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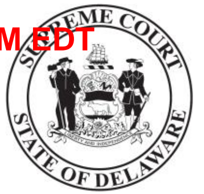

IN THE SUPREME COURT OF THE STATE OF DELAWARE

THE HONORABLE KAREN WELDIN STEWART, CIR-ML, INSURANCE COMMISSIONER OF THE STATE OF DELAWARE, IN HER CAPACITY AS THE RECEIVER OF SECURITY PACIFIC INSURANCE COMPANY, INC. IN LIQUIDATION, SPI-202, INC. IN LIQUIDATION, SPI-203, INC. IN LIQUIDATION, and SPI-204 IN LIQUIDATION,	)	No. 204, 2015
Plaintiff below, Appellant,	)	Appeal from Interlocutory Order of the Court of Chancery of the State of Delaware in Civil Action No. 9306-VCP
v.	)	
WILMINGTON TRUST SP SERVICES, INC.; JOHNSON LAMBERT & CO., LLP; JOHNSON LAMBERT, LLP; MCSOLEY MCCOY & CO.; and STEPHEN D. KANTNER,	)	
Defendants below, Appellees.	)	

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NATURE OF THE PROCEEDINGS

Plaintiff-Below Appellant The Honorable Karen Weldin Stewart, CIR-ML, Insurance Commissioner of the State of Delaware in her capacity as the Receiver (the “Receiver”) of Security Pacific Insurance Company, Inc., SPI-202, Inc., SPI-203, Inc., and SPI-204, Inc. filed a verified complaint (the “Complaint”) on January 31, 2014, alleging claims for breach of fiduciary duty, breach of contract, negligence, and aiding and abetting against, *inter alia*, Wilmington Trust SP Services, Inc. (“WT”), Johnson Lambert & Co. LLP, Johnson Lambert, LLP (“Johnson Lambert”), McSoley McCoy & Co. (“McSoley McCoy” and together with Johnson Lambert, the “Auditor Defendants”), and Stephen D. Kantner.[1] *See* A18-154.

On April 22, 2014, Johnson Lambert moved to dismiss the Complaint pursuant to Court of Chancery Rules 12(b)(2) and 12(b)(6). *See* A277-78. On April 25, 2014, WT, Kantner, and McSoley McCoy each moved to dismiss pursuant to Court of Chancery Rule 12(b)(6). *See* A279-84. On March 26, 2015, the Court of Chancery, Vice Chancellor Parsons, issued an opinion (“the Opinion”) dismissing the claims for breach of contract (Counts 2, 5, 6, and 9) and negligence

[1] The Receiver asserted breach of fiduciary duty (Count 11) and aiding and abetting (Count 12) claims against Kantner. Neither claim is the subject of the instant appeal.

(Counts 3, 7 and 10) pursuant to the equitable doctrine of *in pari delicto*.[2] Vice Chancellor Parsons did not, however, dismiss the Receiver's aiding and abetting claims, finding Delaware's fiduciary duty exception to *in pari delicto* applicable to those claims.[3]

On April 6, 2015, the Receiver applied for certification of an interlocutory appeal from the Opinion and associated order. The Court of Chancery certified the interlocutory appeal on April 27, 2015. On May 11, 2015, this Court issued an order accepting the Receiver's interlocutory appeal.

This is the consolidated answering brief of WT and the Auditor Defendants (collectively, "Appellees") in opposition to the Receiver's appeal.

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[2] The Court of Chancery also dismissed the breach of fiduciary duty claims asserted against WT (Counts 1 and 11), Johnson Lambert (Count 4) and McSoley McCoy (Count 8) for reasons unrelated to *in pari delicto*. The dismissal of these claims is not before the Court.

[3] Vice Chancellor Parsons dismissed the aiding and abetting claims against McSoley McCoy on grounds that they were not well pleaded. (Op. at 88-93).

SUMMARY OF THE ARGUMENT

1. Denied. The Trial Court carefully considered and correctly concluded that the defense of *in pari delicto* is recognized in Delaware and applies to the Receiver's claims brought on behalf of a failed protected cell captive insurer. The Receiver alleges that the captive insurer was harmed by the fraud of James M. Jackson, who was the president, board chair, and beneficial owner of the captive insurer. Further, the Receiver alleges that the Appellees, two audit firms and a captive manager, should be liable for failing to detect that fraud. Although Jackson's fraud is imputed to the insurer, the Receiver argues that the public policy of the Delaware Insurers Liquidation Act (the "Act") should trump the long-standing policies underlying *in pari delicto*. The Act does not provide such extraordinary power to the Receiver. Nor does the Act or other law permit the Receiver to assert claims on behalf of others, such as policyholders and creditors, for alleged harm to the defunct entity. The Receiver fails to demonstrate sound reasons to abandon the policy reasons for application of *in pari delicto*. Therefore, *in pari delicto* applies to the Receiver's claims, just as it would apply to similarly situated plaintiffs who step into the shoes of an entity to advance the claims of the entity, and who are subject to the defenses applicable to the entity. Accordingly, the Trial Court's reasoning was sound, and therefore must be confirmed.

STATEMENT OF FACTS

A. Formation of the SPI Entities

In May 2005, defendant James M. Jackson ("Jackson") formed a protected cell captive insurance company in the District of Columbia named Security Pacific Insurance Company, Inc. ("SPIC-DC"). (A 33, ¶¶ 42-45). SPIC-DC was formed and funded by insureds Ryan Building Group ("RBG") and OOM, LLC, which were novated and merged into Delaware cell captives SPI-202 and SPI-203. (A 34, ¶¶ 48-49). Both RBG and OOM were in the residential home construction business. (*Id.* ¶ 49).

SPIC-DC was a wholly-owned subsidiary of Carolina Holdings, Inc., a California corporation 100% owned by Jackson. (A 33, ¶¶ 43-44). Jackson served as the President and Chairman of the Board of SPIC-DC. (*Id.* ¶ 44).

In July 2007, Jackson sought to re-domesticate SPIC-DC and its two special purpose cells (SPI-202 and SPI-203) to Delaware. (A 36, ¶ 56). Under Jackson's plan, SPIC-DC was to merge into a newly formed Delaware corporation (also called Security Pacific Insurance Company, Inc.), and the Delaware entity (hereafter, "SPIC") would survive the merger. (*Id.* ¶ 57). The plan also called for SPIC-DC's cells to merge into the newly incorporated SPI-202, Inc. and SPI-203, Inc. entities. (*Id.* ¶ 58). In addition, Jackson proposed the creation of an another Delaware special purpose cell (SPI-204, Inc.) that would insure the risk of Alexa

Holding Company, LLC, another entity solely owned by Jackson. (*Id.* ¶ 60). Jackson's re-domestication plan would come to fruition in the ensuing months.

Jackson submitted the application and related materials for re-domestication to the Delaware Department of Insurance ("DDOI") in October 2007. (*Id.* ¶ 62). Jackson represented in his application and the supporting materials that SPIC, SPI-202, SPI-203 and SPI 204 would hold initial capital amounts, in the aggregate, of approximately $2.7 million. (*Id.* ¶¶ 63-67). The application submitted by Jackson allegedly included financial statements indicating that SPIC-DC had total assets of roughly $4.8 million. (*Id.* ¶ 68-69).

On December 31, 2007, the DDOI issued certificates of authority to SPIC, SPIC-202, SPI-203 and SPI-204 (hereafter, the "Captives") that incorporated them in Delaware and allowed them to transact business in this State. (*Id.* ¶ 94). The DDOI allegedly made the approval of the incorporation of the Captives contingent on its receipt of the 2007 audited financials of SPIC-DC and proof of capitalization for the Captives. (*Id.* ¶ 95). However, these financial documents were not submitted to the DDOI until July 2009. (*Id.* ¶ 263). Despite the nearly 18-month delay, the DDOI allowed the Captives to operate in Delaware without proof of adequate capitalization. (*Id.* ¶ 266). In particular, the DDOI failed to conduct an examination of the financial status of SPIC-DC or the Captives or request that they submit annual reports as required under 18 *Del. C.* § 6909(a)(3) and §6907(b). The

Captives operated as Delaware-domiciled special purpose captive insurance companies from December 31, 2007 through June 15, 2011. (A 21, ¶ 2).

B. Retention of WT and Auditor Defendants

WT and SPIC-DC entered into a Management Services Agreement ("MSA") in October 2007, pursuant to which WT agreed to serve as captive manager for the SPI entities by providing the administrative, office and management services identified in the MSA. (A 39-40, ¶¶ 71-72). The MSA expressly limited WT's duties to those specified in the agreement and exculpated WT from liability in the absence of gross negligence or willful misconduct. (A 194, ¶ 6).

In November 2007, SPIC-DC retained Johnson Lambert to prepare audited financial statements for calendar year 2007.[4] (A 45-46, ¶ 89). Johnson Lambert also prepared the Captives' audited financial statements for 2008. (A 100, ¶ 267). In or around October 2009, SPIC decided to replace Johnson Lambert. (A 105-106, ¶¶ 281-82). SPIC then engaged McSoley McCoy in April 2010 to prepare audited financial statements for 2009. (*Id.* ¶¶ 282-3). By 2011, the Receiver had assumed control over SPIC and the Captives. (A 114, ¶ 307).

C. The Captives' Pervasive Fraud

The Receiver has alleged that Jackson engaged in a calculated and manipulative scheme to conceal the Captives' true financial condition in order to

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[4] Johnson Lambert served as the independent auditor for SPIC-DC for 2005 and 2006. (A 46, ¶ 90; A 175).

enable the Captives to conduct insurance business in the State of Delaware. (A 44, ¶¶ 83-85). During the 2007 auditing process, Jackson represented that the Captives' assets consisted of the cash surrender value of a "key man" life insurance policy issued by The Hartford Insurance Company in Jackson's name with a supposed payout value of approximately $628,000 as of December 31, 2006. (A 38-39, ¶ 69; A 50-51, ¶¶ 103-105). This policy was owned by SPIC-DC, and its cash surrender value comprised a substantial portion of the assets SPIC-DC claimed in its re-domestication application filed with the DDOI. (A 38-39, ¶ 69; A 49, ¶ 100). However, through a series of misrepresentations, Jackson concealed from Appellees that the key man policy had lapsed in 2006 and was worthless by the time SPIC-DC submitted its re-domestication application. (A 57, ¶ 130).

According to the Complaint, Jackson also inflated the value of bank account statements as part of his scheme. Allegedly, Jackson altered monthly financial statements, falsified and forged other documents and repeatedly concealed information from the Appellees in an effort to overstate the value of several bank accounts held for the benefit of SPIC-DC and SPIC. (A 44, ¶¶ 83-85; A 69, ¶ 166). Jackson's deceit and manipulations were a major component of his efforts to qualify the Captives to conduct business in Delaware.

D. Audits Prepared and Approved Based on Falsified Information Provided By Jackson

In December 2008, Johnson Lambert completed its 2007 audit report for the Captives based on the falsified information submitted to it by Jackson. (A 83, ¶ 210). The 2007 audit included a "significant matters" letter from Johnson Lambert to the boards of directors of the Captives that made reference to significant delays in completing the audit and difficulties in reconciling discrepancies with certain of the Captives' account statements. (A 85, ¶ 217). The 2007 audit also included a letter to Jackson that recommended the implementation of procedures to address the issues noted in the "significant matters" letter. (A 86, ¶ 218). The directors approved the 2007 audit during a special meeting held in Delaware on February 3, 2009. (A 84-85, ¶¶ 212, 215). On July 14, 2009, the DDOI received the 2007 audit report for the first time, along with copies of bank statements as proof of capitalization for the Captives. (A 99, ¶ 263). The DDOI allegedly "approved" the Captives' re-domestication application based on the receipt of this information, although it had already authorized them as Delaware corporations that could transact business as captive insurers as of December 31, 2007. (A 100, ¶ 266).

Johnson Lambert completed the 2008 audit report on July 21, 2009. (*Id.* ¶ 267). On October 8, 2009, the directors of the Captives approved the 2008 audited financial statements. (A 103, ¶ 273). In 2010, McSoley McCoy prepared the 2009 audit for the Captives. (A 110, ¶ 296). The directors of the Captives approved the

2009 audited financials during a December 15, 2010 board meeting, a mere matter of months before the Receiver initiated these proceedings. (A 112, ¶ 301). The Receiver contends that the 2007, 2008 and 2009 audits were inaccurate as a result of Jackson's deliberate effort to falsify financial information relied upon by the Auditor Defendants. (A 27, ¶¶ 83-85). It is not alleged that anyone other than Jackson had any knowledge of or participated in Jackson's scheme.

E. The DDOI Initiates Liquidation Proceedings

In March 2011, WT informed the DDOI that "it had noted certain irregularities or discrepancies" in bank statements provided by Jackson on behalf of the Captives. (A 114, ¶ 305). The DDOI conducted its own investigation and uncovered information suggesting that Jackson provided inaccurate, falsified bank statements. (*Id.* ¶ 306). The DDOI then sought and obtained a Confidential Seizure and Injunction Order dated March 25, 2011, followed by an order putting the Captives into Liquidation and appointing the Commissioner of the DDOI as receiver for the Captives. (A 114, ¶¶ 307-309). In the liquidation proceedings, RBG, the exclusive policyholder of SPI-202, filed a proof of claim with the Receiver which sought, among other things, "the immediate liquidation of SPI-202, the closure of the receivership with respect to SPI-202, and the immediate distribution of all of the remaining assets of SPI-202 to RBG." (B1-2; B67). RBG has since settled its claims with the Receiver.

ARGUMENT

A. Question Presented

Whether, under Delaware law, when the Commissioner of Insurance, acting as the receiver of a Delaware captive insurance company, sues a third-party based on fraud committed by former management of the company, is the Receiver entitled to a public policy exception to the *in pari delicto* defense that has not been granted to similarly situated plaintiffs. *See* A319-24; A368-70; A399-408.

B. Scope and Standard of Review

This Court reviews a dismissal pursuant to Court of Chancery Rule 12(b)(6) *de novo*. *In re General Motors (Hughes) S'holders Litig.*, 897 A.2d 162, 167-68 (Del. 2006) (citing *Malpiede v. Townson*, 780 A.2d 1075, 1082 (Del. 2001)).

C. Merits of the Argument

The Receiver acknowledges, as she must, that the "venerable" *in pari delicto* defense is founded upon important legal and policy considerations. But the Receiver argues that pursuant to the Act she has "super powers" not available to any other person or entity and, as such, *in pari delicto* does not apply with equal force to her claims. The Receiver contends that the policies afforded under the Act should trump the policies underlying the *in pari delicto* defense. Vice Chancellor Parsons carefully analyzed and rejected those contentions by the Receiver. This Court should affirm the Trial Court, for the reasons discussed herein.

I. THE PUBLIC POLICIES AT ISSUE

A. The Policies of *In Pari Delicto*

In pari delicto is an affirmative defense that bars a party "'from recovering damages [from third parties] if his losses are substantially caused by activities the law forbade him to engage in.'" *In re Am. Int'l Grp., Inc. Consol. Deriv. Litig.*, 976 A.2d 872, 883 (Del. Ch. 2009) (quoting *In re LJM2 Co-Investment, L.P.*, 866 A.2d 762, 775 (Del. Ch. 2004)) [hereinafter "*AIG II*"]. One of the "primary purposes" of the *in pari delicto* doctrine "is to prevent courts from having to engage in the inefficient and socially unproductive accountings between wrongdoers." *Id.* at 877. *In pari delicto*, thus, serves at least two policy goals: deterring wrongful conduct by barring wrongdoers from seeking relief from third parties and preserving judicial resources. *See id.* at 882 n.21. Delaware has embraced this "venerable *in pari delicto* doctrine." *Id.* at 882.

There are exceptions to the *in pari delicto* doctrine, none of which are applicable to the Receiver's claims. One such exception is the public policy exception. Generally speaking, "even if the parties do bear equal fault, *in pari delicto* will not bar an action where the suit involves sufficiently important countervailing interests of public policy." *Id.* at 883. The Receiver urges that the public policy of the Act (18 *Del. C.* §§ 5901 *et seq.*) trumps the policy of *in pari*

delicto. For the reasons set forth herein, the public policy of the Act does not outweigh the application of *in pari delicto*.

The Court of Chancery has addressed the application of *in pari delicto* in a pair of decisions in *In re American International Group, Inc. Consolidated Derivative Litigation* [hereinafter "*AIG I*"]. *See AIG I*, 965 A.2d 763 (Del. Ch. 2009); *AIG II*, 976 A.2d 872. In *AIG I*, the Court addressed the application of the *in pari delicto* defense to claims by a corporation against its auditor, Pricewaterhouse Coopers LLC ("PwC") under New York law. *AIG I*, 965 A.2d at 822-31. The Court held that the *in pari delicto* doctrine barred malpractice and breach of contract claims against PwC and, thus, dismissed the claims against PwC. *Id.* at 827-30.

In *AIG II*, the Court of Chancery applied the *in pari delicto* doctrine to derivative claims against the corporation's alleged co-conspirators. The Court of Chancery held that there was no public policy justification for setting aside the *in pari delicto* doctrine and, therefore, dismissed the claims against the alleged co-conspirators. In so holding, the Court of Chancery rejected the plaintiffs' argument that it would be "unjust" to prevent innocent stockholders from recouping some of their losses. *AIG II*, 976 A.2d 889. The Court of Chancery noted that stockholders have "the ability to sue corporate insiders on behalf of the

company" and, thus, "[t]he issue is . . . not whether stockholders can seek relief on the corporation's behalf, but from whom stockholders can seek that relief." *Id.*

B. Captive Insurance Companies

The SPI entities that are the subject of the liquidation in this case utilized a sponsored, protected cell, captive insurance company structure. (*See* Compl., ¶¶ 42-63, A-33 to A-38). Such captive insurance structures are substantially different from the typical commercial insurance company because it insures only the liabilities of the individual corporate owner or "participant" of each segregated cell within the captive structure. *See* 18 *Del. C.* §§ 6931 *et seq*. Such a captive insurance company does *not* insure members of the general public. Rather, a captive is formed to insure the liabilities of each of its corporate "participants." Such a captive insurer is formed to self-insure the risks of the corporations in their own protected and segregated "cells." Captive insurers, therefore, are subject to their own set of regulations. *See* 18 *Del. C.* §§ 6901 *et seq.*

II. THE ROLE OF THE RECEIVER UNDER THE ACT.

A. The Receiver Stands Only "in the Shoes of" the Defunct Insurer

The Receiver's authority to assert claims against WT and the Auditor Defendants is set forth in the "Liquidation and Injunction Order" issued by the Court of Chancery. (A 157-74). The "Liquidation and Injunction Order" vests the Receiver with "all of [the Captives'] rights of action." (*Id.*). The Receiver, thus, "acts as the representative of the corporation, and has no greater rights or powers."

See Bovay v. H.M. Byllesby & Co., 22 A.2d 138, 142 (Del. Ch. 1941). In other words, the Receiver "stands in the shoes" of the Captives. *Lank v. N.Y. Stock Exch.*, 548 F.2d 61, 67 (2d Cir. 1977) (applying Delaware law to a receiver appointed under Delaware's receivership statute). Because the Receiver "stands in the shoes" of the Captives, the Receiver is "subject to the same defenses" that could have been asserted against the Captives. 65 Am. Jur. 2d Receivers § 367 (2011) ("A receiver's rights as plaintiff are subject to the same defenses as the received entity he or she represents. . . .").

B. Neither the Act Nor the Liquidation Order Authorizes the Receiver to Bring Claims "on Behalf of" Third Parties

The Receiver argues that the Liquidation Order and/or the Act cloak her with the power to bring claims not only on behalf of the defunct entity (which subject her to defenses applicable to that entity, such as *in pari delicto*), but also "on behalf of" policyholders, creditors, and even the general public. Presumably, the Receiver is trying, in the guise of "policy," to assume the power to make claims "on behalf of" persons or entities who would not be subject to the imputation of the alleged fraudulent acts of Jackson, so as to avoid the clear application of the *in pari delicto* defense. But, neither the Liquidation Order nor the Act gives the Receiver such authority.

Delaware law provides that the powers of the receiver of an insurance company in liquidation are controlled by the language of the order that places the

entity into liquidation, and that the powers granted by that order cannot exceed those authorized by statute. 18 *Del. C.* § 5911. In pertinent part, that statute says:

> An order to liquidate the business of a domestic insurer shall direct the Commissioner forthwith to take possession of the property *of the insurer*, to liquidate *its* business, to deal with *the insurer's* property and business in the Commissioner's own name as Insurance Commissioner or in the name of the insurer, as the court may direct, and to give notice to all creditors who may have claims against the insurer to present such claims.

18 *Del. C.* § 5911(a) (emphasis added).

That statute does not say that the insurance receiver has title to the claims of policyholders, creditors and stockholders, or the right to bring claims on their behalf. Nor for that matter does any other section in the Act. The two other provisions relied upon by the Receiver in purported support of her asserted "super-plaintiff" powers are 18 *Del. C.* §§ 5903 and 5913. (*See* Br. at 14, 16, 21, 27 for § 5903, and Br. at 15 for § 5913). Section 5913 states that the receiver shall: (a) "take possession *of the assets of the insurer*"; and (b) "be vested by operation of the law with the title to all of the property, contracts and rights of action and all the books and records *of the insurer*. . . ." 18 *Del. C.* § 5913(a)-(b) (emphasis added). That statute does not state anywhere that the receiver takes possession of the assets or assumes the rights of anyone other than the insurer itself.

Section 5903 provides the authority for the Insurance Commissioner to commence delinquency proceedings, stating that upon application for a liquidation

order, "the court shall either deny the application or grant the application, together with such other relief as the nature of the case and the interests of the policyholders, creditors, stockholders, members, subscribers or the public may require." 18 *Del. C.* § 5903. Paragraph 6 of the Liquidation Order tracks the language of Section 5903. (A 161-162.) Paragraph 6 does not vest the Receiver with the rights of the SPI entities' policyholders, creditors or stockholders.

Paragraph 9 of the Liquidation Order sets forth the scope of the Receiver's rights to bring and defend legal claims, stating that the Receiver is:

> hereby authorized to deal with the Assets, business and affairs of [the SPIC entities] including, without limitation, *the right to sue, defend* and continue to prosecute *suits or actions* already commenced by or for [the SPIC entities], or *for the benefit of the policyholders, cedants, creditors and stockholders* of [the SPIC entities] in the courts, tribunals, agencies and arbitration panels for this state and other states and jurisdictions in her name as the Insurance Commissioner of the State of Delaware, or in the name of the [SPIC entities].

(A 163)(emphasis added).

The Liquidation Order's reference to the right to bring suits "*for the benefit of*" policyholders, creditors and stockholders is *not the same* as the right to bring claims "*on behalf of*" policyholders, creditors and stockholders. This is an important distinction that the Receiver apparently ignored. In her Brief, the Receiver cited to inapposite cases from other jurisdictions where either the

liquidation statute specifically allows a receiver to sue "on behalf of" others, or the law of that jurisdiction allows a court's order to extend that power.[5]

While the Act does instruct the Receiver to consider the interests of policyholders, creditors and the public, it does *not* give the Commissioner the right to sue "on behalf of" policyholders, creditors and the public. Therefore, the Receiver cannot seek to bring claims that belong to the stakeholders of the SPIC entities, if any, by analogizing to the powers of her counterparts in a few other states that explicitly provide those rights.

Moreover, the Receiver's assertion that she has the authority to sue on behalf of the policyholders is contradicted by her own actions. In this lawsuit, the Receiver sued Ryan Building Group, one of the three "policyholders" – the participant in the segregated cell SPI-202. (*See* A 18). This fact demonstrates the fallacy of the Receiver's contention that she has the standing to sue "on behalf of" policyholders, creditors etc.

The irrefutable principle entrenched in Delaware case law is that the powers of the insurance receiver are circumscribed by the specific language of the

[5] *See* Br. at 34 *et seq.*; *Javitch v. Transamerica Occidental Life Ins. Co.*, 408 F. Supp. 2d 531, 538 (N.D. Ohio 2006) (order granted the receiver authority to pursue claims on behalf of third-party investors); *see also Reider v. Author Andersen, LLP*, 784 A.2d 464, 475-76 (Conn. Super. Ct. 2001); *Integrity Ins. Co. v. Yegen Holdings Corp.*, 573 A.2d 928, 936 (N.J. Super. Ct. App. Div. 1990); Karl L. Rubinstein, *The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit*, 10 Conn. Ins. L.J. 309 (2004) (Underscoring that giving the insurance receiver the right to bring claims "on behalf of" stakeholders is crucial). The Delaware legislature chose not to use such language in its statute.

liquidation order, which, in turn, must be within the parameters of the statute. *See generally In re Rehab. of Nat'l Heritage Life Ins. Co.*, 656 A.2d 252 (Del. Ch. 1994) (examining the Act and noting that the Court cannot give a receiver new legal rights outside its scope through an *ex parte* order).

It should also be noted that there is no support for the Receiver's assertion that she *herself* brings claims, which are therefore not derivative of the failed insurer's claim. Vice Chancellor Parsons properly rejected that notion when he concluded that "the claims subject to the pending motions to dismiss are the SPI Entities' claims, not the Insurance Commissioner's." (Op. at 74). The Trial Court's conclusion is in line with Delaware law and the Liquidation Order which do not provide the Receiver with such a power.

Finally, every count in the Receiver's complaint is brought by the Receiver on behalf of the SPI entities only. (*See* A 116-A153, ¶¶ 317-382). It is too late for the Receiver to escape her own pleading. Although the Receiver is now arguing that the "public policy" of the Act allows her to bring claims "on behalf of" herself and the policyholders and creditors, this allegation does not match her own allegations in the Complaint and therefore this contention must be denied.

III. *IN PARI DELICTO* SHOULD APPLY TO CLAIMS BY AN INSURANCE RECEIVER – THERE IS NO POLICY THAT SUPPORTS "SUPER POWERS" UNIQUE TO A DELAWARE INSURANCE RECEIVER

A. Courts From Numerous Jurisdictions Have Applied *In Pari Delicto* to Claims Brought by a Receiver

Contrary to the suggestion in the Receiver's brief, numerous courts in other jurisdictions have reached the same conclusion as the Trial Court and applied the doctrine of *in pari delicto* to claims brought by a receiver against third parties. *See, e.g.*, *Knauer v. Jonathon Roberts Fin. Grp., Inc.*, 348 F.3d 230 (7th Cir. 2003) (dismissing claims against third parties on *in pari delicto* grounds); *Williamson v. PricewaterhouseCoopers, LLP*, 2007 WL 5527944 (N.Y. Sup. Ct. Nov. 7, 2007) ("[G]enerally, courts do apply *in pari delicto* against a receiver or non-bankruptcy trustee when the claim does not involve a fraudulent conveyance."); *see also Hays v. Pearlman*, 2010 WL 4510956 (D.S.C. 2010) (receiver's claim barred by *in pari delicto*); *Freeman v. Dean Witter Reynolds, Inc.*, 865 So. 2d 543, 551 (Fla. Dist. Ct. App. 2003) (distinguishing fraudulent transfers from "common law tort claims against third parties"); *Seidman & Seidman v. Gee*, 625 So. 2d 1 (Fla. Dist. Ct. App. 1992) (the trial court judgment for the insurance liquidator against an auditor was reversed by the court of appeals based on imputation of the fraud of the corporate insider to the liquidator's claims). The same result should occur here.

B. The Law From Other Jurisdictions Cited by the Receiver Does Not Support Her Contentions

The Receiver relies heavily on *F.D.I.C. v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995), for the proposition that "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver" (Br. at 25). Subsequent authorities, however, clarify that *O'Melveny* is a narrow holding that does not stand for the proposition advanced by the Receiver. As Vice Chancellor Parsons noted:

> [i]n any case, it is not clear that *O'Melveny & Myers* stands for a proposition that is helpful to the Receiver. *See, e.g.*, *In re Imperial Corp. of Am.*, 92 F.3d 1503, 1509 (9th Cir. 1996) (clarifying that *O'Melveny* does not mean that equitable defenses can never be asserted against FDIC acting as a receiver); *In re Bartoni-Corsi Produce, Inc.*, 130 F.3d 857, 862 (9th Cir. 1997) (clarifying that *O'Melveny* was focused on the question of fiduciary liability, and finding *O'Melveny* inapposite in the context of determining whether a third party non-fiduciary is liable to a corporation) (emphasis added).

(Op. at 72-73, n. 202).

The Receiver's reliance on *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995), is similarly flawed. In *Scholes*, the Seventh Circuit declined to apply *in pari delicto* to bar the claims of the receiver because, in that particular case, the defendant asserting the defense was the recipient of funds that were embezzled from the corporation. 56 F.3d 750. Subsequent cases held that *Scholes* did not stand for a blanket proposition that receivers are not subject to *in pari delicto*. Rather, subsequent courts have ruled that *Scholes* holds only that recipients of

fraudulent conveyances could not assert this defense against receivers. In *Knauer v. Jonathon Roberts Financial Group, Inc.*, 348 F.3d 230 (7th Cir. 2003), the Seventh Circuit affirmed the trial court's dismissal of the claims by a receiver against the defunct entity's broker dealers on *in pari delicto* grounds, and explicitly distinguished *Scholes*, as follows:

> The key difference, for purposes of equity, between fraudulent conveyance cases such as *Scholes* and the instant case is the identities of the defendants. The receiver here is not seeking to recover the diverted funds from the beneficiaries of the diversions (e.g., the recipients of Douglas's transfers in *Scholes*). Rather, this is a claim for tort damages from entities that derived no benefit from the embezzlements, but that were allegedly partly to blame for their occurrence. In the equitable balancing before us, we find *Scholes* less pertinent than the general Indiana rule that the receiver stands precisely in the shoes of the corporations for which he has been appointed.

Id. at 236.

Decisions after *Knauer* acknowledged that "generally, courts do apply *in pari delicto* against a receiver or non-bankruptcy trustee when the claim does not involve a fraudulent conveyance." *Williamson*, 2007 WL 5527944 (discussing *Knauer*). *Knauer* thus represents the general rule.[6]

The Receiver's claims are grounded in tort and contract against non-fiduciary, third-party entities who were not the recipient of any of the embezzled

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[6] Other cases following *Knauer* have similarly held that receivers are subject to *in pari delicto* where they seek recovery from third parties for claims not based on fraudulent conveyances. *Hays*, 2010 WL 4510956; *Myatt v. RHBT Fin. Corp.*, 635 S.E.2d 545, 548 (S.C. Ct. App. 2007); *Freeman*, 865 So. 2d 543, 551.

funds. Accordingly, as in *Knauer* and the majority of cases decided since, the *in pari delicto* defense is applicable to the claims against the Appellees.

C. The Court Should Not Carve Out a New, Special Exception for an Insurance Receiver

As Vice Chancellor Parsons concluded, there is "no cogent reason for sparing the innocent Receiver the effect of *in pari delicto* while equally innocent stockholders or policyholders would be barred from relief in the derivative context." (Op. at 72). There is similarly no cogent reason to treat the insurance receiver differently than a bankruptcy trustee for a defunct non-insurance corporation, who also steps into the shoes of a defunct entity and, when suing a third party, is subject to the defenses that are applicable to the defunct entity. *See AIG II*, 976 A.2d at 889.

1. An Action by an Insurance Receiver is Akin to a Shareholder in a Derivative Action

The Receiver asserts that, for vague "public policy" reasons, her position in bringing suit for alleged losses of the insurance entity is substantively different from that of a shareholder in a derivative suit seeking to recover for harm to the entity. (Br. at 20). Her contention is without merit.

First, the Receiver argues that an insurance delinquency proceeding is different from a shareholder derivative action because it is not just for the benefit of creditors and shareholders, but "also is for the benefit of the policyholders and

the public." (Br. at 21). This is not a convincing distinction. Shareholder derivative actions have just as much benefit to the "innocent" investors and the general public as do insurance delinquency proceedings, to the extent that they encourage proper corporate governance and create more transparency in the capital markets. Further, *AIG I* and *AIG II* demonstrate that many derivative actions (where the plaintiffs are subject to *in pari delicto*) dwarf this case in regard to potential benefit to the public. 976 A.2d at 889.

Second, this argument fails to account for the unique nature of policyholders in captive insurance companies. In the case of the SPI entities, the policyholders were not "mom-and-pop" buyers of retail insurance policies. The policyholders were sophisticated corporations (Ryan Building Group, OOM, LLC, and Alexa Holdings) that decided to insure themselves by forming and placing funds into their own protected cell within the SPI entities. In this way, the policyholders of the SPI entities are akin to the sophisticated types of shareholders who typically bring derivative actions. Therefore, if the claims of shareholders in derivative actions can be subject to *in pari delicto* – as was the case in *AIG I* and *AIG II* – so too can the claims of a receiver for a protected cell captive insurance group.

2. Insurance Receivers Who Sue Third Parties Based on Duties Allegedly Owed to the Defunct Entity Are Substantively and Legally Like Bankruptcy Trustees, and Should Similarly be Subject to the Defenses Applicable to the Defunct Entity

Despite the Receiver's efforts to distance her role from that of a trustee in bankruptcy, the role of a receiver in an insurance liquidation is similar to that of a trustee in bankruptcy. Both a bankruptcy trustee and an insurance receiver are the creatures of statute. Both a bankruptcy trustee and an insurance receiver acquire the legal rights of the entity. 18 *Del. C.* § 5913(b). Further, just as the Bankruptcy Code provides a regime to prioritize the distribution of assets of the entity, so too does the Act. *See* 18 *Del. C.* § 5918.[7] Accordingly, like a bankruptcy trustee, an insurance receiver uses whatever legal rights the entity had, to collect what it can, and then distribute that to the stakeholders.

It is well-established that bankruptcy trustees "stand in the shoes" of the defunct entity and are therefore subject to defenses based on the imputed conduct of the entity. *See, e.g.*, *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 355-56 (3d Cir. 2001); *Peterson v. McGladrey & Pullen LLP*, 676 F.3d 594, 596 (7th Cir. 2012); *Zazzali v. Hirschler Fleischer, P.C.*, 482 B.R. 495, 512 (D. Del. 2012). The same principle should apply to a receiver.

[7] Providing, in part: "(e) [t]he priority of distribution of claims from the insurer's general assets shall be in accordance with the order in which each class of claims is herein set forth."

D. The Public Policy Interests of the *In Pari Delicto* Defense Are Not Reduced Where Claims Are Brought by an Insurance Receiver Against Auditors and Captive Managers

1. The Application of *In Pari Delicto* to the Receiver's Claims Against Auditors and Captive Managers Does Not Interfere With the Appropriate Regulatory Enforcement Scheme

As Vice Chancellor Parsons explained (Op. at 75), the Legislature gave sweeping regulatory powers to the DDOI, including the power to regulate and manage service providers to captive insurers, such as auditors and captive managers. Nothing in the authorizing statutes, or in the insurance regulations, suggests that the DDOI may use private causes of action against such third parties for enforcement purposes. Rather, in the context of captive insurers, the Commissioner has broad regulatory powers, requiring captive insurers to select from a list of audit firms and captive managers that are pre-approved by the Commissioner. 18 *Del. Admin. C.* §§ 302-2.4, 302-4.2. Moreover, to the extent that the Legislature determines that the DDOI needs further powers, it is for the Legislature as opposed to the court to consider and tailor such a resolution. So, as Vice Chancellor Parsons carefully described, it is not "appropriate to undermine the policies advanced by the *in pari delicto* doctrine, when the purported benefits of doing so here appear to be achievable within the robust regulatory framework that already exists." (Op. at 76).

2. *In Pari Delicto* Creates a Stronger Incentive for Better Regulation of Insurance Companies in Delaware

The Receiver argues that applying imputation defenses such as *in pari delicto* to insurance receivers will not advance the doctrine's purpose of "deterring illegality." To the contrary, when the DDOI knows that imputation defenses may apply to a claim to recover against a third-party service provider for the fraud perpetrated by an insurer's insiders, the DDOI should be further incentivized to vigilantly exercise its regulatory authority over insurers as well as over service providers to the insurers.

The Insurance Code gives DDOI broad regulatory authority, including the power to inspect insurance companies and examine their finances. DDOI has a statutory duty to "personally visit" each domiciled insurance company and "thoroughly inspect and examine its affairs to ascertain its financial condition." 18 *Del. C.* § 6908(a); *see also* 18 *Del. C.* § 318.[8]

[8] Significantly, it appears from the Receiver's own allegations that the DDOI did not fulfill its oversight duties. On December 31, 2007, DDOI issued Certificates of Authority for the Captives, contingent upon the receipt of the 2007 Audit Report. (A 47 ¶¶ 94-95.) However, the DDOI did not receive them until July 2009, nearly 18 months later. (*Id.* ¶ 263.) Despite the delay, the DDOI neglected to conduct a thorough examination of the SPI entities. Further, the DDOI failed to suspend or revoke the SPI entities' authority to conduct business in Delaware, which it has authority to do for their failure to submit an annual report by March 1 of each year. *See* 18 *Del. C.*§ 6909(a)(3) and § 6907(b).

3. There Is no Public Policy Reason That Dictates Denial of Imputation Defenses to Third Parties Like Auditors and Captive Managers in the Context of an Insurance Company, as Opposed to the Context of any Other Corporation

Contrary to Receiver's assertions, public policy is not enhanced by preventing service providers from raising imputation defenses. And, whatever policy reason the Receiver thinks it advances, that does not outweigh the primary reason for applying *in pari delicto*, which is to preclude an entity (that the Receiver now represents) from using the court to collect from third parties when the entity itself was committing active fraud (or other wrongful acts) and concealing that fraud from the very same third parties from which it now seeks to collect. While *in pari delicto* cannot be raised as a defense by an insider, auditors and captive managers are not "corporate agents", insiders or fiduciaries as the Receiver tries to suggest. The Appellees were not hired to find fraud. Their limited roles are defined by their engagement agreements, which are exhibits to the Receiver's Complaint.[9] An auditor's role is to selectively test records, and to then opine on whether the financial statements appear reasonable. A captive manager's role is limited to primarily office and administrative duties that facilitate an insurer's

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[9] The auditors' engagement agreements expressly provide that auditors "will not perform a detailed examination of all transactions, [and] there is a risk that material errors, fraud, or other illegal acts may exist and not be detected". (A-200, A-250). WT's Captive Manager services agreement states, at paragraph 7, that it may rely upon the information provided to it by the insurer, without independent verification. (A 192).

compliance with DDOI regulations. Insiders can manipulate and falsify records that may go unnoticed by the auditors and captive managers.

Here, there is no allegation that the Auditor Defendants or WT knew of fraud – in fact, the allegations consistently state that they did not see it. But, the Receiver asserts that, because the Receiver herself did no wrong, and is therefore herself "innocent" in her personal capacity, *in pari delicto* should not apply even though she is standing in the shoes of the entity to which the fraudulent conduct is imputable. However, this reasoning is consistently rejected in Delaware. As cogently stated in *AIG II*, to do otherwise would "eviscerate the *in pari delicto* doctrine and contravene the policy judgments upon which that doctrine rests." *AIG II*, 976 A.2d at 889.

IV. THE POLICIES UNDERLYING THE DELAWARE INSURANCE ACT DO NOT TRUMP THE EQUITABLE DEFENSE OF *IN PARI DELICTO*

The Receiver posits that it is the responsibility of this Court to rank in scale the policy interests advanced by the *in pari delicto* doctrine on the one hand, and those policy interests served by the Delaware Insurance Act. However, it is not the role of the judiciary to establish this hierarchy; rather, as set forth herein, that task is appropriately served by Delaware's legislature.

As set forth by the Trial Court (and *infra*), *in pari delicto* serves "important policy goals." (Op. at 50). The Receiver asserts that these goals are "lessened"

because the Delaware Insurance Act serves an "important public policy interest." (Br. at 30). By the Receiver's estimation, the policies served by the Act are somehow of more value to the public than those policies served by *in pari delicto.* However, this Court need not engage in a ranking of the societal interests potentially at stake. A fundamental tenet of the *in pari delicto* doctrine in Delaware is that the court is excused from weighing fault or balancing policies. Quite to the contrary, "that is precisely the type of analysis the doctrine is meant to avoid." *In re Nortel Networks, Inc.,* 469 B.R. 478, 508 (Bankr. D. Del. 2012); *AIG II*, 976 A.2d at 883-84.

It is explicitly left to the legislature of each state, in its discretion, to provide the judiciary with direction regarding the interplay between the policy goals advanced by *in pari delicto* and the applicable insurance regulatory laws. "Questions of public policy are best left to the legislature, and when it declares a public policy consistent with the constitution, we will apply it." *Sternberg v. Nanticoke Mem. Hosp., Inc.*, 62 A.3d 1212, 1217 (Del. 2013). Moreover, "competing public policy questions" are best left to the "General Assembly [which] can more effectively debate, consider and resolve through the legislative process." *Shea v. Matassa*, 918 A.2d 1090, 1092 (Del. 2007); *see also, Moss Rehab. v. White*, 692 A.2d 902, 909 (Del. 1997) ("The General Assembly is best able to address the competing public policy issues"). As the Trial Court noted, a

bill was introduced in the Delaware Senate that would have precluded parties from raising the defense of *in pari delicto* against claims asserted by an insurance company receiver (B 86, n.30); the policies purportedly advanced by the Act notwithstanding. That bill has since been stricken.[10]

Without the support of any favorable Delaware domestic statutory or case law, the Receiver primarily is relying on the law of foreign jurisdictions. Of course, the application of *in pari delicto* is highly location dependent; it varies from state to state.[11] The Receiver has therefore cherry-picked a small handful of cases from several states to conjure a sympathetic legal environment.

First, Appellant relies upon *G-I Holdings v. Reliance Insurance Co.,* 2006 WL 3825142 (D.N.J. Dec. 22, 2006) for the proposition that courts have "consistently observed" that the administration of insurance claims "are matters of substantial public concern." (Br. at 30). Of course, this point is hardly in dispute. However, *G-I Holdings,* is inapposite to the Receiver's claims herein. In that case, a class of plaintiffs initiated a coverage dispute arising from over $200 million in losses associated with underlying asbestos liability litigation. *In pari delicto* is not addressed in the decision. Prior to filing suit in federal court, two of the insurer

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[10] S.B. 48, 148th Gen. Assemb. (Del. 2015), *available at* http://legis.delaware.gov/LIS/LIS148.NSF/93487d394bc01014882569a4007a4cb7/f9a8b9fdea722ea485257e14005c3647?OpenDocument

[11] According to the Trial Court, a choice of law analysis was "necessary" because the application of *in pari delicto* "might differ depending on which state's law governs." (Op. at 28). The Trial Court concluded, and no party disputed, that Delaware law governs.

defendants were placed in receivership in New York. The defendants successfully moved to dismiss all claims pursuant to an abstention theory. Given "the complex New York administrative scheme established to resolve claims against insolvent insurance companies," the court agreed that abstention was appropriate and dismissed all claims. *G-I Holdings*, 2006 WL 3825142, at *11. Thus, the decision has no bearing on the issues *sub judice*.

Next, the Receiver relies upon a series of non-Delaware law foreign decisions to support her argument that imputation should *never* apply in an insurance delinquency proceeding in Delaware. In *McRaith v. BDO Seidman, LLP,* 909 N.E.2d 310 (Ill. App. Ct. 2009), the Illinois Director of Insurance in his capacity as receiver of several insolvent automobile insurers pursued claims of professional negligence against the insurers' former auditor. Allegedly, the insurers' officer engaged in fraud by stealing assets that "should have been used to pay policyholder claims." *Id.*, at 318. Similarly, in *Reider v. Arthur Anderson, LLP*, 784 A.2d 464, 469-70 (Conn. Super. Ct. 2001), also relied upon by the Receiver, the Connecticut Insurance Commissioner in his capacity as receiver of an insolvent life insurer pursued an audit malpractice claim. Much like the "bad actor" in *McRaith,* the receiver in *Reider* alleged that the insurers' officer "siphoned off" for personal use insurer funds that were intended to pay policyholders. *Reider*, 784 A.2d at 467.

The receivers in *McRaith* and *Reider* argued that "their unique legal responsibilities to policyholders" mandated a finding that the corporate fraud not be imputed to the receiver. *McRaith,* 909 N.E.2d at 333 and *Reider,* 478 A.2d at 466-67. Both courts accepted this argument and refused to apply imputation because the fraud was committed *on* the company and not *by* it. *McRaith*, 909 N.E.2d at 333, *citing Reider*. The courts reasoned that the victimized insurers encompassed the interests of their policyholders which could not be considered "willing participants in the fraud." *United States v. $7,599,358.09*, 953 F. Supp. 2d 549, 562 (D.N.J. 2013). The two cases are readily distinguishable because there was no factual basis upon which to impute the wrongdoing to the corporate master. Indeed, had these cases arisen outside of the receivership context the outcome, presumably, would have been the same vis-à-vis imputation.

The Receiver attempted to advance the theory that corporate misdeeds cannot be imputed to an insurance receiver. This theory was soundly rejected by the Trial Court. *See*, Op. at 70. Vice Chancellor Parsons correctly held that the wrongful acts of management were imputed to SPIC, applying well-established legal principles. Neither *McRaith* nor *Reider,* cases in which imputation was unwarranted due to the purely self-serving nature of the wrong, lend support to the Receiver's arguments.

Additionally, the Receiver has not identified any policyholders victimized by the alleged theft of funds from SPIC. Of the three special purpose insurance cells that comprised SPIC, one was controlled by Jackson, one was controlled by RBG (which has settled its claims), and the third was a corporate client of Jackson's in the business of residential construction. *See,* Op. at 5-6. This is not a case in which citizen policyholders have suffered the loss of insurance coverage; quite to the contrary. Compare the role of the Receiver in the instant case with that of the receiver in *McRaith,* who advocated on behalf of automobile insurance policyholders, and that of the receiver in *Reider,* who sought to protect life insurance policyholders. This distinction is dispositive and further justified the Trial Court's refusal to accept the Receiver's blanket assertion that "the *in pari delicto* defense cannot apply to any case in which the claims are being asserted by an insurance company." (Op. at 90). Moreover, this argument was considered and "expressly rejected" in Delaware in *AIG II* because, as the Trial Court found, "it would gut the *in pari delicto* defense regardless of who was raising it." (Op. at 70).

The Receiver also relies upon *Arthur Andersen LLP v. Superior Court*, 67 Cal. App. 4th 1481 (1998) in which the California Insurance Commissioner in his capacity as receiver of an insolvent automobile insurer pursued a malpractice claim against the insurer's auditors, arising from the insurer's insolvency. *Arthur*

Andersen LLP argued that the Commissioner lacked standing in that he was not within the "universe of permissible plaintiffs" that may justifiably rely on an auditor's report, under California case law. *Id.* at 1506. The court held the Commissioner is indeed a reasonably foreseeable user of the audit reports, and may on that basis, consistent with the California Insurance Code, sue for audit malpractice on behalf of policyholders. *Id.* at 1507. The *Arthur Andersen* decision does not offer support for Plaintiff's proposed immunity from such common law legal and equitable defenses as *in pari delicto*, under Delaware law, pursuant to the Liquidation Order.

CONCLUSION

For the foregoing reasons, the Appellees respectfully request that this Honorable Court affirm that portion of the Trial Court's Order of March 26, 2015, that dismissed Counts 2-3, 5-7, and 9-10 of the Complaint.

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