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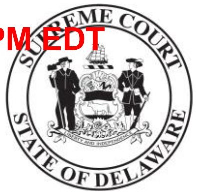

IN THE SUPREME COURT OF THE STATE OF DELAWARE

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,	) No. 204, 2015
SPI-202, INC. IN LIQUIDATION, SPI-203, INC. IN	)
LIQUIDATION, and SPI-204, INC. IN LIQUIDATION,	)
	)
Plaintiff below,	) Appeal from
Appellant,	) Interlocutory
	) Order of the
v.	) Court of
	) Chancery
WILMINGTON TRUST SP SERVICES, INC.;	) of the State of
JOHNSON LAMBERT & CO., LLP; JOHNSON	) Delaware in
LAMBERT, LLP; MCSOLEY MCCOY & CO.; and	) Civil Action
STEPHEN D. KANTNER,	) No. 9306-VCP
	)
Defendants below,	)
Appellees.	)

APPELLANT'S OPENING BRIEF

Respectfully submitted,
/s/ Diane J. Bartels
Diane J. Bartels, DE Bar No. 2530
1807 North Market Street
Wilmington, DE 19802-4810
Tel. (302) 656-7207
Attorney for The Honorable Karen Weldin Stewart, CIR-ML, Insurance Commissioner of the State of Delaware, in her Capacity as Receiver of Security Pacific Insurance Company, Inc. in Liq., SPI-202, Inc. in Liq., SPI-203, Inc. in Liq., and SPI-204, Inc. in Liq.

Dated: June 10, 2015

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I. STATEMENT OF THE NATURE OF THE PROCEEDINGS

This is the appeal of 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., from the March 26, 2015, Order and Memorandum Opinion of the Honorable Donald F. Parsons, Jr., Vice Chancellor, Court of Chancery ("the Trial Court") (Exhibit "A" hereto), granting in part and denying in part the Motions to Dismiss of Defendants Wilmington Trust SP Services, Inc. ("Wilmington Trust"), Johnson Lambert & Co., LLP, Johnson Lambert, LLP (collectively "Johnson Lambert"); McSoley McCoy & Company ("McSoley McCoy"), and Stephen D. Kantner ("Kantner").

On April 6, 2015, the Receiver sought certification pursuant to Rule 72 of the Court of Chancery and Rules 41 and 42 of the Supreme Court for an Order Certifying an Appeal. On April 24, 2015, the Receiver filed a Notice of Appeal from Interlocutory Order. By Order of April 27, 2015, the Trial Court issued the Order Granting to Appeal from Interlocutory Order and corresponding Letter Opinion, which are Exhibits "1" and "2" to the Receiver's Supplemental Notice of Appeal from Interlocutory Order filed on May 1, 2015. On May 11, 2015, this Court issued an Order accepting the Receiver's interlocutory appeal.

This is the Receiver's Opening Brief in support of her appeal.

II. SUMMARY OF THE ARGUMENT

The Trial Court erred as a matter of law in finding that the public policy of the Delaware Uniform Insurers Liquidation Act (the "Insurers Liquidation Act"), and the Insurance Code generally, does not outweigh the public policy underlying the doctrine of *in pari delicto*. The unique standing of an Insurance Receiver, acting pursuant to the Insurers Liquidation Act, which receivership exclusively encompasses the rights of all policyholders, all creditors, the public, and the stockholders, together with the Insurers Liquidation Act's command to the Receiver to determine the causes and marshal the assets of an insolvent insurer, outweighs the application of *in pari delicto* which otherwise applies to the successor of a corporate entity. The public policy concerns of *in pari delicto,* to deter wrongful conduct by refusing wrongdoers legal relief, and to protect the resources of the legal system from having to use its assets to adjudicate accounting among wrongdoers, should yield to the Insurers Liquidation Act's goals of protecting creditors, policyholders, and the general public by providing a comprehensive and efficient means for collecting an insolvent insurer's assets, equitably paying the claims of creditors, and protecting policyholders and others who may be harmed by the business practices of insurers.

III. STATEMENT OF THE FACTS

The SPI Entities

In 2005, Defendant James M. Jackson ("Jackson") incorporated Security Pacific Insurance Company as a captive insurance company[1] in the District of Columbia ("SPIC-DC"), which he solely owned through a holding company. (A-33, ¶ 42-45). Beginning in July 2007, Jackson sought to re-domicile SPIC-DC and its subsidiary cells to Delaware. Pursuant to the relevant statutory provisions, Jackson submitted an application to the Delaware Department of Insurance ("DDOI"). (A-36-37, ¶¶ 56-62). Included in the application were SPIC-DC's audited financial statements from its inception in 2005 to December 31, 2006, which reported that SPIC-DC had total assets of roughly $4.8 million. (A-38, ¶ 68-69). Johnson Lambert prepared and certified those audited financial statements.

In October 2007, SPIC-DC entered into a Management Services Agreement with Wilmington Trust, whereby Wilmington Trust agreed to serve as "captive manager" in Delaware by providing management, administrative, compliance, and other related services. (A-22, 39-43, ¶¶ 5-6, 71-80). The SPI Entities did not

[1] As the Trial Court explained: "a 'captive insurance company' is a business entity formed as a subsidiary of a non-insurance parent company for the purpose of insuring the parent's business risk, or the risk of the parent's affiliates or customers. It is a self-insurance mechanism in which the insurer is wholly owned by the insured. In the State of Delaware, captive insurance companies, like all commercial insurers, are subject to extensive regulatory oversight and requirements, ranging from licensure and reporting to minimum capital and reserve thresholds. Opinion (hereinafter "Op.") at p. 5 (citing *18 Del. C.* §§ 6901 to 6983).

possess the experience or expertise to supervise and operate their "insurance company" alone, so the SPI Entities relied upon and were highly dependent upon the experience, expertise, and oversight of Wilmington Trust. (A-19).[2] Jackson directly provided monthly statements accounts via an online data link. (A-43-44, ¶¶ 81-82). Jackson's position as an intermediary between Wilmington Trust and the SPI-Entities' banks was critical to his fraudulent scheme. (A-44 at ¶¶ 83-85).

On December 31, 2007, the DDOI approved the SPI Entities' application, contingent on satisfactory receipt of the 2007 Audited Financial Statements, and the SPI Entities were incorporated in Delaware as special purpose captive insurance companies. From December 31, 2007, through June 15, 2011, the SPI Entities were Delaware-domiciled special purpose captive insurance companies, organized and existing under and by virtue of the laws of the State of Delaware, including 8 *Del. C.* § 101, et seq., and 18 *Del. C.* § 6901, *et seq*. (A-21, ¶2).

The Preparation of the 2007 Financial Statements and "Alpesh"

During the time the SPI Entities operated in Delaware, Jackson engaged in several schemes and conduct designed to hide his theft of millions of dollars from the SPI Entities and policyholders. (A-33-113, ¶¶ 42-304). These included Jackson's exclusive control of the flow of information to Wilmington Trust and the

[2] Wilmington Trust's role as the captive manager for the SPI Entities was so central to their successful operation and the safeguarding of the SPI Entities' financial integrity that defendant Wilmington Trust has analogized the captive manager's role in the promotional material that it provides to the captive insurance industry to that of a football quarterback. (A-41, ¶ 77).

Auditor Defendants, the use of fraudulent documents and persons; and numerous "stall tactics." (*See generally*, Op. at pp. 8-17).

After considerable delay, toward the end of August of 2008 Allan Drost of Wilmington Trust ("Drost") emailed Jackson a list of issues preventing Johnson Lambert from completing its audit--including one confirm showing a balance $300,000 less than the corresponding bank statement provided by Jackson, and another confirm reflecting a balance of $104, when the statement submitted by Jackson showed a balance of $2,361,706,[3] as well as other discrepancies and missing information. (A-62-63, ¶ 147). In this time period, Wilmington Trust told Jackson that if Wilmington Trust had direct access to the bank accounts that these "logistical difficulties could be avoided." However, Jackson ignored the request and never gave Wilmington Trust such access. (A-64-65, ¶¶ 151-153).

In mid-September 2008, Johnson Lambert informed Wilmington Trust it had still not received calls Jackson had told it to expect from Wells Fargo or Wachovia Securities. (A-65, ¶ 154). Jackson provided Wilmington Trust and Johnson Lambert the contact information for "Alpesh" and his assistant "Rachel" at Wachovia and "Joe Lobe" and his assistant "Pamela" at Wells Fargo. (A-66, ¶ 156). According to Jackson, "Alpesh" (whose last name was never provided by

[3] The Trial Court noted that "[o]ne would think that [this item], at least, screamed for attention." (Op. at p. 13).

Jackson) was alleged to be Jackson's banking contact at both Wachovia Bank and Wachovia Securities. (A-68, ¶ 160).[4] As of December 29, 2008, Bolton from Johnson Lambert was still waiting for a call from "Alpesh" at Wachovia Bank/Securities in order to finalize the audit. (A-80, ¶ 203). Later that day, a person identifying himself as "Alpesh" called Bolton and told him the bank confirm discrepancies were allegedly resulting from a sale of "securities before year end that took a while to clear." (A-81, ¶ 204). Bolton asked Drost to verify that information and Drost responded that he did not see any pending trades at the end of 2007. (A-81, ¶ 205). Bolton replied to Drost that:

> I believe what he was saying is that maybe they were sold from another account abd [sic] then deposited into this one? At any rate does this make sense to you? ***He ["Alpesh"] caught me at a bad time and the reception was not good, so it was hard to hear him.***

(A-81, ¶ 206) (Emphasis added). Wilmington Trust's explanation was that it must have been a mistake at the banks and that the banks were attempting to cover their error instead of the much more logical explanation that Jackson was providing them fraudulent information. (A-82-83, ¶ 208).

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[4] Drost of Wilmington Trust indicated to Johnson Lambert that it was "odd" that the contact would be for both Wachovia's securities and retail banking accounts, and, after receiving a confirm from "Rachel," "Alpesh's" assistant, that they should be "curious" about the Wells Fargo and Wachovia confirmations because of their "sudden resolution." (A-69-72, ¶¶ 165-174).

Johnson Lambert used, and Wilmington Trust accepted, the fraudulent bank balances from the documents provided by Jackson in preparing the 2007 Audited Financial Statement rather than the written confirmations of different, and significantly lesser amounts, received directly from the banks. (A-83, ¶ 209). Johnson Lambert completed the 2007 Audited Financial Statement on or about December 26, 2008[5] and provided an unqualified opinion that the financial statements were correct in all material respects. (A-83, ¶ 210).

Notably, a "significant matters" letter dated December 26, 2008, from Johnson Lambert to the Board of Directors of the SPI Entities that accompanied the 2007 Audited Financial Statement made reference to a significant delay in the completion of the audit procedures as a result of two items: (1) six of seven confirmations sent to financial institutions "...did not agree to the bank reconciliations or bank statements by significant amounts ($2,361,602 in one case) and that several inquiries were required along with follow-up with the president, James Jackson, in order to resolve the discrepancies"; and (2) financials later than June 2008, were not available until November 2008 which created delays in the preparation of third quarter 2008 bank reconciliations which were necessary to for testing subsequent activity. (A-85-86, ¶ 217).

[5] Thus, defendant Johnson Lambert certified the 2007 financial statements even before receiving the "Alpesh" phone call where Bolton could not hear him very well. (A-80-83, ¶¶ 203-210).

The audited financials were accompanied by a letter addressed to the SPI Entities' boards from Johnson Lambert. The Letter discussed the significant delay in completing the audit, and noted that six of the seven bank account confirmations diverged from the relevant account statements by "significant amounts ($2,361,602 in one case)" and that several follow-up inquiries were needed to resolve the discrepancies. (A-83, ¶ 209; A-224-226). Johnson Lambert also addressed a letter to Jackson, as President and Chairman of Security Pacific,[6] outlining several recommendations for improving operations, which indicated that the identified issues were "not considered to be material weaknesses." (A-86-87, ¶ 218, A-228).

The 2008 Audited Financial Statements

Johnson Lambert and Wilmington Trust went through an almost identical process for fiscal year 2008. (A-90, ¶ 225). Jackson again engaged in delay tactics and obfuscation in his dealings with Wilmington Trust and Johnson Lambert. (A-90-93, ¶¶ 227-238). In June of 2009 Wilmington Trust and Johnson Lambert received fraudulent bank confirmations from Jackson himself or through "Alpesh." (A-97-98, ¶ 256). These fraudulent confirmations were used by Johnson Lambert in preparing the 2008 Audited Financial Statements. (A-98, ¶ 258). Johnson Lambert did not follow up on the two letters provided to the Board for the previous audit, and the recommended changes were never made. (A-103-105, ¶¶ 274-279).

[6] The letter was provided to the whole board. (A-85-87, ¶ 217-218).

The 2009 Audited Financial Statements

In April of 2010, McSoley McCoy was engaged to prepare the audit for the year ending December 31, 2009. (A-106, ¶ 283). On May 12, 2010, Drost forwarded confirmation to McSoley McCoy used in the previous year's audit, and explained "in previous years Wilmington Trust and the auditors had relied on verbal confirmations from someone named "Alpesh" whom he could never reach on the phone...." (A-107-108, ¶ 287). About two months later, either Jackson or "Alpesh" provided confirmations. Once again, the confirmations were fraudulent. The fraudulent confirmations were used by McSoley McCoy in the preparation of the 2009 Audited Financial Statements. (A-109, ¶¶ 288-291).

The Fraud is Discovered

In March 2011 Wilmington Trust informed the DDOI it had noted discrepancies involving bank statements provided by Jackson on behalf of the SPI Entities. On March 15, 2011, Wilmington Trust sent an email to the DDOI comparing several of the SPI Entities' accounts as reported in their recent statement to the DDOI (based on figures received from Jackson) to those reflected in confirmations received directly from Wachovia. (A-114-116, ¶¶ 305-316; A-275-276). Jackson's figures showed a total of $4.6 million. In reality, those accounts held a few hundred dollars each, except for one account, which seemed to be closed. (*Id.*) On March 25, 2011, the DDOI took steps to initiate receivership.

IV. ARGUMENT

Question Presented

Whether, under Delaware Law, the doctrine of *in pari delicto* should apply to bar the Commissioner of Insurance, acting in her capacity as Receiver pursuant to the Delaware Uniform Insurance Liquidation Act, from proceeding on claims against third parties.

Scope and Standard of Review

The standard of review for dismissal under Rule 12(b)(6) is *de novo*. *In re Santa Fe Pacific Corp. Shareholder Litig*., 669 A.2d 59, 70 (Del. 1995).

Merits of the Argument

The Trial Court recognized that *in pari delicto* should not be applied by courts of equity "in all cases in which public policy is considered as advanced by allowing either party to sue for relief against the transaction." (Op. at p. 71) (quoting *In re American Intern. Group, Inc., Consol. Derivative Litigation* ("*AIG II*"), 976 A.2d 872, 888 n.43 (Del. Ch. 2009), aff'd 11 A.3d 228 (Del. 2011) (quoting *Seacord v. Seacord*, 139 A. 80, 81 (Del. Super. 1927)).[7] However, the Trial Court erred in holding that suit against third parties would not advance the

[7] Delaware's recognition that the *in pari delicto* doctrine gives way to countervailing public policies has also been expressed as: "the *in pari delicto* defense will not be applied when its acceptance would contravene an important public policy." *In re HealthSouth Corp. S'hlders Litig.,* 845 A.2d 1096, *aff'd* 847 A.2d 1121 (Del. 2004), and "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." *AIG II,* 976 A.2d at 883.

public policy of the Insurers Liquidation Act. In addressing the Trial Court's error, this Brief examines the public policy underpinning the Insurers Liquidation Act and the doctrine of *in pari delicto* (Section "A"); discusses why the public policy of the Insurers Liquidation Act is advanced by allowing an insurance receiver to pursue claims against third parties ("Section "B"); and discusses why the public policy interests of the *in pari delicto* doctrine are substantially reduced where claims are brought by an insurance receiver against third parties. (Section "C").

A. The Public Policies At Issue

1. The Policy of the Insurers Liquidation Act

The insurance industry has always been of paramount importance to the states due to the absence of the same type of comprehensive federal regulation that governs other industries such as banking, securities, and commodities. Insurance companies are also excluded from federal bankruptcy law.[8] Delaware recognizes the importance of the regulation of insurance and a uniform, orderly, and equitable scheme for making and processing claims against financially troubled insurers. This is reflected in Delaware's adoption of the Uniform Insurers Liquidation Act, codified at 18 *Del. C.* §5901 *et seq.* (the "Insurers Liquidation Act"). The Insurers

[8] As noted hereafter, this fact is significant as there are some important substantive differences between the Bankruptcy Code and state insurance insolvency law. In particular, unlike a bankruptcy trustee, a receiver of an insolvent insurer represents the interests of all of the stakeholders in the marshaling and distribution of estate assets, which include, but are not limited to, the policyholders, creditors, and the public. The receiver pursues the recovery of assets on their behalf. *See* Sections C(2) and D, below.

Liquidation Act confers broad powers on the Commissioner and Court of Chancery. The Commissioner is solely authorized to institute a delinquency proceeding to seize, rehabilitate, liquidate, conserve, or reorganize an insurer. 18 *Del. C*. §§ 5902-5906, 5910-5911, and 5943. Upon application for liquidation, the court may enter an order directing the receiver to manage the insurer's property and vesting the receiver with title to the insurer's property and rights to the insurer's contracts and rights of action. 18 *Del. C.* §5911.

In *Cohen v. State ex rel. Stewart*, 89 A.3d 65 (Del. 2014), this Court considered the public interest in the Insurers Liquidation Act. The *Cohen* Court specifically acknowledged "the important public policy interest of protecting policyholders served by the Insurers Liquidation Act." *Id.* at 79 (citing with approval *Matter of Transit Cas. Co.*, 588 N.E.2d 38, 42 (N.Y. 1992) ("The over-all purpose of the Uniform Act, like liquidation proceedings generally, is not only to preserve available assets for the benefit of creditors, but to protect the interest of persons who purchased insurance policies from a company which has become insolvent")).

Cohen arose in the context of appeals from various orders of the Court of Chancery in the supervision and later rehabilitation of Indemnity Insurance Company, Risk Retention Group ("Indemnity") brought by its owner, Jeffrey Cohen. Mr. Cohen asserted various deprivations of due process in the Court of

Chancery's Orders, which this Court analyzed under the rubric of *Mathews v. Eldridge*, 424 U.S. 319 (1976). *Cohen,* 89 A.3d at 87. One of the factors to be balanced under this test is the interest of the government. *Id.* (citing *Eldridge*, 424 U.S. at 335).

In considering this interest, this Court explained the policy goals of the Insurers Liquidation Act as "preventing further damage to a potentially insolvent insurer and protecting remaining assets to pay the claims of its policyholders and creditors." *Cohen,* 89 A.3d at 91 (citing *Matter of Transit Cas. Co.,* 588 N.E.2d at 42). ("The over-all purpose of the Uniform Act, like liquidation proceedings generally, is not only to preserve available assets for the benefit of creditors, but to protect the interest of persons who purchased insurance policies from a company which has become insolvent.") This Court further explained, in balancing the *Eldridge* factors, that "[t]he Insurance Department has a strong countervailing interest in consumer protection and preventing fraud at Indemnity, an interest recognized by the General Assembly when it passed the Insurers Liquidation Act." *Id.* (citing *Remco Ins. Co. v. State Ins. Dept.,* 519 A.2d 633, 635 (Del. 1986) (noting that the statute grants the Insurance Department "broad regulatory authority to protect policyholders and others who may be harmed by business practices of insurers")).

As this Court recognized, "[u]nder the Insurers Liquidation Act, the Commissioner is charged with preventing further damage to an insurer and protecting the remaining assets to pay the potential claims of policyholders and creditors. *Cohen*, 89 A.3d at 93 (citing *Kentucky Cent. Life Ins. Co. v. Stephens,* 897 S.W.2d 583 (Ky. 1995) (noting that the purpose of the Uniform Insurers Liquidation Act is "the protection of the interest of the insured, creditors, and the public generally")).

To this point, the Insurers Liquidation Act specifically requires that an application for a delinquency order, if granted, include "such other relief as the nature of the case ***and the interests of the policyholders, creditors, stockholders, members, subscriber or the public may require***." 18 *Del. C.* § 5903 (emphasis added). The insurance commissioner, acting as a liquidator of an insolvent insurance company "may, and under some circumstances must, pursue any litigation that has the potential of increasing the assets of the company." Steven Plitt, Daniel Maldonado, Joshua D. Rogers, and Jordan R. Plitt, *Couch on Insurance* § 5:39 (3d ed. 2013). This includes suits against "auditors for alleged negligence and malpractice in the performance of auditing services, breach of contract in performance of actuarial and auditing services, misrepresentation, and negligent misrepresentation." *Id.* (citations omitted).

The overall policy of liquidations under the Uniform Insurers Liquidation Act "is for the domiciliary receiver to marshal the assets of an insolvent insurer and distribute them to those with claims against the insurers pursuant to the priorities set forth in the act." *See, e.g., Ainsworth v. Cincotta*, 721 P.2d 455, 461 (Or. App.), rev. den. 727 P.2d 129 (Table) (1986).[9] The Insurers Liquidation Act requires the Receiver to marshal all assets of the estate. 18 *Del. C.* § 5911(a). To this end, 18 *Del. C.* § 5913(b) vests the Receiver with title to all rights of actions of the insurer and grants the right to recover and reduce them to possession. The Liquidation Order likewise grants possession of such rights of action (A-161-162, ¶ 6) and grants the receiver the right to *inter alia*, "sue, defend, and continue to prosecute suits or actions already commenced by or for [the SPI Entities], **or for the benefit of the policyholders, cedants, creditors and stockholders** of [the SPI Entities]…in her name as the Insurance Commissioner of the State of Delaware, or in the name of [the SPI Entities]." (Emphasis added) (A-163, ¶ 9). The ability of the Receiver to marshal assets, through litigation or otherwise, so that the recovered assets can be equitably distributed to policyholders is so central to the insurance liquidation process that it is hand-in-glove with what commentators have described as the dominant concerns that drive the insurance insolvency process: (1)

[9] Cases from other jurisdictions provide persuasive guidance about how to interpret the Insurers Liquidation Act. *Cohen,* 89 A.3d at 94 (citing 18 *Del. C.* § 5920) ("The [Insurers Liquidation Act] shall be so interpreted and construed as to effectuate its general purpose to make uniform the law of those states that enact it").

maximization of estate assets; (2) minimization of administrative expenses of the estate; (3) equitable distribution of estate assets; and (4) timely distribution of estate assets. Philip A. O'Connell, Jr., Christopher E. Prince, and Joel T. Muchmore, *Insurance Insolvency: A Guide for the Perplexed*, 27 No. 14 Ins. Litig. Rep., 669 (2005). "In practice, from the perspective of the insurance regulator and receiver, each of these considerations is ultimately subordinated to the overall goal of maximizing the payment of legitimate policyholder claims." *Id*. at fn. 13. In this regard it cannot be over-emphasized that unlike a bankruptcy trustee, the Commissioner as Receiver, by virtue of the Insurers Liquidation Act and the Liquidation Order, ***herself*** brings actions on behalf of policyholders, creditors, and stockholders that are not derivative of the failed insurer. (18 *Del. C.* § 5903; A-163, ¶ 9).

2. The Policy of *In Pari Delicto*.

The doctrine of *in pari delicto* is a general rule that courts "will not extend aid to either of the parties to a criminal act or listen to their complaints against each other but will leave them where their own act has placed them." *AIG II*, 976 A.2d at 883 (citing 1 Am. Jur. 2d Actions § 40). As the *AIG II* Court explained: "There is no societal interest in providing an accounting between wrongdoers." *Id.* The underlying policy has been described as "either the general principal that courts should not aid parties that engaged in illegal conduct or the more specific, but

related, idea that by closing their doors to a plaintiff that is *in pari delicto*, courts are deterring illegal conduct." *Id.* at 883, n. 21 (citing *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985))(noting that *in pari delicto* based on principles that "courts should not lend their good offices to mediating disputes between wrongdoers" and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality"). Despite its availability as a defense, the *in pari delicto* doctrine is ***not*** for the benefit of either party or to punish them, but instead is imposed from motives of public policy. *Id.*, at n. 21.

The doctrine of *in pari delicto* has not been extensively discussed by this Court and the issue presented here is of first impression. However, the Court of Chancery and the Superior Court have considered the doctrine on several occasions. In a pair of decisions, the Court of Chancery discussed the application of the doctrine in the context of derivative claims against insiders, agents, and co-conspirators of American International Group, Inc. ("AIG"). *See In re American Intern, Group, Inc., Consol. Derivative Litigation* ("*AIG I*")*,* 965 A.2d 763, 806-07, 816-31 (Del. Ch. 2009), aff'd 11 A.3d 228 (Del. 2011); *AIG II*, 976 A.2d at 882-95. In the two AIG cases, the Court of Chancery discussed the application of i*n pari delicto* under Delaware law as against insiders and co-conspirators of AIG, and under New York law as against auditors, as agents of AIG.

In *AIG I*, the Court of Chancery rejected the application of the *in pari delicto* doctrine to fiduciaries. 965 A.2d at 806 (citing *In re HealthSouth Corp. S'hlders Litig.*, 845 A.2d at 1108 n. 22 ("Under Delaware law, where insiders have a disabling conflict that gives them a reason to hide information from the corporation's independent directors and stockholders, their knowledge is not imputed to the corporation for purposes of a suit seeking to hold the insiders who committed wrongdoing accountable for the harm they caused to the corporation")). It also applied the doctrine, under New York law, to auditors. *Id.* at 822-832. In *AIG II*, the Court applied the doctrine to co-conspirators. 976 A.2d at 884-895.[10]

B. Public Policy of Insurers Liquidation Act Advanced by Allowing Insurance Receiver To Pursue Claims Against Third Parties

As discussed in Section A(1), above, important public policy interests underlie the Insurers Liquidation Act. Further, the two bases for the imposition of the *in pari delicto* doctrine, that "courts should not lend their good offices to mediating disputes between wrongdoers" and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality"[11] do not apply.

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[10] AIG I and AIG II involved claims concerning a publicly traded non-insurance holding entity which engaged in and controlled diversified holdings of financial and other businesses. The subject entity was not an insurance company, was not regulated pursuant to the Insurers Liquidation Act or similar statutory schemes, and no assets of policyholders were implicated in the disputes. Accordingly, AIG I and AIG II did not address or implicate the analysis of *in pari delicto* in the unique context of an insurance receivership.

[11] *Berner*, 472 U.S. at 306 (*cited in AIG II,* 976 A.2d at 883 n. 21).

Although the Trial Court recognized that the *in pari delicto* doctrine should not be applied by courts of equity "in all cases in which public policy is considered as advanced by allowing either party to sue for relief against the transaction" (Op. at p. 71)(quoting *AIG II*, 976 A.2d at 888 n.43) (quoting *Seacord*, 139 A. at 81), it erred in finding that the public policy of the Insurers Liquidation Act was not advanced by allowing suit against third parties. (Op. at pp. 71-76). The obverse analysis illustrates the Trial Court's error: policyholders and creditors must cede their recovery rights to the Receiver under the Insurers Liquidation Act and Liquidation Order, who then, with the application of the doctrine of *in pari delicto*, would be precluded from bringing suit to vindicate those very rights because of the wrongdoing of persons or corporations that caused the policyholder and creditor loss. This absurd result does not advance the recognized policies of the Insurers Liquidation Act which include providing a comprehensive and efficient means of marshaling assets and equitably paying claims of policyholders and creditors. It is not enough to say that the Receiver, in her role as regulator, has other supervisory or regulatory powers over wrongdoers such that the policies of the Insurers Liquidation Act are advanced by the application of the doctrine. (Op. at pp. 74-76). The rights of policyholders and creditors who cede their interests to the Receiver are best and most immediately served by the Receiver recovering losses caused by the misconduct of third parties.

Throughout the Trial Court's Opinion, the Court consistently equated the position of the Receiver to that of a stockholder in a derivative suit.[12] Among the many cases cited by the Receiver relating to insurance receiverships, the only case the Trial Court discussed in its Opinion was *Reider v. Arthur Andersen,* 784 A.2d 464 (Conn. Super. 2001). The Trial Court summarily dismissed *Reider* stating: "This type of argument was expressly rejected in *AIG II* because it would make *in pari delicto* a dead letter. *AIG II*, 976 A.2d at 893 ("[A]n innocent insider exception, like the plaintiffs' personal interest exception, would allow corporations to sue their own co-conspirators for actions that were undertaken, at least in part, for the corporation's own interest, giving corporations rights that natural persons do not have.") (Op. at p. 70 n. 197).

However, the Court never engaged with the Receiver's argument--that ***because*** of the public policy in the insurers liquidation act, the Receiver is not treated like a shareholder in a derivative suit, and that the Insurers Liquidation Act and the Liquidation Order do, in fact, give the Receiver rights that natural persons do not have.

The *AIG II* Court stated that "[t]he policy behind the in pari delicto doctrine, including the need to give corporations a strong incentive to comply with the law,

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[12] In its Letter Opinion on leave to appeal, the Trial Court recognized that the issue of whether "the Receiver arguably is sufficiently different from other plaintiffs against whom the *in pari delicto* defense might be raised, such as a stockholder pursuing a derivative claim" is an issue of first impression in Delaware. See, Exhibit "2" to the Supplemental Notice of Appeal.

is seen to trump the interest of innocent corporate investors and creditors." 976 A.2d at 893. No such incentive is applicable in an insurance delinquency proceeding. Compliance with the law is incentivized by the fact that noncompliance results in a seizure and liquidation of the insurer. Additionally, more than creditors' and shareholders' interests are at stake. As discussed in Sections C(2) and (D), below, the insurance delinquency proceeding also is for the benefit of the policyholders and the public.

The crux of the Trial Court's argument that the public policy of the Insurers Liquidation Act is not advanced by suit against third parties is its statement that the Insurers Liquidation Act "does not suggest that the Legislature intended private causes of action to play a part in its enforcement, and the Receiver has not cited any case law indicating otherwise." (Op. at p. 75). This appears to be a misunderstanding of the role of the Commissioner as Receiver. The Commissioner, by virtue of the Insurers Liquidation Act and the Liquidation Order ***herself*** brings actions on behalf of policyholders, creditors, and stockholders. (18 *Del. C.* § 5903; A-163, ¶ 9). The Receiver, in briefing below, and in Sections C(2) and D, argued that insurance receivers bring claims on behalf of themselves as well as policyholders and creditors. (A-578-579).

The overall policy of the Uniform Insurers Liquidation Act "is for the domiciliary receiver to marshal the assets of an insolvent insurer and distribute

them to those with claims against the insurers pursuant to the priorities set forth in the act. See, e.g., *Ainsworth*, 721 P.2d at 461. *See also Couch on Insurance* § 5:39 (Receiver "may, and under some circumstances must, pursue any litigation that has the potential of increasing the assets of the company"); 8 *Del. C.* § 5911(a) (requiring Receiver to marshal all assets of the estate).

Although the United States Supreme Court has held that the doctrine of in *pari delicto* should not be applied where it undermines private suits as a means for enforcing federal laws,[13] to the extent that a suit brought by an insurer's receiver is not characterized as "a private cause of action," there is nothing to suggest that the policy interests in *Berner* and *Perma Life* would be any different for a claim brought by an insurance receiver under a state regulatory system.[14] Such a result would be anomalous.

The Ninth Circuit, in *F.D.I.C. v. O'Melveny & Myers*, declined to apply *in pari delicto* to a bank receiver's claim against the bank's former lawyers, based, in part, on the fact of the "intricate regulatory scheme" by which it became receiver. 61 F.3d 17 (9th Cir. 1995) ("Also significant is the fact that the receiver becomes the bank's successor as part of an intricate regulatory scheme designed to protect the interests of third parties who also were not privy to the bank's inequitable

[13] *See Berner*, 472 U.S. at 306-11 (securities law); *Perma Life Mufflers, Inc. v. Int'l Parts Corp*, 392 U.S. 134, 166 (1968) (antitrust law).

[14] *Berner* held that the federal laws need not expressly provide for private remedies. 472 U.S. at 310.

conduct. That scheme would be frustrated by imputing the bank's inequitable conduct to the receiver, thereby diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets.") Indeed, in *Mosier v. Stonefield Josephson, Inc.*, in a claim by a receiver appointed by the ***SEC,*** the Court held that allowing the defendant to invoke *in pari delicto* "would frustrate the Court's plan by 'diminishing the value of the asset pool held,' thereby hurting innocent third-party creditors, while benefitting… an alleged wrongdoer." 2011 WL 5075551 * 5 (C.D. Cal. Oct. 25, 2011) (citing *O'Melveny*).

Finally, the Trial Court's suggestion that Wilmington Trust or the Auditor Defendants could be punished by regulatory action to revoke their acceptability in further captive insurance cases misses the point. At issue is not punishment of defendants, but rather, whether, in accordance with Delaware public policy, the insurance receiver can marshal the assets of insolvent insurers. The Trial Court erroneously held that public policy is not advanced by allowing the Receiver to sue for relief in order to marshal the assets for distribution. In doing so, it erred.

C. The Public Policy Interests of the *In Pari Delicto Doctrine* Are Substantially Reduced Where Claims are Brought by an Insurance Receiver Against Third Parties

The unique standing of an Insurance Receiver, acting pursuant to the Insurers Liquidation Act, which exclusively encompasses the rights of all policyholders, creditors, public, and stockholders, together with the Insurers

Liquidation Act's command to the Receiver to determine the causes and marshal assets of an insolvent insurer, outweigh the application of *in pari delicto* doctrine.

1. The Public Policy Interests of *In Pari Delicto* Are Reduced When the Action is Brought by a Receiver

The public policy interest of keeping the Court from becoming embroiled in making fine distinctions in claims among wrongdoers is substantially lessened where any corporate receiver is the party bringing suit.

In a case against corporate insiders, the Court of Chancery in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.* declined to apply the doctrine of *in pari delicto*. 906 A.2d 168, 212 n. 132 (Del. Ch. 2006), *aff'd* 931 A.2d 438 (Del. 2007). In doing so, it approvingly cited *Scholes v. Lehmann,* 56 F.3d 750 (7th Cir.), cert. den. 516 U.S. 1028 (1995), as "explaining the defense of *in pari delicto* functions to prevent a wrongdoer from profiting from the recovery awarded by a court for the wrong but that when the wrongdoer will not be able to share in the corporation's recovery **the defense of *in pari delicto* 'loses its sting'**)."[15] *Id.*

The concept that fault-based defenses to liability such as *in pari delicto* lose much of their vitality when used against a receiver is embodied in 65 Am. Jur. 2d Receivers § 367, which provides, in pertinent part:

[15] *Scholes* involved an equity receiver for a corporation originally controlled by the wrongdoer. *Scholes,* 56 F.3d at 754-55.

> Factors considered in determining whether the in pari delicto defense, which bars a plaintiff who has participated in wrongdoing from recovering damages resulting from the wrongdoing, applies to a receiver are: (1) whether the wrongdoer would benefit from the receipt of the funds sought by the receiver, (2) whether the defendant in the case gained some illegitimate benefit from the wrongdoer's act, and (3) whether applying the in pari delicto defense would frustrate the purposes of the law the receiver seeks to invoke. ***The defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver.***
>
> ***Actions by equity receivers against third parties are viable, even if a member of the entity in receivership participated in a third party's fraud, where the wrongdoer has been removed.***

(Emphasis added). Other courts have likewise held that because a receiver is not a wrongdoer, the public policy interests of *in pari delicto* are not satisfied, and have on that basis declined to bar claims by receivers based on wrongful conduct of the corporation. *See Grant Thornton, LLP v. FDIC*, 435 F. Appx. 188 (4th Cir. 2011) (affirming district court's decision not to allow *in pari delicto* defense because receivers "vindicat[e] the rights of the public"); *O'Melveny*, 61 F.3d at 19 (under California law, "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver"); *Mukamal v. BDO Seidman, LLP (In re E.S. Bankest, L.C.)*, 2010 WL 2926203 (Bankr. S.D. Fla. July 23, 2010) (relying on *Scholes* to bar *in pari delicto* defense as a matter of law against receiver bringing claims against auditor; "[s]ince it was this Court-appointed Receiver that

put Bankest into bankruptcy -- and no prior wrongdoing could be imputed to him in that capacity and thus no *in pari delicto* defense could apply -- it would make no sense to say that suddenly imputation and *in pari delicto* were 'back' when that Receiver caused Bankest to file for bankruptcy"); *Goldberg v. Chong*, 2007 WL 2028792, at *10 (S.D. Fla. July 11, 2007) ("The Court fails to see how the purposes of the principle of *in pari delicto* would be served by preventing recovery on account of [the principal's] wrongdoing."); *Javitch v. Transamerica Occidental Life Ins. Co.*, 408 F. Supp. 2d 531, 537-38 (N.D. Ohio 2006) ("Actions by equity receivers against third parties are viable where the 'wrongdoer' has been removed."); *Yessenow v. Exec. Risk Indemnity, Inc.*, 953 N.E.2d 433 (Ill. App. 2011) (finding that receiver, as an "instrument of the law and an agent of the court," had "rights and powers" that company in receivership did not).

The Public Policy Interests of *In Pari Delicto* Are Further Reduced When Claim is Brought by an Insurance Receiver

Even if this Court were not to bar the application of *in pari delicto* against receivers in general, the public policy interests giving rise to the *in pari delicto* doctrine apply with significantly lesser force where, as here, an insurance receiver has taken the place of an insolvent insurer which committed the wrongdoing.

This Court has recognized "the important public policy interest of protecting policyholders served by the Insurers Liquidation Act." *Cohen*, 89 A.3d at 79. As

discussed in Section A(1) above, the Insurers Liquidation Act and the Liquidation Order provide for the marshalling of assets, and protection of the interests of policyholders, creditors, stockholders, members, subscribers, and the public and bringing of claims for the benefit of policyholders, cedants, creditors, and stockholders of the insurer. (18 *Del. C.* § 5903, A-163, ¶ 9).

Although a receiver is often said to "stand in the shoes" of the corporation, an insurance receiver does not stand precisely in the shoes of delinquent insurers due to the special nature of its representation. As the Louisiana Court of Appeals explained in *Republic of Texas Sav. Ass'n v. First Republic Life Ins. Co.*:

> The rehabilitator is vested with title to all property, contracts and rights of action of the insurer as of the date of the order directing rehabilitation. La.R.S. 22:735. He has the responsibility of protecting the interests of the policyholders, creditors and the insurer; he has the authority to void transfers or liens upon the property of the insurer which any creditor, stockholder or member of the insurer might have avoided. La.R.S. 22:736 and 745(D). These powers and responsibilities indicate that the rehabilitator does not stand precisely in the shoes of First Republic. While a party to the instrument may be estopped from asserting defenses based on previous misrepresentations, this restriction does not extend to the rehabilitator.

417 So. 2d 1251, 1254 (La. Ct. App.), writ den. 422 So.2d 161 (1982). *See also generally*, Karl L. Rubenstein, *The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit*, 10 Conn. Ins. L.J. 309 (2004) (citations omitted).

Although stockholders are a represented constituency, where, as here, the insurer is insolvent, under Delaware's statutory scheme of priority under the Insurers Liquidation Act, stockholders may receive no payment.[16] Courts of other states have relied upon these two issues: (1) that the receiver represents the interests of the public, as well as innocent policyholders and creditors; and (2) shareholders of insolvent insurers are last to receive distributions under the state's statutory priority system; to deny application of the *in pari delicto* doctrine. *See*, *e.g. McRaith v. BDO Seidman, LLP,* 909 N.E.2d 310, 336 (Ill. App.), appeal den. 919 N.E.2d 354 (Table) (Ill. 2009) ("In the instant case, the *in pari delicto* doctrine cannot apply because the Liquidator, by statutory definition, is not the wrongdoer; rather, he serves to protect the insurance industry and the public interest by ensuring the victims of the misconduct can recover monies entitled to them"); *Schacht v. Brown,* 711 F.2d 1343, 1348-49 (7th Cir.), cert denied, 464 U.S. 1002 (1983) (since shareholders are "last in line for recovery" from insolvent insurer's estate, principals underlying *in pari delicto* doctrine do not prevent suit); *Wooley v. Lucksinger*, 61 So.3d 507, 606 (La. 2011) (holding insurance receiver not subject to *in pari delicto* because role to protect interests of innocent policyholders and creditors); *Bonhiver v. Graff,* 248 N.W.2d 291, 296-97 (Minn. 1976) ("[t]he receiver represents the rights of creditors and is not bound by the fraudulent acts of

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[16] *Cohen*, 89 A.3d at 95 (citing 18 *Del. C.* § 5918(e)(9)) (placing "[t]he claims of shareholders or other owners arising out of such capacity" as last in priority).

a former officer of the corporation"); *Jo Ann Howard & Assoc., P.C. v. Cassity*, __ F. Supp. 3d __, 2015 WL 144903 *12 (E.D. Mo. Jan 12, 2015) (declining to apply *in pari delicto* against a receiver bringing claims on behalf of creditors, members, policyholders, shareholders and the public); *Cordial v. Ernst & Young,* 483 S.E.2d 248 (1996) (rejecting defendant accounting firm's argument that receiver's rights rise no higher than those of the corporations they represent and instead finding receiver acts to vindicate rights of the public, including policyholders and creditors).

The concerns set forth by the *AIG I* and *AIG II* Court show that in claims against a corporate agent employed to help ensure lawful operation of an insurer, such as an auditor or captive manager, the policy interests informing the *in pari delicto* doctrine are even further substantially reduced. In dicta in *AIG I* and *AIG II,* the Court of Chancery suggested that although New York law applied, under Delaware law claims in a stockholder derivative lawsuit against a company's auditor or other agents would be treated the same as claims against a corporate fiduciary. *AIG I*, 965 A.2d at 828 & n. 246; *AIG II*, 976 A.2d at 895 & n. 60. As the Court of Chancery noted, this would have the effect of allowing such claims to proceed even over a defense of *in pari delicto*. *Id.* Although *AIG I*'s analysis was primarily directed towards auditors, it is equally applicable to Wilmington Trust, the captive manager. *AIG II*, 976 A.2d at 890 n. 49 ("As indicated in [*AIG I*], the

policy basis for allowing such derivative suits can easily be seen as justifying claims against corporate agents like outside auditors and counsel for the corporation's compliance committee")(citing *NCP Litig. Trust v. KPMG LLP,* 901 A.2d 871, 888 (N.J. 2006)); *See also id.* at 895 n. 60 ("making sure that gatekeepers comply with their duties would seem to foster, not impede society's interest in corporate law compliance"). Thus, the public policy concerns underpinning the *in pari delicto* doctrine apply with even less force in an insurance receivership than in an "ordinary" receivership.

D. The Public Policy Interests of the *In Pari Delicto* Doctrine Are Lessened Due to the State Regulation of Insurance Insolvency

As discussed in Section A(1), above, the Insurers Liquidation Act serves an "important public policy interest of protecting policyholders" and protecting remaining assets to pay the claims of policyholders and creditors. *Cohen*, 89 A.3d at 79, 91, 93. The Trial Court recognized that "the public has an interest in keeping insurers solvent and in overseeing or facilitating the orderly disposition of insolvent or delinquent ones." (Op. at p. 74). Courts in the Third Circuit, construing other states' similar insurance delinquency statutes have consistently observed that the insolvency of insurance companies and the administration of claims against the debtor insurer are matters of substantial public concern. *See, e.g. G-I Holdings v. Reliance Insurance Co.*, 2006 WL 3825142 * 7 (D.N.J., Dec.

22, 2006) (citing *Lac D'Amiante Du Quebec, Ltee v. American Home Assurance Co.*, 864 F.2d 1033, 1045 (3d Cir. 1988)); *Grode v. Mutual Fire, Marine and Inland Ins. Co.*, 8 F.3d 953, 958 (3d Cir.), reh. den. (1993). Courts in other jurisdictions, in analyzing the application of the *in pari delicto* doctrine to claims of insurance receivers have recognized that public policy concerns inherent in insurance delinquencies militate against imputation of fault to the receiver or applying the *in pari delicto* doctrine.

Courts have used the public policy inherent in the statutory regulation of insurance solvency to defeat defenses that a receiver in an insurance delinquency proceeding is subject to imputation of wrongful conduct by former management, or that the doctrine of *in pari delicto* applied. In *McRaith*, the court denied an auditor's motion to dismiss based on the doctrine of *in pari delicto*: "the *in pari delicto* doctrine cannot apply because the Liquidator, by statutory definition, is not the wrongdoer; rather, he serves to protect the insurance industry and the public interest by ensuring the victims of the misconduct can recover monies entitled to them." 909 N.E.2d 310, 336 (Ill. App. 2009). As the *McRaith* Court held:

> [W]e find as a matter of first impression that the imputation defense is inapplicable against the Liquidator. This decision is supported by Illinois law and public policy that vests the Liquidator with the statutory authority to liquidate the property, business and affairs of the insolvent insurance company in order to protect

> policyholders and creditors from the type of misconduct which occurred here

Id. Likewise, in *Reider v. Arthur Andersen*, the court denied an auditor's attempt to impute fraud to an insurance receiver based on the difference between an "ordinary" corporation and an insurance company, due to the important public policy considerations:

> The public, though the Insurance Commissioner, has a vital interest in the continuing solvency of the insurer and the right, which it exercises through the Commissioner, to take over the insurer's business activities to protect that interest.

784 A.2d at 474. On that basis, the *Reider* Court held the owners' fraud should not be imputed to the insurer: "The [owners'] fraud is not imputable to First Connecticut because their interests were always adverse to the public's enforceable interest in ensuring the insurer's continuing solvency." 784 A.2d at 475.

In *Arthur Andersen v. Superior Court,* the California Court of Appeal refused to impute the insurer's management's fraud to the insurer's receiver, holding that "[t]he Insurance Commissioner hence represents far broader interests than those typically represented by an ordinary receiver, whose potential claims are limited to those of the company in receivership." 79 Cal. Rptr. 2d 879, 882 (Cal. App. 2nd Dist. 1998), reh. den. (1998), rev. den. (1999). The Court explained that

> No authority is offered for the proposition that the ***Insurance Commissioner acts merely as an ordinary receiver***.... Ordinary receivers do not monitor the solvency of an entity on behalf of persons, such as policyholders, who do business with the entity. The Insurance Code, by contrast, assigns such pre-conservatorship duties to the Insurance Commissioner.... In carrying out these duties, the Insurance Commissioner acts not in the interests of the equity owners of the insurance company, but rather in the interests of policyholders. Thus the Insurance Commissioner in this case is not seeking merely to prosecute claims of an entity under receivership. To the contrary, ***the essence of the Insurance Commissioner's claim is that AA damaged the policyholders.*** Thus even though a receivership may bear some points of analogy to a statutory insurance company liquidation (primarily in that each can involve the marshalling of the assets of an estate), an ordinary receivership is a different procedure for a different situation.

Id. at 888 (emphasis added). Having explained that the claims brought by the liquidator against Arthur Anderson pursuant to a "different position for a different situation" the Court concluded that "AA's line of cases regarding ordinary receiverships, imputation of knowledge from a corporate officer to an ordinary receiver, etc., therefore does not apply to the instant case." *Id.* at 889; s*ee also McRaith,* 909 N.E.2d at 336 ("the *in pari delicto* doctrine cannot apply because the Liquidator, by statutory definition, is not the wrongdoer; rather, he serves to protect the insurance industry and the public interest by ensuring the victims of the misconduct can recover monies entitled to them. To equate the Liquidator with [the wrongdoer] under *in pari delicto* is illogical and unavailing"); *Matter of*

Integrity Insurance Co., 573 A.2d 928 (N.J. App. 1990), cert. den. 506 U.S. 869 (1992) (holding that the liquidator was not barred by the defendant accounting firm's imputation defense because of the "unique situation" of an insurance insolvency proceeding).

Because of the strong public interests served by the Insurers Liquidation Act, the policy interests informing the *in pari delicto* doctrine are substantially reduced in a claim by a receiver of a delinquent insured.

V. CONCLUSION

For the foregoing reasons, Appellant respectfully submits that this Honorable Court should reverse that portion of the Trial Court's Order of March 26, 2015, dismissing Counts 2-3, 5-7, and 9-10 of the Complaint.

Dated: June 10, 2015 Respectfully submitted,

/s/ Diane J. Bartels
Diane J. Bartels
Del. Bar No. 2530
Brandywine Village
1807 North Market Street
Wilmington, DE 19802-4810
Tel. (302) 656-7207

Attorney for 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, Inc. in Liquidation