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**A District Court may not Enjoin Third-Party Claims Against Insurers in a Securities-Fraud Receivership without Alternative Compensation Scheme**

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**Introduction**

Within its equitable power, a district court may place the assets of a defendant into receivership and appoint a receiver to protect a plaintiff's interest in property where the rights over that property are disputed.<sup>1</sup> In general, the purpose of this equity receivership is to marshal assets, preserve value, equitably distribute to creditors, and, either reorganize, or orderly liquidate.<sup>2</sup> This power is an extraordinary remedy only justified by extreme situations, such as where there is a high probability that fraudulent conduct has occurred or will occur to frustrate the claim, or when there is a threat that the disputed property will be concealed, lost, or diminished in value.<sup>3</sup> In cases involving Ponzi schemes, courts have held that the insurance policies and proceeds covering the company and its employees will be considered property of the receivership.<sup>4</sup>

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<sup>1</sup> See Fed. R. Civ. P. 66; see also *Varsames v. Palazzolo*, 96 F.Supp. 2d 361, 365 (S.D.N.Y 2000); *Gilchrist v. Gen. Elec. Capital Corp.*, 262 F. 3d 295, 302 (4th Cir. 2001).

<sup>2</sup> See *Janvey v. Alguire*, No. 3:09-CV-0724-N, 2014 WL 12654910 at \*17 (N.D. Tex. 2014) (citing *Duparquet Huot & Moneuse Co. v. Evans*, 297 U.S. 216, 221 (1936)); see also *SEC v. Wealth Mgmt. LLC*, 628 F.3d 323, 334 (7th Cir. 2010).

<sup>3</sup> See *Aviation Supply Corp. v. R.S.B.I. Aerospace, Inc.*, 999 F.2d 314, 316-17 (8th Cir. 1993).

<sup>4</sup> See *SEC v. Stanford Int'l Bank, Ltd.*, 927 F.3d 830 (5th Cir. 2019); see also *Tringali v. Hathaway Mach. Co.*, 796 F.2d 553 (1st Cir. 1986).

The receiver is given broad authority to acquire, organize, and distribute the property of the estate and is vested with complete jurisdiction over the receivership property.<sup>5</sup> Similar to a trustee in bankruptcy, an equity receiver has the authority to sue, but only to redress injuries to the entity in receivership.<sup>6</sup> The equity receiver also has the authority to enter into settlements, subject to the district court’s finding of the agreement to be “fair and equitable and in the best interests of the estate.”<sup>7</sup>

Furthermore, a district court has the authority and wide discretion to issue injunctions to prevent third-parties from diminishing property of the receivership estate.<sup>8</sup> This power, in conjunction with the district court’s power to approve settlements, provides a framework for analyzing a settlement which requires injunctions on third-party claims against an insurer.<sup>9</sup>

This memorandum addresses whether a district court, presiding over a securities-fraud receivership, has the power to enjoin third-party claims against insurers without an alternative compensation scheme. First, this memo explores the relationship between securities-fraud receivership and bankruptcy principles surrounding the court’s power to enjoin claims of third-parties. Second, it analyzes the restrictions on the authority of the receiver and receivership court to extinguish third-party contractual claims. Lastly, it examines how courts have balanced these considerations to both protect assets of the estate and protect coinsureds with contractual rights in the receivership property.

## **I. Equity and Bankruptcy Receivership Principles**

Because equity receiverships and bankruptcy receiverships share the same legal heritage, as well as serve common purposes, courts have looked to bankruptcy law to analyze conflicts in

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<sup>5</sup> See 28 U.S.C. § 754.

<sup>6</sup> See *Scholes v. Lehmann*, 56 F.3d 750, 753 (7th Cir. 1995).

<sup>7</sup> See *Tri-State Fin., LLC v. Lovald*, 525 F.3d 649, 654 (8th Cir. 2008).

<sup>8</sup> *Stanford Int’l Bank, Ltd.*, 927 F.3d at 840.

<sup>9</sup> See *id.* at 841-42; see also *Matter of Zale Corp.*, 62 F.3d 746 (5th Cir. 1995).

equity receiverships.<sup>10</sup> In fact, securities-fraud receiverships are essentially equivalent to a chapter 7 bankruptcy proceeding.<sup>11</sup> Thus, courts have found bankruptcy caselaw and principles persuasive when analyzing conflicts in these equity receiverships.<sup>12</sup>

Similar to equity receiverships, under section 541(a) of title 11 of the United States Code (the “Bankruptcy Code”), a bankruptcy estate includes all legal or equitable interests of the debtor.<sup>13</sup> This provision has been interpreted as including all tangible and intangible property, including causes of action.<sup>14</sup> Courts have consistently held that section 541(a) includes a debtor’s interest in liability insurance.<sup>15</sup>

Once the defendant’s assets are in receivership, the district court has broad powers to determine the appropriate relief through both statutory and “ancillary relief” measures.<sup>16</sup> District courts have thus exercised discretion in granting blanket stays of litigation which would reduce or interfere with receivership assets.<sup>17</sup> Similarly, bankruptcy courts are expressly authorized to enjoin actions against non-debtor parties and channel those claims to the estate.<sup>18</sup>

In conjunction with this authority, receivership courts, like bankruptcy courts, have the ability to approve settlements of disputed claims when the settlement is “fair and equitable and in the best interest of the estate.”<sup>19</sup> However, the power of the receiver and receivership court to approve a settlement which enjoins third-party claims is not unlimited.<sup>20</sup>

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<sup>10</sup> See Janvey, 2014 WL 12654910 at \*17; see also *Wealth Mgmt. LLC*, 628 F.3d at 334.

<sup>11</sup> See *Wealth Mgmt. LLC*, 628 F.3d at 334 (“The goal in both securities-fraud receiverships and liquidation bankruptcy is identical – the fair distribution of assets.”).

<sup>12</sup> See Janvey, 2014 WL 12654910 at \*17; see also *Wealth Mgmt. LLC*, 628 F.3d at 334.

<sup>13</sup> See 11 U.S.C. § 541(a).

<sup>14</sup> See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204-205 (1983).

<sup>15</sup> See *Tringali*, 796 F.2d at 553; see also *In re Davis*, 730 F.2d 176, 184 (5th Cir. 1984).

<sup>16</sup> See *SEC v. Wenke*, 622 F.2d 1363, 1369 (9th Cir. 1980); see also *SEC v. Safety Fin. Services, Inc.*, 674 F.2d 368, 372-73 (1982) (citing *SEC v. Lincoln Thrift Assoc.*, 577 F.2d 600, 606 (9th Cir. 1978)).

<sup>17</sup> See *SEC v. Stanford Int’l Bank, Ltd.*, 927 F.3d 830; see also *SEC v. Stanford Int’l Bank Ltd.*, 424 F. App’x 338, 340 (5th Cir. 2011) (“It is axiomatic that a district court has broad authority to issue blanket stays of litigation to preserve the property placed in receivership pursuant to SEC actions.”).

<sup>18</sup> See *Travelers Indem. Co. v. Bailey*, 557 U.S. 137, 155 (2009).

<sup>19</sup> See *Ritchie Capital Mgmt., L.L.C. v. Kelley*, 785 F.3d 273, 278 (8th Cir. 2015) (citing *Tri-State Fin., LLC v. Lovald*, 525 F.3d 649, 654 (8th Cir. 2008)).

<sup>20</sup> See *infra* Section II.

In order to examine the authority of a district court, the third-party claims against the insurers must be split into two categories. First, there may be contractual claims against the insurers for defense and indemnity payable from policy proceeds.<sup>21</sup> Second, there may be independent, non-derivative, third-party claims against the insurers for tort or statutory violation.<sup>22</sup> The authority of a court to approve a settlement that requires injunctions against third-party claims differs between the two, and thus must be examined separately.<sup>23</sup>

## II. Third-Party Contractual Claims against Insurers

The first type of claim against the insurers involves contractual claims for defense and indemnity against lawsuits by the receiver. When an entity is put into receivership, the proceeds of its insurance policy become property of the estate. This is true both in equity receiverships and in bankruptcy proceedings.<sup>24</sup> In *Tringali*, the United States Court of Appeals for the First Circuit held that section 541(a) of the Bankruptcy Code was broad enough to include an interest in the debtor's liability insurance as property of the estate.<sup>25</sup> Similarly, corporate insurance policies and proceeds have been held to be property of the equity receivership in securities fraud proceedings.<sup>26</sup> Because these insurance proceeds are considered part of the receivership estate, the court has the power to both settle claims regarding the disputed proceeds and enjoin claims that would either dissipate or interfere with these assets.<sup>27</sup> However, when a settlement requires orders barring all actions against the insurers relating to the policies, as well as any claims to the

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<sup>21</sup> See *Stanford Int'l Bank, Ltd.*, 927 F.3d at 845.

<sup>22</sup> See *id.*

<sup>23</sup> See *id.*

<sup>24</sup> See *Tringali*, 796 F.2d at 561.

<sup>25</sup> See *id.* at 560; see also *MacArthur Co. v. Johns-Mansville Corp.*, 837 F.2d 89, 92 (1988) (“Numerous courts have determined that a debtor’s insurance policies are property of the estate, subject to the bankruptcy court’s jurisdiction.”).

<sup>26</sup> See *SEC v. Stanford Int'l Bank, Ltd.*, 927 F.3d at 831; see also *SEC v. Kaleta*, 530 F'Appx 360 (5th Cir. 2013).

<sup>27</sup> See *Stanford Int'l Bank, Ltd.*, 927 F.3d at 840; see also *Ritchie Capital Mgmt., L.L.C. v. Kelley*, 785 F.3d at 278; see also *Loewi Realty Corp. v. Chanticlear Assoc., Ltd.*, 592 F.2d 70, 73-73 (1979) (holding a bankruptcy court’s “power to preserve its jurisdiction by enjoining proceedings that would remove property from the bankruptcy estate is fundamental”).

receivership property, the court must take the fairness and interests of all parties claiming an interest in the estate into account.

Courts have considered a number of factors in determining whether a settlement which requires the court to enjoin investors from filing claims against the third-parties closely affiliated with the receivership entities is fair and equitable.<sup>28</sup> The Fifth Circuit in *SEC v. Kaleta* found that the injunction orders were necessary to obtain the settlement, preserved the investors rights to pursue claims through the receiver's claim process, and did not strip investors from any other putative claims not associated with the underlying securities fraud action.<sup>29</sup> These factors contributed to the settlement being fair, equitable, necessary, and in the interest of the receivership estate and its claimants.<sup>30</sup> Similarly, in *SEC v. DeYoung*, the court approved a settlement that would enjoin claims by defrauded IRA account holders against a depository bank where the accounts were illegally commingled.<sup>31</sup> There, the court noted that the defrauded account holders, pursuant to the settlement, would continue to have an avenue to file a claim against the receivership estate – preserving their legal right in the proceeds.<sup>32</sup>

Claimants who are covered under the insurance policies have a legal right to share in the receivership assets.<sup>33</sup> Therefore, a district court may not enjoin these third-parties from accessing any proceeds of the insurance policy by barring both claims against the insurers and claims against the receivership estate.<sup>34</sup> In *SEC v. Stanford Int'l Bank*, the Fifth Circuit held that the district court lacked authority to approve a settlement which not only enjoined third-party claims against the insurers, but also specifically excludes the third-parties from the proceeds of the

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<sup>28</sup> See *SEC v. Kaleta*, 530 F'Appx 360.

<sup>29</sup> See *id.* at 362-363.

<sup>30</sup> See *SEC v. Kaleta*, 2012 WL 401069 (S.D. Tex. Feb 7, 2012).

<sup>31</sup> See *SEC v. DeYoung*, 850 F.3d 1127 (10th Cir. 2017).

<sup>32</sup> See *id.* at 1182-83.

<sup>33</sup> See *Stanford Int'l Bank, Ltd.*, 927 F.3d at 840.

<sup>34</sup> See *Stanford Int'l Bank, Ltd.*, 927 F.3d at 841-42.

receivership estate.<sup>35</sup> By claiming the policy proceeds assets of the receivership estate and subsequently barring third-party coinsureds' access to the proceeds, the overall fairness of the settlement was undermined.<sup>36</sup> Thus, only a settlement between a receiver and insurer that preserves the rights of all claimants to share in the insurance policy proceeds will be considered "fair and equitable and in the best interests of the estate."<sup>37</sup>

This principle is also relevant in bankruptcy caselaw regarding injunctions on third-party claims against the debtor's insurers. In *In re SportStuff, Inc.*, the United States Bankruptcy Appellate Panel of the Eighth Circuit held that a settlement which enjoined any party from pursuing claims against the insurers, while also limiting policy proceeds to personal injury claimants, violated the principles of fairness.<sup>38</sup> The court noted that settlements which artificially terminate an insured's right to a defense have been criticized.<sup>39</sup> Thus, when a settlement impermissibly disposes of a third-party's right to share in the proceeds of the insurance policy which they are insured under, the requirement that the settlement be fair and equitable is not satisfied.<sup>40</sup>

### **III. Extracontractual Claims Against the Insurers**

The second type of claim relates to independent damage claims against insurers. These claims include common law bad faith breach of duty and possible state specific claims.<sup>41</sup> These types of claims are independent, meaning "they do not arise from derivative liability nor do they

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<sup>35</sup> *See Id.* at 846.

<sup>36</sup> *See id.* at 846-47.

<sup>37</sup> *See id.*; *see also* Tri-State Fin., LLC v. Lovald, 525 F.3d at 654.

<sup>38</sup> *In re SportStuff, Inc.*, 430 B.R. 170, 179-80 (BAP 8th Cir. 2010).

<sup>39</sup> *See Id.* at 178; *see also* National Casualty Co. v. Insurance Company of North America, 230 F.Supp. 617 (N.D.Ohio 1964) (citing 8 Appleman, Ins. Law & Prac. § 4685) (explaining that these settlements allow an insurer to "walk into court, toss the amount of the policy on the table, and blithely inform the insured that the rest was up to him").

<sup>40</sup> *See Id.* at 179-80.

<sup>41</sup> *See* SEC v. Stanford Int'l Bank, Ltd., 927 F.3d at 847 (examining injunction of claims relating to bad faith breach of duty and violation of the Texas Insurance Code).

seek contribution or indemnity from the estate.”<sup>42</sup> Because these claims would not interfere with or diminish the assets of the receivership estate, they must be treated differently by the court.<sup>43</sup>

A district court’s *in rem* jurisdiction limits its authority over independent, third-party claims.<sup>44</sup> Courts have rejected a broad reading of 28 U.S.C. § 754, that suggests a court’s *in rem* jurisdiction extends to every claim connected to that property.<sup>45</sup> Therefore, equity receivership courts, as well as bankruptcy courts, have held that a court may not authorize a settlement that enjoins independent third-party claims against the insurers.<sup>46</sup>

Similarly, a receiver that does not have standing to sue, similarly does not have standing to settle.<sup>47</sup> In a securities fraud proceeding, the insurance policy proceeds are considered the assets of the estate, but these third-party claims are completely unrelated to the receivership estate.<sup>48</sup> Thus, a receiver has no authority to enter a settlement, and the district court no authority to approve a settlement, which would bar third-party claims that have no relation to the insurance policy proceeds.<sup>49</sup>

#### **IV. Balancing Fairness and Protecting the Estate.**

To both adequately protect and preserve the property of the estate, while also recognizing the legal rights of third parties, a court should channel the third-party claims into the receivership estate.<sup>50</sup> When a court “channels” the third-party claim, it protects the assets of the estate, while

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<sup>42</sup> *Id.*

<sup>43</sup> *See id.*

<sup>44</sup> *See id.* at 841.

<sup>45</sup> *See id.*; *see also* Rishmague v. Winter, 2014 WL 11633690 at \*2 (2015).

<sup>46</sup> *See* SEC v. Stanford Int’l Bank, Ltd., 927 F.3d at 841-42; *see also In re Vitek*, 51 F.3d 530, 536 (5th Cir. 1995) (holding that a bankruptcy court has no authority to enjoin suits by coinsureds against insurers that were not property of the estate).

<sup>47</sup> *See* DSQ Prop. Co., Ltd. v. DeLorean, 891 F.2d 128, 131 (6th Cir. 1989); *see also* Wuliger v. Mfr’s Life Ins. Co., 567 F.3d 787, 794 (6th Cir. 2009).

<sup>48</sup> *See* Stanford Int’l Bank, Ltd., 927 F.3d at 847; *see also In re Heritage Bond Litigation*, 546 F.3d 667, 680 (2008) (holding that independent claims against settling defendant could not be barred by a court order).

<sup>49</sup> *See* SEC v. Stanford Int’l Bank, Ltd., 927 F.3d at 848.

<sup>50</sup> *See* Stanford Int’l Bank, Ltd., 927 F.3d at 846-47.



also preserving the legal rights of the coninsureds.<sup>51</sup> For example, in *MacArthur v. Johns-Mansville Corp.*, the Second Circuit held that bankruptcy courts had the authority to approve settlements and “channel” claims arising under the policy to the property of the estate.<sup>52</sup> The bankruptcy court determined that the Bankruptcy Code, under section 363(f), provides statutory support for the injunction orders.<sup>53</sup> Under section 363(f), a receiver may sell the property in the estate so long as third-parties retain their respective rights in the proceeds of the sale.<sup>54</sup>

Even if there were no statutory support for the ability of a district court to enjoin claims against insurers, relevant bankruptcy and securities-fraud caselaw has provided support for this power. Because securities-fraud receiverships are essentially the same as a chapter 7 bankruptcy proceeding, relevant bankruptcy caselaw can be considered by the court in analyzing the conflict.<sup>55</sup> In this context, the Supreme Court has held that a bankruptcy court has inherent authority to sell a debtor’s property and transfer third-party claims in the property to the proceeds of the sale.<sup>56</sup> While the court in *MacArthur* noted that an insurance settlement and accompanying injunction are not identical to a traditional sale, the underlying principle of preserving the receivership assets and channeling claims into one proceeding remains the same.<sup>57</sup> This channeling method has also been used by equity receivership courts to preserve assets of the estate.<sup>58</sup> Therefore, when a third-party is enjoined from making a claim against an insurer pursuant to a settlement agreement, but instead given the right to file a claim against the receivership estate, the settlement will be fair and equitable.<sup>59</sup>

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<sup>51</sup> *See id.*

<sup>52</sup> *MacArthur Co. v. Johns-Mansville Corp.*, 837 F.2d at 93.

<sup>53</sup> 11 U.S.C. § 363(f).

<sup>54</sup> *See* 11 U.S.C. § 363(f)(4); *see also* *Ray v. Norseworthy*, 90 U.S. 128, 134-35 (1874) (explaining that a court may sell the bankrupt’s property encumbered by third-party claims if third-party’s interest is retained in the proceeds from the sale).

<sup>55</sup> *See* *Janvey*, 2014 WL 12654910 at \*17; *see also* *Wealth Mgmt. LLC*, 628 F.3d at 334.

<sup>56</sup> *See* *Van Huffel v. Harkelrode*, 284 U.S. 225 (1931).

<sup>57</sup> *See* *MacArthur*, 837 F.2d at 94.

<sup>58</sup> *See* *Kaleta*, 530 F’Appx at 360; *see also* *DeYoung*, 850 F.3d at 1182.

<sup>59</sup> *See* *MacArthur*, 837 F.2d at 94; *see also* *Kaleta*, 530 F’Appx at 360; *DeYoung*, 850 F.3d at 1182.

## **Conclusion**

In order to provide adequate protection to both third-parties covered by the insurers, as well as preservation of receivership properties, a district court must have the authority to enjoin third-party claims against the insurers. However, the district court is limited by its *in rem* jurisdiction, as well as general receivership principles, in its authority over the different types of third-party claims. To gain court approval as fair and equitable, a settlement must not only differentiate between contractual and extracontractual claims, but also preserve the legal rights of the third-parties. So long as the third-party's interest are transferred to the property of the receivership estate, the settlement between the receiver and insurer would be in the best interest of all parties. The settlement would provide maximum value to the receivership regarding the insurance policy proceeds while also giving coinsureds access to proceeds for defense and indemnity. Therefore, a court should limit its authority to approve settlements contingent on injunction orders to where there is an alternative compensation scheme for third-parties.