

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

January 2006

An intermediate appellate court in New Jersey, 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 transaction did not involve the purchase or sale of securities. *Federal Ins. Co. v. Campbell Soup Co.*, 885 A.2d 465 (N.J. Super. Ct. App. Div. 2005). The trial court's decision was summarized in the August 2004 issue of *The Executive Summary*.

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 and was not in consequence of a purchase or sale of securities, and therefore did not constitute a "Securities Claim." Coverage litigation ensued.

The appellate court affirmed the trial court's holding that the spin-off transaction did not constitute a "Securities Transaction" under the unambiguous language of the policy and thus could not give rise to a "Securities Claim." 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 appellate court looked to the meanings of "sale" and "purchase" under the same body of law. It concluded that the "spin off" transaction was not a

"sale" or "purchase" because it merely shifted corporate assets within the overarching corporate structure.

The appellate court noted that "[t]he purpose of the securities laws is not to protect [the parent] from itself, and no reasonable corporation in [the parent]'s position could have thought otherwise and believed that it had purchased this insurance for protection while engaging in an intra-corporate exchange, a movement of assets from one corporate pocket to the other." It also affirmed the trial court's rejection of 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), noting that the parent "concedes that the crucial transaction here was not the distribution of the [wholly owned subsidiary's] shares through [the parent] to the [parent's] shareholders, but the transfers between [the parent] and . . . its wholly owned subsidiary," and that "as to a transaction of that sort, the [Vesco] court held that a parent corporation's transfer of stock to its wholly owned subsidiary did not 'dispose of' the stock because the parent retained control, and nothing was relinquished."

Moreover, the appellate court rejected the parent's reliance on dictionary definitions of "purchase" and "sale," noting that such definitions also require a transaction between two distinct parties. It further reasoned that the potential boon to the parent of reversing the trial court's grant of summary judgment revealed the "lack of merit" in the parent's position. Specifically, the appellate court recognized that, absent affirmance of the trial court's ruling, the parent would have reaped a substantial windfall by converting \$200 million in corporate debt into an insurance claim.

Finally, the appellate court rejected the corporation's contention that the underlying complaint gave rise to a duty to defend. The court reasoned that the complaint clearly and unambiguously stated that the transaction was between a corporate parent and a wholly owned subsidiary and "that is not an allegation of a sale or purchase of securities" potentially within the scope of the policy's grant of coverage.

For more information, please contact us at 202.719.7130