Commentary

The Viability Of The Deepening Insolvency Theory Of Liability In Failed Insurer Proceedings

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Often, an Insurer put into a rehabilitation or liquidation proceeding has been insolvent for a considerable period of time prior to the start of the proceeding. During the pre-petition period, the Insurer's statutory financial statements may have incorrectly shown a surplus when, in reality, the Insurer was insolvent because its assets were overstated, its reserve liabilities understated or both. The Insurance Receiver must then determine whether the Insurer's insolvency had been improperly disguised by the misconduct of management (possibly with the help of the insurer's outside advisors, such as accountants, actuaries or lawyers) and its existence unduly prolonged. The Receiver may also look at the reinsurance transactions of the Insurer to determine whether those transactions actually transfer the risk they purport to transfer, or are instead a sham.

Insurance Receivers have brought lawsuits against former management, outside advisors and reinsurers, attempting to hold them responsible for the damages purportedly caused by the wrongful delay in the filing of an insurance delinquency proceeding. In prosecuting such "deepening insolvency" claims, the Receiver has asserted a variety of theories of liability, including breach of fiduciary duty, alter ego, fraud or negligent misrepresentation, professional malpractice or, in some cases, civil RICO violations.

The deepening insolvency cases brought by insurance receivers bear many similarities to deepening insolvency cases brought by bankruptcy trustees on behalf of the estates of non-insurers. In the reported deepening insolvency cases, whether involving an insurance receiver or a bankruptcy trustee, courts invariably must decide whether the receiver or trustee has standing to bring such claims, what factual elements they must establish to prevail, in which instances the misconduct of former management serves as a defense to such claims, and what are the proper damages to assess if wrongdoing is successfully demonstrated.

An Insurance Receiver's prosecution of deepening insolvency claims can be complicated by the fact that insurance companies are regulated. The Director of Insurance, who under state insurance law typically serves also as the Receiver, is responsible for independently examining the financial condition of the insurer and may have knowledge that the actual condition is not as rosy as portrayed in the insurer's financial statements. Moreover, the Director, being aware of the precarious financial condition may have delayed an insolvency proceeding by issuing a confidential supervision order to keep the Insurer operating while retaining the power to approve or disapprove every material financial action of the Insurer.[2] Indeed, the purpose of such confidential corrective or supervisory powers is to avoid taking public action which may destroy the public confidence in a potentially insolvent insurer which the State Insurance Director believes may be able to remedy the insolvency. *See, e.g.*, Tex. Ins. Code § 441.001.

This article examines how issues that commonly arise in these cases might be resolved under the Insurance Receivership Model Act ("IRMA"), which was adopted by the NAIC in December 2005 and has been subsequently enacted in two states.[3] We begin with a brief overview of the development of the deepening insolvency case law.

Deepening Insolvency Theory Is Born

The deepening insolvency theory of liability first surfaced in a Chapter 11 bankruptcy case brought in the District Court for the Southern District of New York called *Bloor v. Dansker*, 523 F.Supp. 533 (S.D.N.Y. 1980). The case involved allegations by a bankruptcy trustee for the Investors Funding Corporation of New York ("IFC") that the IFC principals had orchestrated a deliberate scheme to conceal IFC's deteriorating financial condition through a series of deceptive transactions and false financial reports that hid the corporation's losses from its shareholders and creditors. After IFC filed for bankruptcy protection, the trustee initiated an action against the directors and an independent auditing firm, alleging that as a direct result of their actions, IFC was able to continue operating "further into deficit and toward its ultimate financial ruin," all to the detriment of IFC's stakeholders. 523 F. Supp. at 541. In an attempt to protect itself from liability, the auditing firm argued that the monies IFC obtained provided valuable operational funding and thus benefited the company. According to the auditors, because their actions were for the benefit of the company, the actions could be imputed to the company, thus barring the claim against the auditors. The court, however, discarded this argument, stating that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *Id*. The Court concluded that the auditors could be held liable for the "prolonged artificial solvency" of IFC because it benefited directors of the corporation personally and not the corporation. *Id*.

Deepening Insolvency Theories Tested In Insurance Insolvencies

The most significant early case concerning an insurance receiver's standing to bring a deepening insolvency claim was *Schact v. Brown*, 711 F.2d 1343 (7th Cir. 1983). In *Schact*, the receiver for an insurer in liquidation brought a civil RICO action against the insurer's former management, its corporate parent, a reinsurer and three former accounting firms, alleging that they engaged in a scheme to use a fraudulent reinsurance transaction to mask the insolvent condition of the insurer which kept it operating "long past insolvency in a manner which resulted in enormous losses to the . . . company." *Id*. at 1346. The complaint alleged that the reinsurance transaction misled the insurance regulators into thinking the company was solvent, delayed the initiation of insolvency proceedings, and caused harm to the company's policyholders. *Id*. at 1345-46. In response to these allegations, the accounting firms and the reinsurer challenged the receivers' standing to bring such a claim. They asserted that the receiver could only bring claims belonging to the insolvent insurer and, as such, was equitably barred from bringing those claims against the outside advisors and reinsurer since the insurer's officers and directors instigated the illegal conduct *in pari delicto*. *Id*. at 1346. The court agreed that the receiver could only bring claims belonging to the insurer, but rejected the notion that the former management's misconduct was an equitable bar to the claim. *Id*. at 1347, 1348. The court reasoned that the fraudulent scheme in question did not benefit the insurer but rather the directors and officers personally, as well as the corporate parent, and thus should not be imputed to the insurer. *Id*. at 1348. The court also pointed out that under the state insolvency priority scheme, any recoveries by the receiver would inure to the benefit of creditors and policyholders, not the insurer's corporate parent or its former management. *Id*.

The *Schact* court also rejected the claim that the receiver had no standing to bring a claim against the reinsurer and accountants seeking damages attributable to the deepening insolvency of the insurers:

> Alternatively, to the extent that the cited cases suggest that a corporation may not sue to recover damages resulting from the fraudulent prolongation of its life past insolvency, we decline to speculate

> that the Illinois courts would accept this restriction on the Director's freedom of action. For each of these cases rests upon a seriously flawed assumption, *i.e.*, that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests. *See, e.g., Bergeson*, 265 F.2d at 232; *Kinter*, 81 A. at 905; Patterson, 35 A. at 206. This premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability. *See In Re Investor's Funding Corp.*, [1980] Fed.Sec.L.Rep. (CCH) ¶ 97,696, at 98,655 (S.D.N.Y. 1980). Indeed, in most cases, it would be crucial that the insolvency of the corporation be disclosed, so that shareholders may exercise their right to dissolve the corporation in order to cut their losses. See Ill.Rev. Stat., ch. 32, §§ 157.75, 157.76 (1981). Thus, acceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible. We are not prepared to conclude that the Illinois courts would adopt such a regime.

Id. at 1350.

Since *Schact*, many courts have considered the circumstances under which deepening insolvency claims can be advanced. *See e.g., Reider v. Arthur Andersen, LLP*, 784 A.2d 464 (Conn. Super., 2001) (upholding insurance commissioner's right to assert claims against accounting firm for aiding and abetting breaches of fiduciary duty by the sole shareholders of an insolvent insurer and rejecting on public policy grounds the argument that the corporation could not have been harmed by the conduct at issue since the only alleged victims were the shareholders themselves). Most of the reported cases involve the standing of a bankruptcy trustee to bring such a claim. At least one Circuit Court of Appeals went as far as to recognize deepening insolvency as an independent cause of action where the management and outside parties take action to incur additional debt without the prospect of repayment. *See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3rd Cir. 2001); *see also In re Exide Techs., Inc.*, 299 B.R. 732 (Bkrtcy.D.Del., 2003).

Other courts have rejected the notion that a separate cause of action for deepening insolvency exists. *See, e.g.*, *Trenwick Amer. Lit. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del.Ch., 2006); *In re Greater S.E. Comm. Hosp. Corp.*, 333 B.R. 506 (Bkrtcy.D.Dist. Col., 2005); *In re Vartec Telecom, Inc.*, 335 B.R. 631 (Bkrtcy.N.D.Tex., 2005); *In re Parmalat Sec. Litig.*, 377 F.Supp.2d 390 (S.D.N.Y. 2005); *In re Parmalat Sec. Litig.*, 383 F.Supp.2d 587 (S.D.N.Y., 2005). These courts have held that deepening insolvency is not a cause of action in and of itself and that such claims are not valid unless facts are alleged which would support an independent cause of action based upon fraud, breach of fiduciary duties, professional malpractice, or breach of contract. *See also, Thabault v. Chait*, __ F.3d __, 2008 WL 4138407 (3d Circuit, September 9, 2008).

Proof Of Reliance And Causation

A related problem for insurance receivers, assuming they have standing, are the causes of action they are allowed to bring. A series of rulings in the Reciprocal of America ("ROA") MDL cases show the potential difficulty for the insurance receiver in bringing misrepresentation claims as part of a civil RICO action. *See In re Reciprocal of Amer. Sales Practices Litig.*, MDL 1551, 2006 WL 1879817 (W.D.Tenn., 2006); *In re Reciprocal of Amer. Sales Practices Litig.*, MDL 1551, 2006 WL 1627802 (W.D.Tenn., 2006); *In re Reciprocal of Amer. Sales Practices Litig.*, MDL 1551, 2006 WL 1579585 (W.D.Tenn., 2006). These cases involved the insolvency of a Virginia reciprocal insurer, ROA, and three Tennessee affiliated insurers that were reinsured by ROA. ROA and its affiliates all wrote professional malpractice insurance for risk retention groups. The insurance receivers for ROA and the affiliates brought civil RICO actions based on mail and wire fraud against the law firm representing ROA, ROA's reinsurer, and its outside accountants and actuaries. The complaints alleged that these defendants participated in fraudulent schemes to conceal the insolvency of ROA by entering into a reinsurance agreement that did not transfer risk, thereby disguising the misappropriation of funds by senior management. The receiver claimed that these actions defrauded not only policyholders of the insurers, but also the Tennessee and Virginia regulators.

The court held that to proceed with its civil RICO claim,[4] plaintiff needed to establish the elements of common law fraud, including reliance. *In re Reciprocal of Amer. Sales Practices Litig.*, 2006 WL 1627802, at *18; *In re Reciprocal of Amer. Sales Practices Litig.*, 2006 WL 1579585, at *16. The court dismissed the receivers' claims on the ground the receiver had not made sufficiently detailed allegations of reliance by the insolvent insurer:

> Absent from these allegations, and fatal to Gross' claim, are facts demonstrating that ROA/TRG relied on the misrepresentations and omissions of the Gen Re Defendants to its detriment. At most, the complaint alleges that, had the regulators not been deceived by the Gen Re Defendants and others as to the true financial status of ROA/TRG, the regulators would have taken steps to prohibit ROA/TRG from incurring additional liabilities sooner than they ultimately did. What it does not allege, and what is required by this Circuit, is that, had ROA/TRG not been deceived by the Gen Re Defendants as to its true financial condition, it would not have suffered the injuries claimed. For example, the complaint alleges that ROA/TRG suffered injury because it continued to issue new policies despite its hazardous financial condition. (Gross Am. Compl. ¶ 419.) However, there is no indication from the allegations in the complaint that the determination of whether to issue new policies was contingent on the assertion of ROA/TRG's financial health as depicted through the fraudulent schemes of the Gen Re Defendants. Rather, the complaint alleges solely that ROA/TRG continued to operate as usual, but because the regulators were deceived, and thus did not act to prohibit ROA/TRG from operating, it suffered injury from doing so. Because the complaint fails to plead facts demonstrating that the injuries asserted by ROA/TRG were suffered in reliance on fraudulent conduct by the Defendants, the Court cannot conclude that the conduct was the proximate cause of its injuries.

In re Reciprocal of Amer. Sales Practices Litig., 2006 WL 1627802, at *15; *see also In re Reciprocal of Amer. Sales Practices Litig.*, 2006 WL 1579585, at *13.

Furthermore, although the Tennessee Receiver asserted that she had standing to bring this action on behalf of the policyholders, the court observed that the injury suffered by policyholders did not establish standing on behalf of the receiver:

> While Flowers argues in her response to the instant motion that she has standing to bring this action on behalf of the RRGs and the policyholders, the complaint itself states only that she "brings this action in her capacity as Liquidator for DIR, ANLIR, and TRA." (Flowers Compl. at ¶ 2) Thus, injury suffered by the policyholders does not, in this Court's view, establish standing on the part of the Commissioner.

In re Reciprocal of Amer. Sales Practices Litig., 2006 WL 1627802, at *13, n.13. Thus, the *ROA* decision pointed out that for any insurance receiver asserting a fraud claim against third parties, it is not enough to allege that the policyholders were defrauded, or that the policyholders were injured; rather the receiver must plead each of the elements of fraud, including reliance and causation. In this case, the court found that these elements were not properly pleaded.

Recently, the U.S. Court of Appeals for the Third Circuit upheld a $182 million jury verdict against an insolvent insurer's auditor in a professional negligence case. The Court concluded that the Receiver established the requisite proximate causation where the evidence showed that the auditor's opinion was incorporated into the insurer's financial statements and explicitly relied upon by state insurance examiners. *Thabault*, at *9. Under those circumstances, it appears not to have mattered that the insurer's management did not itself rely on the auditor's opinion regarding the financial condition of the company.

In Pari Delicto

Still other cases decided since *Schact* have considered whether the wrongful action of management may operate as an equitable bar to a claim brought by the Bankruptcy Trustee. Often these courts refer to the equitable bar as the affirmative defense of *in pari delicto*, which "provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim." *R.F. Lafferty & Co.*, 267 F.3d at 354. The judicial approach has been to consider a variety of factors in determining whether outside defendants can successfully assert the *in pari delicto* defense. For example, if management's actions were taken in good faith belief that it was in the best interest of the company, *in pari delicto* might be a defense in the case. *See., e.g., In re RSL Com Primecall, Inc.*, 2003 WL 22989669, at *9 (Bkrtcy. S.D.N.Y., 2003.) Conversely, if the wrongful acts of management were adverse to the integrity of the company, *in pari delicto* is not a viable affirmative defense. *See, e.g., In re Amer. Bus. Fin. Serv., Inc.*, 384 B.R. 80, 86 (Bkrtcy.D.Del., 2008) (citing *R.F. Lafferty & Co.*, 267 F.3d at 359.) For other courts, examination of the whether the action had any benefit at all for the company will be conducted. *See, e.g., In re Reading Broadcasting, Inc.*, 2008 WL 2051110, at *21 (Bkrtcy.E.D.Pa., 2008) (citing *R.F. Lafferty & Co.*, 267 F.3d at 358-59.) Other courts will look to whether there is a greater fault on the part of management than on the part of third parties, and if so, allow the *in pari delicto* defense. *See, e.g., Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006).

In applying New Jersey law, the Third Circuit found that the *in pari delicto* defense was not available where management's misconduct could not be imputed to the company because it caused the company to continue past the point of insolvency, which the Court found "cannot be deemed to have benefitted the corporation." *Thabault, at* *14.

* * * * *

In conclusion, since the ground-breaking decision in *Schact* more than fifteen years ago, courts have struggled with the deepening insolvency theory of liability in the insurance insolvency context. While the theory is still viable in many quarters, courts have generally restricted its applicability and called into question the standing of insurance receivers to pursue such claims.

IRMA

In December 2005, the NAIC adopted a model insurance insolvency act, entitled the Insurance Receiver Model Act ("IRMA"). This model act made many substantial changes in the rights and obligations of an insurance receiver, including changes broadening the rights of an insurance receiver to bring claims against third parties beyond those that a bankruptcy trustee may bring. These changes, which, again, have only been adopted by Texas and Utah, will have a bearing on the kinds of deepening insolvency claims that an insurance receiver can bring against third parties.

Standing Of Receiver To Bring Deepening Insolvency Claims

The most pertinent IRMA provisions are Section 504 regarding the Receiver's powers, and Section 112 regarding suits by the Receiver. It is clear that under Section 504A(3) that the Receiver has broad authority to collect on all claims belonging to the insolvent insurer. Further, under Section 504A(9), the receiver has the power "[t]o continue to prosecute and to institute in the name of the insurer or in the liquidator's own name suits and other legal proceeding . . . ." Section 504A(10) gives the receiver specific, but limited, authority to bring claims on behalf of creditors and policyholders and others:

> To prosecute or assert with exclusive standing any action that may exist on behalf of the creditors, members, policyholders or shareholders of the insurer or the public against any person, *except to the extent that a claim is personal to a specific creditor, member, policyholder or shareholder and recovery on the claim would not inure to the benefit of the estate*. This subsection does not infringe or impair any of the rights provided to a guaranty association pursuant to its enabling statute or otherwise;

(emphasis supplied.)

Although IRMA does not define what kind of suit is "personal to a creditor," there is substantial consensus in the case law that a cause of action is "'personal' if the claimant is harmed and no other claimant himself or creditor has an interest in the cause[,] [b]ut allegations that could be asserted by any creditor could be brought by the trustee as a representative of all creditors." *Koch Refining Co. v. Farmers Union C. Exchange*, 831 F.2d 1339, 1348-49 (7th Cir. 1987). An example of a general claim would be an alter ego claim brought by the receiver on behalf of all creditors against the insolvent company's owners, *see, e.g., In Re Ozark Restaurant Equip. Co., Inc.*, 816 F.2d 1222 (8th Cir. 1987), or a claim against directors and officers for breach of fiduciary duty to the corporation or to its shareholders, *see, e.g., In re W. World Funding, Inc.*, 52 B.R. 743 (Bkrtcy.D.Nev., 1985).

However, a claim that a policyholder or creditor was defrauded by a scheme disguising the insolvency of the company would be personal to the creditors or policyholders in question. *See, e.g.*, *Holland v. Arthur Andersen & Co.*, 571 N.E.2d 777 (Ill. App. 1991). In *Holland*, the corporation's creditors claimed that they were defrauded by the financial statements for which the corporation accountants gave unqualified opinions. The court held that the claims were personal to each of the creditors and required proof that each creditor relied on the information prepared by the defendant account firm. *Id.* at 653-54. In light of this precedent, a strong argument could be made that by excluding personal claims from those a receiver is permitted to bring on behalf of creditors or policyholders, Section 504A(10) limits the type of fraud claims that can be brought to those belonging to the pre-petition Insurer.

Limitation Of Defenses To Claims Brought By Receiver

IRMA Section 112 also appears to make it easier for a Receiver to bring deepening insolvency type claims by immunizing the Receiver from certain defenses. Section 112B provides that "[n]o prior wrongful or negligent actions of any present or former officer, manager, director, trustee, owner, employee or agent may be asserted as a defense to a claim by the receiver under a theory of estoppel, comparative fraud, intervening cause, proximate cause, reliance, mitigation of damages or otherwise . . . ."[5] Section 112C provides that "[n]o action or inaction by the insurance regulatory authorities may be asserted as a defense to a claim by the receiver."

Thus, Section 112B makes it clear that any attempt to raise management misconduct as an affirmative defense to a suit by the Receiver will fail. In other words, *in pari delicto*, estoppel and "comparative fraud" defenses will not be available to outside financial professionals who participate in otherwise actionable schemes that improperly mask the insolvency of the Insurer. Moreover, Section 112B dispenses with the detailed factual inquiry concerning whether or not the Insurer benefitted from the management misconduct. *See, e.g., In re Reading Broadcasting, Inc.*, *supra*. Instead, it rejects *any* and all attempts to raise *in pari delicto* as an affirmative defense.

However, where the Receiver sues an outside advisor for fraud or negligent misrepresentation, the application of Section 112B is less clear because such claims affirmatively require proof of reliance and breach of duty. For example, imagine a scenario where management fraudulently prepared the Insurer's financial statements and then obtained an unqualified opinion from its outside auditors that the statements were prepared in accordance with GAAP or SAP. If, pre-petition, an Insurer had brought a fraud or negligent misrepresentation claim against the auditors, it would have to establish as part of its affirmative case that the company relied on the truth of the auditor's opinion, which, in the above example, it could not do because management knew that the opinion was false and did not rely on it.

If the Receiver were to bring the same claim, he could be expected to argue that pursuant to Section 112B, defendants cannot assert the prior wrongful acts of management as a defense under a theory of reliance. However, the auditors can be expected to argue that Section 112B should not apply because it does not by its terms exempt the Receiver from proving any of the elements of its claim, it merely prevents a defendant from raising defenses. Once the Receiver puts the management conduct at issue, for example, by alleging reliance upon the auditor's opinion, the auditors should be able to assert that the management's conduct showed that it did not reply on the opinion. Moreover, the auditor in attempting to show he was not negligent in rendering his opinion, might show that despite her reasonable and thorough procedures, she simply did not detect any fraud by the company. Section 112B should not be read as an obstacle to this type of defense.

The auditor may further argue that to interpret Section 112B as allowing the Receiver to bring misrepresentation claims without showing reliance, in effect, gives the Receiver new causes of action that did not belong to the Insurer pre-petition, and would violate the standing provisions of IRMA. As a general matter, the Receiver steps into the shoes of the insurer, and obtained the Insurer's rights, no more and no less, as of the date of the petition. The Insurer has no right to bring misrepresentation claims without establishing reliance, and the Receiver should have no right to bring such a claim after the company enters insolvency proceedings.

In some of the cases discussed above, Receivers argued that the regulators were defrauded or detrimentally relied upon the auditor's erroneous opinion. With the adoption of IRMA, a Receiver might invoke Section 112C, which provides that "no action or inaction by the insurer regulatory authorities may be asserted as a defense to a claim[,]" to argue that the auditor is barred from asserting that the regulatory authorities were not defrauded. Once again, it would seem unfair to allege that regulators were defrauded, but deny the defendant the ability to contravene that fact.

The conduct of the regulators may also be relevant concerning any claim that a defendant should be held responsible for damages caused by the deepening insolvency. For example, if the regulator deferred putting the company into a delinquency proceeding because it thought it was still possible to remedy the company's financial ills, then these facts should be taken into consideration in determining whether the defendant's acts, rather than the regulator's actions, actually caused the deepening insolvency damages. Under Section 112C, the receiver could argue otherwise, highlighting one of the areas of uncertainty courts will have to wrestle with in interpreting IRMA.

Conclusion

The Insurance Receivership Act in many ways codifies and clarifies the prior case law on deepening insolvency. However, it can be construed by receivers to broaden the type of deepening insolvency claims that could be brought against defendants, especially professional advisors who are personally sued for having been professionally negligent in their duties, rather than for being part of a fraud conspiracy. States which are still considering whether to adopt the Model Act may wish to consider whether it makes sense to give the receiver greater rights to bring these lawsuits than a trustee in bankruptcy would have in a non-insurance bankruptcy.

Endnotes

1. Messrs. Hassan and Morsch are partners at Butler Rubin Saltarelli & Boyd LLP in Chicago. The views expressed in the article are those of the authors and not necessarily that of the firm or its clients.

2. *See* Administrative Supervision Model Act, National Association of Insurance Commissioners, § 5 (2002).

3. *See* Tex. Ins. Code § 443.001, *et seq*.; Utah Code Ann. § 31A-27a-101, *et seq*.

4. In June 2008, the U.S. Supreme Court held that in a civil RICO action predicated upon mail or wire fraud, it is not necessary to plead or prove reliance. *Bridge v. Phoenix Bond Indemnity Co.*, 128 S. Ct. 2131, 2141 (2008). Nevertheless, the reasoning of the *ROA* cases would still seem to apply to cases based upon common law fraud or negligent misrepresentation RICO.

5. Section 112B provides for an exception to allow the affirmative defenses of fraud in the inducement in response to a contract claim by the receiver. ■