exchange Funds on deposit at each QI from theft by the QI. *Id.* ¶¶ 107, 110, 113-120.  
 11 Continental knew that QI members of the FEA were advertising the enhanced commercial crime  
 12 coverage as a financial guarantee and accepted these representations as either being true (that  
 13 there was such coverage) or false (that there was no such coverage). *Id.* ¶¶ 86-87 and 199-200. If  
 14 Continental believed that the QI representations about coverage were false and it went ahead and  
 15 continued to issue the policies to collect its \$800,000 in annual premiums, Continental knowingly  
 16 aided and abetted the fraud being committed by Vesta and Excalibur against the Henka Plaintiffs.  
 17 *Id.* ¶¶ 201-202. Continental ratified the fraud committed against the earlier Exchangers doing  
 18 business at Vesta and Excalibur.

## 19 2. Plaintiffs Have Adequately Alleged Reliance

20 Continental asserts that, as a matter of law, the Henka Plaintiffs could not have

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21  
 22 <sup>23</sup> QIs who pay older 1031 Exchanges with after-acquired funds when the trust is in a deficit operate  
 23 a Ponzi scheme which is a fraud. *See Taxel v. Vaca (In re San Diego Realty Exch., Inc.)*, 132 B.R.  
 24 424, 429 (Bankr. S.D. Cal. 1991), *rev'd on other grounds, sub. nom. Taxel v. Surnow*, 132 B.R. 424,  
 25 1994 U.S. App. LEXIS 10317 (9th Cir. Cal. May 2, 1994). Even when a QI does not start out as a  
 26 Ponzi scheme, once [the company] mismanaged and converted the funds of some clients, and kept  
 27 taking in the business and assets of others, it quickly became that.” *Manty v. Miller & Holmes, Inc.*  
 28 *(In re Nation- Wide Exch. Servs.)*, 291 B.R. 131, 149 n. 20 (Bankr. D. Minn. 2003) (stating that this  
 case could be termed a “resulting Ponzi scheme or Ponzi schemes by performance”). The very nature  
 of a Ponzi scheme guarantees that the persons who are harmed are not those who deposit money in  
 the beginning, but those who make their deposits right before the collapse. Courts recognize that the  
 Ponzi scheme itself presupposes proximate causation (or foreseeability) because the intent to defraud  
 future undertakers can be inferred as a matter of law. *Emerson v. Maples (In re Mark Benskin &*  
*Co.)*, 1995 U.S. App. LEXIS 16053, \*12-13 (6th Cir. Tenn. June 26, 1995); *Merrill v. Abbott (In re*  
*Indep. Clearing House Co.)*, 77 B.R.843, 860 (D. Utah 1987).

1 reasonably relied on the 2004 policy issued to Vesta, or the 2005, 2006 and 2007 policies  
2 issued to Excalibur, because those policies expired before the Henka Plaintiffs deposited their  
3 money. In essence, Continental is arguing that for QIs to be ongoing participants in the  
4 insurance fraud being perpetrated with the assistance of Continental, each defalcating QI had to  
5 continue paying its fair share to Continental in exchange for the right to continue to represent  
6 fraudulent coverage. For a QI to pay for only a few of the earlier fraudulent policies, but reap  
7 the financial benefits of being able to continuously represent fraudulent coverage, would be  
8 unfair to Continental. Continental's argument asks the Court to enforce honor amongst  
9 thieves.

10 The Henka Plaintiffs relied on the existence of coverage as advertised by Vesta and  
11 Excalibur. As demonstrated by Plaintiffs, the Continental coverage issued to Vesta in 2004  
12 and to Excalibur in 2005, 2006 and 2007 would provide insurance to pay for the Henka  
13 Plaintiffs' losses if the coverage was interpreted as it was represented, irrespective of the fact  
14 that the effective dates of the policies lapsed before Plaintiffs deposited their money.  
15 Therefore, Plaintiffs' reliance on Vesta's misrepresentations was not unreasonable as a matter  
16 of law. Continental cannot claim that expiration of its fraudulent policies interrupted the causal  
17 chain making Plaintiffs' reliance unreasonable.

18 Continental also ignores the subrogation allegations in the Henka Plaintiffs' complaint  
19 which allow them to stand in the shoes of the earlier Exchangers who were defrauded by the  
20 misrepresentations about the scope of coverage. Complaint ¶¶ 127-128. The Henka Plaintiffs'  
21 money was used without their consent by Vesta and Excalibur to cover up thefts dating back to  
22 each of the Continental Crime Policy periods. *Id.* The Henka Plaintiffs, as the involuntary  
23 payors of obligations owed to the prior Exchangers, have the same rights the prior Exchangers  
24 had when their money was stolen, including the right to proceed against Continental for fraud.  
25 *Id.* ¶ 127. The Henka Plaintiffs allege that, in addition to themselves, these earlier Exchangers  
26 (the Henka Plaintiffs' subrogors) relied upon the representations made by the QIs and endorsed  
27 by Continental. *Id.* ¶¶ 119 and 201-202.

1           **3. Plaintiffs Have Adequately Alleged Substantial Assistance**

2           Continental next argues there was no substantial assistance sufficient to support a claim  
 3 for aiding and abetting fraud. Continental argues that the Exchangers had no “special  
 4 relationship” with Continental giving rise to a duty to cure the ongoing misperception.  
 5 Continental cites three cases for the proposition that nondisclosure or concealment may  
 6 constitute actionable fraud only in circumstances where there is some “special duty” owed by  
 7 one party to another. These cases are inapposite. Issuing a surety bond which is to be used as  
 8 part of a fraudulent scheme is substantial assistance if it assists in the perpetration of the  
 9 underlying scheme. See *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Calinvest*, 1992  
 10 U.S. Dist. LEXIS 1956 (S.D.N.Y February 13, 1992) (allegations that insurer intentionally  
 11 participated in a fraudulent limited partnership scheme by bonding the investments adequately  
 12 alleged substantial assistance). Moreover, even if a “special duty” was required between  
 13 Continental and the Exchangers, one did exist, as a result of the three party surety relationship.  
 14 “The surety relationship is a tripartite one; it is a third party (the obligee), not the principal,  
 15 who is protected, although the principal pays the premium.” *Airlines Reporting Corp. v. United*  
 16 *States Fidelity & Guar. Co.* 31 Cal App 4<sup>th</sup> 1458, 1464 (1995). Continental had a contractual  
 17 relationship with its obligees, and armed with knowledge that they were acting upon a false set  
 18 of facts, Continental had a duty to stop assisting the fraud and prevent future misunderstanding  
 19 regarding the coverage provided. Complaint ¶ 202.

20           **4. Plaintiffs Have Adequately Alleged Knowledge**

21           Continental’s final argument is that Plaintiffs have failed to allege the knowledge  
 22 element needed to support a claim for aiding and abetting fraud. Continental refers to the  
 23 e-mail dated August 11, 2006<sup>24</sup> (which is an admission of grotesque corporate greed and  
 24 obfuscation) and claims it is irrelevant because the corporate memo post-dates the expiration of  
 25 the 2004 Vesta Crime Policy, and pre-dates Plaintiffs’ deposit of their Exchange Funds.

26 \_\_\_\_\_  
 27 <sup>24</sup> See the Henka Plaintiffs’ Request for Judicial Notice, Exhibit 3.  
 28

1 Continental then suggests that its admitted state of knowledge as of August 11, 2006 could not  
2 have contributed to the losses suffered by Plaintiffs. Continental is wrong.

3 The fact that Vesta continued its fraud without paying Continental its share of the booty  
4 is a non-justiciable dispute between Continental and Vesta. The policy Continental did issue to  
5 Excalibur after August 11, 2006 covers the Henka Plaintiffs' damages if construed as  
6 represented. In addition, Continental ignores the Henka Plaintiffs' right to stand in the shoes of  
7 the Excalibur Exchangers who were defrauded by the 2006 renewal policy issued to Excalibur  
8 four days after the August 11, 2006 email. The Henka Plaintiffs have made a *prima facie* case  
9 from August 11, 2006 forward and are now entitled to discover the exact date when  
10 Continental discovered the fraudulent use of its policies, but did nothing to stop the fraud,  
11 thereby ratifying the ongoing fraud for the \$800,000 in annual premiums it was receiving, so  
12 long as no claims were being submitted.

13 **VIII. CONCLUSION**

14 At the hearing, Continental should be required to explain how Endorsement No. 3  
15 works if the Exchangers are not covered for theft of their Exchange Funds by the insured QI.  
16 We need to hear Continental's lawyers explain what was supposed to happen after a QI stole  
17 \$100,000 in Exchange Funds. After hearing their answer, Continental's motion to dismiss may  
18 be denied. If the Court concludes the Continental policy is still a two-party agreement solely  
19 for the benefit of Vesta and Excalibur, then Plaintiffs request leave to amend on grounds that  
20 the agreements between Continental, Vesta and Excalibur constitute a conspiracy to steal  
21 Exchange Funds.

22 DATED this 1<sup>st</sup> day of March, 2010

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