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NEWSLETTER

Suit Concerning Corporate Spin-Off Is Not a "Securities Claim"

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An intermediate appellate court in New Jersey, in an unpublished decision, applying New Jersey law, has held that a D&O policy with entity coverage for securities claims did not afford coverage for a lawsuit against the insured corporation in connection with the spin-off of one of its subsidiaries because the spin-off did not involve the purchase or sale of securities. *Federal Ins. Co. v. Campbell Soup Co.*, 2004 WL 1631405 (N.J. Super. Ct. Law Div. June 25, 2004).

The insurer issued a D&O policy to a corporation. The policy provided entity coverage to the corporation for "all Loss for which it becomes legally obligated to pay on account of any Securities Claim." The policy defined "Securities Claim" in relevant part as "any Claim which is, in whole or in part,...based upon, arising from or in consequence of a Securities Transaction..." The policy defined "Securities Transaction" as "the purchase or sale of, or offer to purchase or sell, any securities issued by an Insured Organization." The policy did not define "purchase" or "sale."

The successor to a bankrupt, former subsidiary of the corporation filed a lawsuit against the corporation alleging that the former subsidiary became bankrupt because of the corporation's actions in connection with the corporate "spin-off" of the subsidiary. During the spin-off, the subsidiary allegedly assumed $500 million of the parent corporation's debt and issued new stock to the parent to be conveyed to the parent's shareholders. The parent in turn purportedly transferred certain stock and business assets to the subsidiary. The parent's shareholders did not pay any consideration for the newly issued shares of the subsidiary. The lawsuit alleged that the subsidiary employed no independent accountants, lawyers or representatives during the spin-off, and that the same individuals simultaneously represented both parties in executing the transaction. The insurer denied coverage for the lawsuit on the ground that it was not based upon, did not arise from or was not in consequence of a purchase or sale of securities, and therefore did not constitute a securities claim. Coverage litigation ensued.

The court agreed with the insurer that the spin-off transaction did not constitute a "securities transaction" under the policy. Reasoning that the purpose of the policy was to insure the parent against private actions arising out of alleged violations of federal securities laws, the court looked to the meaning of "sale" and "purchase" under the same body of law. The court noted that "[t]he case law supports [the] assertion that a spin-off transaction does not constitute a 'purchase' or 'sale' of securities under the scheme of securities regulation."

The court relied in particular on the decision by the United States Court of Appeals for the Seventh Circuit in *Isquith v. Caremark International, Inc.*, 136 F.3d 531 (7th Cir. 1998), in which the court held that a transaction was a spin-off and not a sale of securities because the corporation's shareholders received stock without giving any consideration in return. The Seventh Circuit reasoned that the shareholders "no more 'bought' [the securities] than the recipient of a stock dividend...buys the stock that he receives as a dividend." Noting that the parent's shareholders similarly had not paid consideration for the newly-issued shares of the subsidiary's stock, the court held that, in this case, a "purchase" or "sale" of securities had not taken place.

The court rejected the parent corporation's argument that dictionary definitions of "sale" and "purchase" warranted a different result, noting that the federal securities laws' definitions of the same terms "do not differ from their dictionary meanings." The court also rejected the parent's reliance on the decision by the United States Court of Appeals for the Second Circuit in *Vesco v. International Controls Corp.*, 490 F.2d 1334 (2d Cir. 1974), in which the court recognized a line of cases holding that "certain subsidiary spin-offs constituted 'sales' for purposes of the Securities Act of 1933...." The New Jersey court stated the Second Circuit's finding in *Vesco* was "odd" because the *Vesco* court concluded that a spin-off was a sale of securities even though no consideration was exchanged, and because the *Vesco* court ignored precedents holding that transactions analogous to stock dividends were not a "purchase" or "sale." The court also reasoned that in the present case, unlike in *Vesco*, the parties to the transaction were both controlled by the same individuals, and the SEC had expressly determined that the transfer of securities pursuant to the spin-off did not have to be registered under federal securities laws.

Finally, the court explained that although the corporation had cited to other decisions finding that a "purchase" or "sale" had taken place, "in all of the cases cited, the courts which did find a purchase and sale were struggling to do so in order to insure a remedy for the wrong, i.e. so that registered securities would not enter the marketplace, or the mischief of an 'unsympathetic' defendant...would not go without a federal remedy." Reasoning that these cases did not provide an "internally consistent or legally cohesive precedent," the court instead held that the spin-off constituted "a mere transfer between corporate pockets," rather than a sale or purchase of securities, and consequently concluded that the policy did not afford coverage for the litigation.

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