

Inadequate Consideration Exclusion Applies to Claim for Debt Restructuring Transaction

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The United States Court of Appeals for the Third Circuit, applying New York law, has held that an inadequate consideration exclusion unambiguously bars coverage for a lawsuit arising out of a debt restructuring transaction. *Delta Financial Corp. v. Westchester Surplus Ins. Co. (In re Delta Financial Corp.)*, 2010 WL 1784054 (3d Cir. May 5, 2010).

The insured participated in a debt restructuring transaction in 2001 in which its debt holders surrendered their unsecured notes and senior secured notes in exchange for "excess cash flow certificates" that the insured valued at about \$153 million. The insured represented that the value of the excess cash flow certificates transferred to the debt holders would equal the outstanding balance of the surrendered notes. In 2003, the debt holders filed a lawsuit against the insured and its directors and officers alleging that the excess cash flow certificates were worth only \$40 million at the time that the restructuring transaction closed. The complaint included counts for breach of contract, fraud, negligent misrepresentation and breach of fiduciary duty.

The insured sought coverage for the debt holders' lawsuit under primary and excess D&O policies. The insurers denied coverage based primarily on an inadequate consideration exclusion, which excepted from coverage claims "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 . . . consideration in connection with the Company's purchase of securities issued by any company." The insured then filed the instant coverage action. The bankruptcy court, as affirmed by the district court, granted the insurers' motions for judgment on the pleadings based on the inadequate consideration exclusion.

On appeal, the Third Circuit affirmed the lower courts' determination that the inadequate consideration exclusion barred coverage. The court concluded that the transfer of the excess cash flow certificates in exchange for the notes constituted the actual payment by the insured of inadequate consideration as contemplated by the exclusion. The court also determined that the exclusion was not ambiguous and noted that the insured had not suggested any alternative meaning or interpretation of the exclusion.

In addition, the court rejected the insured's argument that the allegations in the underlying complaint did not fall entirely within the exclusion. In this regard, the insured argued that the underlying allegations could be interpreted as a discharge of debt via a strict foreclosure on the excess cash flow certificates under New York

statute. The court reviewed the elements of the relevant statute and concluded that the underlying allegations were inconsistent with such a transaction.

Finally, the court rejected the insured's argument that the second cause of action in the underlying complaint, which alleged that the insured breached a management agreement by failing to report that it had devalued comparable cash flow certificates on its own books, did not fall within the exclusion's terms. In contending that this cause of action was unrelated to the excluded conduct, the insured noted that this cause of action sought only \$500,000 in damages, whereas the plaintiffs otherwise sought \$110 million in the complaint. The court determined that the exclusion applied because there would be no basis for the second cause of action but for the excluded conduct—*i.e.*, the transfer of the cash flow certificates worth substantially less than their represented value in exchange for the notes.