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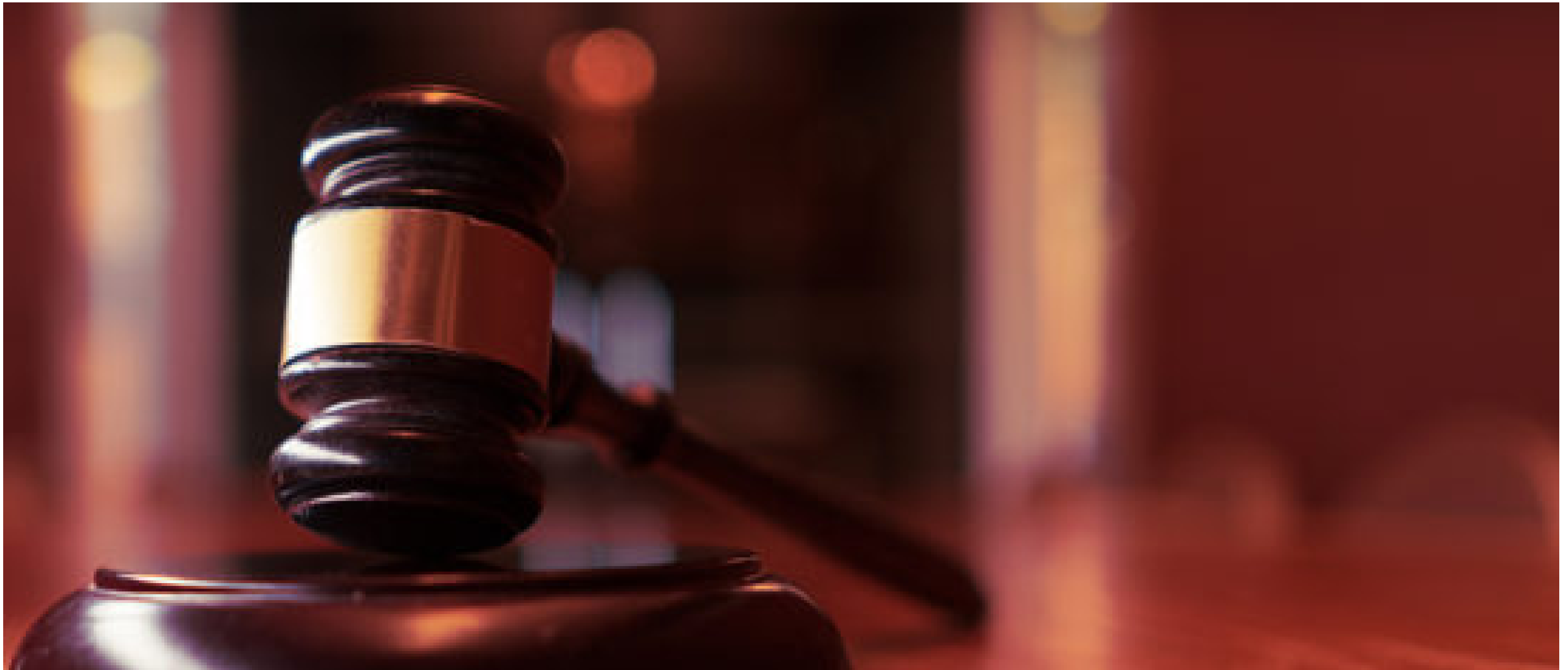
Fifth Circuit Overturns Receiver’s Settlement Barring Third-Party Claims Against Stanford Financial Insurers



By Toby M. Galloway & Matthias Kleinsasser on June 25, 2019

The Fifth Circuit overturned a U.S. District Court's approval of a settlement between Ralph Janvey, the Receiver for Stanford International Bank, and various insurance company Underwriters, under which the Underwriters had agreed to pay $65 million to the Stanford Receivership estate. Writing for the Court, Judge Edith H. Jones held that the District Court abused its discretion in approving the settlement because the injunction issued by the District Court (referred to as a "bar order") nullified claims by third-party coinsureds to policy proceeds without an alternative compensation scheme. The settlement also improperly released third-party tort and statutory claims against the Underwriters that the estate did not own.

The Stanford Financial Ponzi scheme defrauded more than 18,000 investors who collectively lost over $5 billion. The proposed settlement was intended to end years of litigation between the Receiver and the Underwriters with respect to

insurance coverage under policies issued to Stanford entities. The Underwriters disputed the amount of available coverage and also contended that various policy exclusions applied. The proposed settlement contained the following terms:

- The Underwriters would pay $65 million into the Receivership estate.
- The Receiver would release the estate's claims/judgments against a relatively small number of Stanford directors and officers.
- The Receiver would retain the right to pursue suits against non-released coinsureds, including numerous other Stanford employees, officers, and directors.
- Further actions against the Underwriters relating to the policies or the Stanford entities would be enjoined by the bar order injunction, including any claims by non-released coinsureds.

Though three groups of Appellants appealed the District Court's order approving the settlement, the Fifth Circuit primarily focused on the arguments of a group of former Stanford managers and employees (the "Employee Appellants"). The Employee Appellants had asserted contractual claims against the Underwriters which they hoped to satisfy using policy proceeds, as well as extra-contractual tort/statutory claims (e.g., bad faith and statutory violations of the Texas Insurance Code). None of the Appellants had been permitted to participate in the settlement talks between the Receiver and the Underwriters. Nor did the District Court conduct an evidentiary hearing on the settlement (though some parties were permitted to file post-hearing affidavits). In approving the settlement, the District Court emphasized that the settlement provided the Receivership estate with a substantial payment and minimized expensive litigation.

No party disputed that the insurance policies and proceeds are assets of the Receivership estate and subject to the District Court's exclusive *in rem* jurisdiction. Therefore, the Fifth Circuit noted, the District Court could issue appropriate bar orders or other injunctions preventing parties from taking actions that would dissipate Receivership assets. The Receiver's powers, however, are limited to collecting and distributing only Receivership assets – *i.e.*, the Receiver has dominion over the *res* of the estate but nothing more. Based on this principle, the Receiver lacked standing to settle third-party claims without consent. Similarly, the District Court's *in rem* jurisdiction could not extend to non-estate assets, such as direct causes of

action belonging to third parties. For these reasons, the District Court lacked authority to approve a settlement that enjoined independent third-party claims against the Underwriters without obtaining the third parties' consent.**[1]**

The Fifth Circuit held that the District Court abused its discretion for two reasons:

First, the settlement improperly allowed the Receiver to pursue estate claims against the Employee Appellants, who were enjoined by the bar order from seeking recovery on their contractual claims from the Underwriters with respect to the insurance policies. In short, the Receiver could collect from the Employee Appellants while the Employee Appellants were barred from reimbursement under the insurance policies. The Fifth Circuit left open the possibility that the Receiver could seek a bar order under which the Employee Appellants retained the right to share in the estate's assets by filing claims against the Receivership estate. "Such 'channeling orders,'" the Fifth Circuit noted, "are often employed to afford alternative satisfaction to competing claimants to receivership assets while limiting their rights of legal recourse against the assets." *Id.* at 23.

Second, by barring the Employee Appellants from pursuing direct extra-contractual tort and statutory claims against the Underwriters, the Receiver had effectively settled claims which the estate did not own. However understandable it may be to accept a large payment that would prevent dissipation of Receivership assets in litigation, the scope of the settlement's bar order – which enjoined prosecution of claims owned by third-parties that did not directly affect the Receivership estate – exceeded the District Court's authority.

Take-Aways:

- Make use of a channeling order to resolve third-party claims that directly affect estate assets: A receiver (or bankruptcy trustee/debtor-in-possession) can potentially enter into a settlement that bars third-party claims that directly affect estate assets – but only if the third-parties consent or are provided an alternative means of compensation from the estate. In this case, a settlement barring the Employee Appellants' contractual claims against the Underwriters would likely be acceptable if the Employee Appellants were allowed to file claims against the Receivership estate to share in distributions. The Receiver could have requested a channeling order to this effect.

- Third-party claims that do not affect estate assets cannot be barred without consent: Third-party claims that do not affect estate assets – here, extracontractual tort/statutory claims against the Underwriters – cannot be barred without obtaining consent from the third party.
- Direct vs. derivative claims: Derivative claims (e.g., fraudulent transfer claims) belong to the estate. Direct third-party claims do not. When considering the terms of a settlement, pay close attention to whether direct third-party claims could potentially exist and might appear to be barred by an overly broad release or injunction.

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[1] The Fifth Circuit cited several bankruptcy cases in support of this principle, most notably *Matter of Zale Corp.*, 62 F.3d 746 (5th Cir. 1995). In *Zale*, the Fifth Circuit refused to enforce a settlement barring third-party bad faith insurance claims that were not property of the bankruptcy estate.

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