**RESPONSIBILITY OF RECEIVERS FOR**

**THE SINS OF PRIOR MANAGEMENT**

**By**

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## I. INTRODUCTION

When an insurer is placed into receivership, the receiver will sometimes bring an action for fraud or other wrongdoing against the officers or directors and/or third parties who may have been in collusion with such directors or officers. The defendants in such actions may counter that any such wrongdoing is imputed to the insolvent insurer through the directors or officers who were agents of the insurer and, for this reason, the receiver, as successor to the company, is barred from pursuing such actions. Such defendants may further argue that the period of time since the receipt of such constructive notice of the wrongdoing has exceeded the statute of limitations for bringing such an action.

The receiver often counters that the innocent parties which it represents should not be barred from recovery by a technical defense such as the statute of limitations and that the wrongdoing of former directors or officers should not be attributable to the estate.[1] In effect, the receiver argues that it should not be responsible for the sins of prior management. More particularly, the receiver may assert that the control or "adverse domination" of the insurance company by individuals acting against the interests of the company should prevent these acts from being imputed to the company and should toll or delay the running of the statute of limitations.

The purpose of this article is to examine the case law concerning exceptions to the rule of imputation of the acts of directors or officers to the insurer, and, therefore, the receiver, and the implications on the statute of limitations. It should be noted that this issue is not limited to insurance company receiverships and that there is a substantial body of case law dealing with this same general issue in other factual contexts.[2]

## II. CASES FINDING ADVERSE DOMINATION OR NO IMPUTATION

### A. Insurance Company Receivership Cases

The court in Clark v. Milam, 872 F.Supp. 307 (S.D.W.Va.1994) defined the adverse domination exception as follows:

Adverse domination occurs when the officers and directors of who control the rights of the corporation act adversely to the corporation's interests, usually for personal gain, to the detriment of the corporation and/or its non-officer/director shareholders.[3]

The court found that under West Virginia law, the plaintiff, who was the receiver of George Washington Life, must make a strong showing that the defendant's alleged wrongdoing constituted "some action" contributing to the adverse domination. The court concluded that the allegations of the receiver (not detailed in the decision) met this test and prevented a dismissal of the action. The court further noted that the knowledge of shareholders who bring a derivative suit ordinarily should be attributed to the corporation and not be subject to the adverse domination exception. However, the court declined to dismiss on this basis since there was evidence that the shareholders had no interest in benefitting the George Washington Life by their action and were attempting, merely, to benefit themselves at the expense of George Washington Life.

In a related case, the Supreme Court of Appeals of West Virginia was posed two certified questions by the district court. Clark v. Milam, 452 S.E.2d 714 (S.C.App.W.Va.1994). In its decision, the court confirmed that West Virginia recognized the doctrine of adverse domination and that any shareholder derivative suit must be for the purpose correcting wrongdoing rather than protecting the beneficiaries of the wrongdoing for such a suit to negate or otherwise terminate adverse domination.

The receiver of Guarantee Security Life Insurance Company brought an action for breach of fiduciary duty against an officer in In Re Blackburn, 209 B.R. 4 (M.D.Fl.1997). The defendant sought a summary dismissal of the action based on the statute of limitations. The court declined summary judgement:

Under this adverse interest exception, the actions and knowledge of the officers and directors are not imputed to the corporation when those agents were acting adversely to the corporation's interests. (Citations omitted). In these circumstances, there is evidence that the acts about which the plaintiff complains involve acts for the defendant's benefit and that were contrary to the interests of (Guarantee). This adverse interest exception to the discovery rule, therefore, would appear to preclude a determination that the statute commenced to run with the imputed discovery of the acts by (Guarantee) which is now imputed to the plaintiff.[4]

Schacht v. Brown, 711 F.2d 1343 (7thCir.1983) was a RICO action by the receiver of Reserve Insurance Company against officers, directors, the parent corporation and several third party defendants for allegedly continuing the company's business past the point of insolvency by looting the company of its most profitable business. In order to find in favor of the adverse domination exception, the court had to distinguish its earlier decision of Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7thCir.1982) (*see* § III C, *infra*) which ruled against adverse domination. As points of distinction, the court found the defendants looted Reserve (*i.e.* they were adverse to Reserve) rather than using Reserve to defraud third parties. In addition, Cencocourt used a two pronged analysis: (1) whether a judgement in favor of the plaintiff would benefit the victims of wrongdoing; and (2) whether such a judgement would deter future wrongdoing. This analysis supported the use of the adverse domination exception since innocent creditors would benefit from the receiver's suit and directors and shareholders would be encouraged to be watchful for fraudulent activity.

In the Matter of Integrity Ins. Co., 573 A.2d 928 (Sup.Ct.N.J.1990) was a suit by a receiver against the accountants for Integrity Insurance Company. The accountant argued that the suit by the receiver was barred because the knowledge of the directors and officers of Integrity must be imputed to the company and the receiver thereof. The court rejected this defense on the bases that a culpable party is estopped from raising it and the broad remedial power of the court in the insurance company receivership context.

**B. Bankruptcy Trustee Cases**

There are a number of cases with similar holdings involving bankruptcy trustees. Presumably, some of the same equitable considerations attach to the role of bankruptcy trustee as do to the role of insurance company receiver.

In Tew v. Chase Manhattan Bank, 728 F. Supp. 1551 (S.D.Fl.1990), the bankruptcy trustee sued the bank on the basis that it assisted the bankrupt in fraudulent activity. The court acknowledged the adverse domination rule that the wrongdoing must be directed at the corporation rather than third parties. The court further noted that the officers and directors obtained corporate loans for personal expenses, did not replay the loans yet received huge salaries and bonuses. Based on this record, the court ruled in favor of adverse domination:

[T]he court finds that there is no genuine issue of material fact as to the actions of the officers and directors. They ran (the bankrupt) into the ground and robbed the corporate entity for their own aggrandizement.[5]

The court distinguished Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7thCir.1982) (*see* § III C, *infra*) on the bases that here, the bankrupt, rather than third parties, was the principle victim, the principle beneficiaries will be innocent creditors and banks will be more diligent in similar situations in the future.

The issue of adversity to the corporation's interests was explored in Beck v. Deloitte & Touche, 144 F.3d 732 (11th Cir.1998). The bankruptcy trustee alleged that the board of directors of a bank colluded with their accountants to misrepresent the value of an acquired bank with the result that the acquiring bank paid dividends and received regulatory approvals long after it actually was insolvent. The lower court dismissed the action on the bases: (1) that under Florida law the interests of the corporate officer must be entirely adverse to the those of the corporation; and (2) the corporation received a short term benefit from the accounting opinion. The appellate court reversed noting that the lower court used an improper baseline to determine adversity to the corporation. The trustee alleged that but for the improper accounting opinion, the acquisition would never have occurred so any short term benefit after the acquisition is not determinative of the issue. The court ruled:

A director's wrongful actions toward his corporation do not have to rise to the level of corporate looting (as in Tew) or embezzlement ( as in Golden Door Jewelry Creations , Inc. v. Lloyds

Underwriters Non-Marine Assoc., 117 F.3d 1328 (11thCir.1997)) in order to be adverse and thereby prevent imputation, as long a the corporation receives no benefit from the director's behavior. Therefore, we hold that the district court erred by ruling that the Trustee did not allege a set of facts that might conceivable entitle him to relief.[6]

In Re Jack Greenberg, 212 B.R.76 (E.D.Pa.1997) was a suit by a bankruptcy trustee against an accounting firm which failed to detect a scheme by an officer to inflate the value of the company by misrepresenting inventory. The trustee alleged the officer did so to tout his skills to his employer and its creditors. The court noted that Pennsylvania required that the activities of the officer have to be actuated, at least in part, by a purpose to serve the employer in order for the employer to be responsible for those activities. The court declined to dismiss the complaint on the basis that the accounting firm failed to demonstrate that officer's activities was a benefit to the employer. The fact that the fraud caused the corporation to overextend itself with customers and lenders was not a benefit to the corporation.

The same dispute came back to the same judge two years later through a motion for summary judgement by the accounting firm based on imputation of the officer's fraud to the corporation. In Re Jack Greenberg, 240 B.R. 486 (E.D.Pa.1999). The court observed that the beneficiaries of the trustee's action would be innocent creditors. The court then ruled that under Pennsylvania law, imputation to the corporation would depend on position of the beneficiaries of the action *i.e.* innocent beneficiaries would support an imputation exception:

Limiting those situations in which the imputation doctrine can be invoked in auditor liability cases to circumstances in which its application would serve the objectives of tort liability would ensure that the doctrine would be used only when it would produce an equitable result.[7]

In Re Sharp International Corp., 278 B.R. 28 (E.D.N.Y.2002) involved management inflating the revenues of the corporation which allowed them to obtain large sums from lenders and investors. These sums and more were diverted to the managers involved in the fraud. Eventually, the corporation's accountants found the fraud and the scheme fell apart. A suit by the trustee against the accountants followed. The court characterized adverse domination as an exception to the rule the acts of a corporation's management are the acts of the corporation. However, there is a "sole shareholder" exception to adverse domination: even if managers are pursing their own personal interests and not those of the corporation, the acts of managers will be attributable to the corporation if the managers in question are the sole shareholders of the corporation. The theory is that in such a case, the personal and corporate interests merge. The court found that the sole shareholder exception did not apply since an innocent 13% shareholder was on the board of directors and was active in reviewing the books. However, the court found that the adverse interest exception did apply. Even though a portion of the sums looted from the corporation can from outside investors, even more came from the funds of the corporation. The fact that managers retain some stock in the corporation does not preclude this result since it is very unlikely that they would ever receive any return on this stock.

## III. CASES FINDING IMPUTATION OR NO ADVERSE DOMINATION

### A. Insurance Company Receiver Cases

Seidman & Seidman v. Gee, 625 So.2d 1 (Dist.Ct.App.Fl.1993) was a suit by an insurance company receiver against accountants who failed to discover that a major asset of the insurer did not exist. The court noted that the fraud of the company's managing director would be imputed to the corporation, and thus a defense to the accountants, if the company benefitted from the fraud. The court ruled that the company did so benefit:

[T]he fraud committed by the managing director was not intended to loot the corporation, but instead was designed to turn the corporation into an "engine of theft" against outsiders - - policyholders. . . . [T]he ultimate financial demise of (the company) was not the determining issue in the case before us. (The managing director's) fraudulent misrepresentation benefitted (the company) as it was the prerequisite to the (company's) approval to continue in business, and was integral to its marketing program.[8]

In Florida v. Blackburn, 633 So.2d 521 (Dis.Ct.App.Fl.1994), it was alleged that officers and directors looted the insurer leaving it insolvent. The defendants argued a "sole shareholder" defense on the basis that the shareholders of 100% of the stock cannot be guilty of looting a corporation which they own in its entirety. The court declined to accept this sole shareholder defense due to the presence of policyholders and other creditors. In addition, the court ruled that the activities of the officers and directors could be imputed to the corporation since "the imputation rule can only be invoked to protect innocent parties, and it is not available to the person who perpetrated the misconduct sought to be imputed."[9]

## B. Other Receivership Cases

There are several cases with similar rulings which do not involve insurance company receivers or bankruptcy trustees. One is Armstrong v. McAlpin, 699 F.2d 79 (2nd Cir.1983). Following an SEC investigation for securities fraud, the court appointed a receiver for an investment fund. The receiver and others sued the principal behind the fund and related entities for fraud and the defendants raised a statute of limitations defense. The receiver argued adverse domination. The court noted that adverse domination requires that the entity be completely dominated by the wrongdoers. The court rejected the adverse domination argument on the basis that the receiver had made no showing that other officers and directors of the investment fund were part of the conspiracy or that there were no independent shareholders who could bring the wrongdoing to light. Conclusory allegations were insufficient to show adverse domination.

Federal Deposit Ins. Corp. v. Ernst & Young, 1991 WL 197111 (N.D.Tex.) was a suit by the FDIC for negligence in performing bank audits. The defendant argued that the knowledge of the bank's board chairman, CEO and sole shareholder should be attributed to the corporation thus barring a suit by the FDIC. The court noted that fraud by the corporation against third parties would be imputed to the corporation and ruled that this applicable rule of law in this matter:

In the present case, Woods was the sole shareholder. As a result, he was the beneficiary of his own fraudulent activity; the victims of the fraud were outsiders to the corporation - - depositors and creditors. Thus, under (citation omitted), Woods' fraudulent acts were taken on behalf of Western. Furthermore, because his actions were taken on behalf of Western, his knowledge is imputable to Western.[10]

**C. Other Case of Note**

A case heavily cited on imputation and adverse domination is Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7thCir.1982) *cert. denied,* 450 U.S. 880 (1982). Although not involving a receivership, it is included here since it is cited in many of the cases above both as support for their results or to distinguish it.

In Cenco, shareholders brought an action against former management for pervasive fraud and against the accountants who failed to detect it. In deciding whether to impute management's actions to the corporation for purposes of the accountant's liabilities, the court examined the underlying objectives of tort liability (*i.e.* whether innocent creditors would benefit) and whether future fraud would be deterred. As to the second point, the court found that future fraud by management would not deterred by shifting liability to the accountants. As to the first point, the court observed that former management held significant stock and would benefit from the action. Other shareholders elected directors to the board who participated in the fraud and must bear some responsibility for the result. On this basis, the court imputed the activities of management to the corporation.

## V. CONCLUSION

There is a line of cases which would: (a) allow imputation of a director's or officer's actions to the corporation and would decline to find adverse domination if the fraud was directed at third parties; but (b) not allow imputation or would find adverse domination if the wrongdoing was aimed at the corporation. This formulation of the rule may present difficulty in the insurance receivership context. The aim of the of the directors or officers may be difficult to ascertain since the effect may be the same *i.e.* an insurer that cannot pay the claims of insureds and other creditors. Moreover, a results-oriented receiver may believe that the specific aim of the wrongdoing is irrelevant to benefitting innocent parties and punishing the wrongdoers.

Receivers are likely to embrace the Conseco, Tew, Schacht and Greenberg line of cases which support the application of the imputation and adverse domination doctrines in a fashion designed to benefit innocent parties and punish wrongdoers regardless of the aim of such wrongdoers. Presumably, the formulation espoused in this line of cases would make it less likely for receivers to be responsible for the sins of prior management.

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**ENDNOTES**

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[1] . The argument is well stated in Clark v. Milam, 452 S.E.2d 714, 720 (W.Va.1994):

When the Commissioner is appointed Receiver for an insolvent insurance company, he is charged with marshalling the assets of the company for the benefit of its policyholders and creditors. (Citations omitted). Those assets include claims against those who may have looted the insurance company as well as their possible accomplices who are either outside lawyers or accountants. (Citations omitted). After all, much more is at stake in this litigation than simply a loss to shareholder investors: we have here an insurance company that was allegedly victimized and that was allegedly looted of monies that should have been available to pay the claims of totally innocent policyholders.

[2] . *See generally*, M. Dore, *Statutes of Limitation and Corporate Fiduciary Claims: A Search for Middle Ground on the Rules/Standards Continuum*, 63 Brook.L.Rev.695 (1997).

[3] .. 872 F.Supp. 307 at 310.

[4] . 209 B.R. 4 at 11.

[5] . 728 F.supp. 1551 at 1559.

[6] . 144 F.3d 732 at 737.

[7] . 240 B.R. 486 at 508.

[8] . 625 So. 2d 1 at 3.

[9] . 633 So.2d 521 at 524.

[10] . 1991 WL 197111 *5.