

Bankruptcy Court Holds Inadequate Consideration Exclusion Bars Coverage

January 2009

A federal bankruptcy court, applying New York law, has dismissed an adversary proceeding brought by a bankrupt home mortgage company against its directors and officers liability insurers, holding that coverage for a pre-petition lawsuit against the mortgage company was barred by application of an "inadequate consideration" exclusion. *Delta Fin. Corp. v. Westchester Surplus Lines Ins. Co.*, No. 07-11880 (Bankr. D. Del. Dec. 15, 2008). The court also held that the coverage dispute was a non-core proceeding. Wiley Rein LLP represented one of the insurers in this case.

The underlying lawsuit arose from the mortgage company's 2001 restructuring transaction. In connection with that transaction, the mortgage company allegedly first convinced its unsecured and senior secured note holders to surrender their notes to a newly formed holding company, for which the note holders were granted certain interests in the holding company. Next, the holding company returned the senior notes to the mortgage company, and, in exchange, the mortgage company transferred excess "cash flow certificates" to the holding company. The mortgage company and the holding company intended that the values of the exchanged senior notes and cash flow certificates would each be approximately \$153 million.

In 2003, the former note holders filed suit against the mortgage company and its directors and officers alleging that, at the time of the restructuring transaction, the cash flow certificates had an actual fair market value of only \$43 million. The plaintiffs ultimately asserted eight causes of action against the defendants concerning various aspects of the restructuring transaction. The mortgage company tendered the suit to its directors and officers liability insurers, and the primary insurer denied coverage based in part on the inadequate consideration exclusion. In 2007, the mortgage company filed for Chapter 11 and brought an adversary proceeding against the insurers seeking damages and a declaratory judgment that the insurers were obligated to advance defense costs and provide indemnification for the underlying lawsuit.

In considering the insurers' motions to dismiss, the bankruptcy court focused on the primary policy's inadequate consideration exclusion, which provided that "[t]he insurer shall not be liable for Loss on account of any Claim made against any Insured: . . . based upon, arising out of, or attributable to the actual or proposed payment by the Company of allegedly inadequate or excessive consideration in connection with the Company's purchase of securities issued by any company." Noting that New York courts rely on a "but for"

causation test to interpret insurance exclusions with "arising from" lead-in language, the bankruptcy court conducted a three-part analysis to determine whether the pre-petition lawsuit was excluded by the inadequate consideration exclusion. First, the bankruptcy court noted that each of the plaintiffs' eight causes of action sought damages related to the harm caused by the alleged difference between the senior notes, worth \$153 million, and the cash flow certificates, worth \$110 million less. Second, the bankruptcy court determined that this harm would not have existed "but for" the restructuring transaction, and, thus, the restructuring transaction was the "operative act." Finally, the bankruptcy court concluded that the operative act was explicitly encompassed by the inadequate consideration exclusion because the restructuring transaction involved an "actual payment" by the mortgage company of "inadequate consideration"—the cash flow certificates—in connection with the mortgage company's purchase of "securities issued by any company"—in this case, its own senior notes. Accordingly, the bankruptcy court determined that the exclusion barred coverage for the underlying complaint in its entirety. As a result of that determination, the court did not reach the insurers' other argument that the amount at issue in the underlying case did not constitute "Loss" as defined by the policies.

After concluding that all of the mortgage company's claims in the adversary proceeding were barred by the inadequate consideration exclusion, the bankruptcy court rejected the mortgage company's waiver and estoppel arguments, which were based on the passage of 18 months before the primary insurer denied coverage. The bankruptcy court noted that, under New York law, an insurer could not waive a defense to coverage, and the mortgage company had failed to allege sufficient facts demonstrating its reliance on the failure to issue a coverage position. Finally, relying on the reasoning in *In re Stone & Webster, Inc.*, 367 B.R. 523 (Bankr. D. Del. 2007), the bankruptcy court agreed with the insurers that the adversary proceeding was a non-core proceeding.