[Bond Case Briefs]

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[Lifespan Corp. v. National Union Fire Ins. Co. of Pittsburgh, Pa.]

United States District Court, D. Rhode Island - November 17, 2014 - F.Supp.3d - 2014 WL 6433361

In January of 1997, Lifespan and New England Medical Center (NEMC) executed an MOU proposing an affiliation in which Lifespan would become NEMC's corporate parent, and NEMC would in turn become one of the hospital subsidiaries in Lifespan's system.

At the conclusion of the litigation that ensued following the disaffiliation of the parties, NEMC and the Massachusetts Attorney General obtained a judgment against Lifespan in the amount of $29,605,282.93 stemming from breaches of fiduciary duties and gross negligence in connection with the negotiation of NEMC's health insurer contracts and an interest rate swap transaction.

The interest rate swap was entered into in connection with the refinancing of $100 million in NEMC revenue bonds. Morgan Stanley served as underwriter of the refi. Lifespan's CFO had a close, longstanding personal friendship with the Morgan Stanley broker who proposed the swap. Lifespan's CFO approved the swap over the objection of NEMC's CFO. Lifespan's CFO neglected to disclose the relationship and was possibly motivated by his desire to join the broker's wine club. Spoiler alert: the swap goes bad.

Lifespan sued its D&O insurers after they refused to cover its losses.

The District Court held that the insurance policy's Unlawful Advantage Exclusion, Deliberate Fraudulent Acts Exclusion, Contractual Liability Exclusion, and Professional Services Exclusion were not applicable to Lifespan's claim against the policy.

The court then took up the issue of whether the Securities Exclusion – pertaining to claims related to the purchase or sale of securities – applied. The Securities Exclusion reads as follows:

"[t]he Insurer shall not be liable to make any payment for Loss in connection with a Claim made against an insured …

(m) alleging, arising out of, or in any way relating to any purchase or sale of securities by the Named Organization, Subsidiary or Affiliate or Claims brought by securities holders of the Organization in their capacity as such; provided, however, this exclusion shall not apply to the issuance by the Organization of tax exempt bond debt or Claims brought by tax exempt bond debt holders."

As the court noted, "Whether this exclusion applies depends on which law defines the term "security" and whether the interest rate swap falls within that definition."

The court began its analysis by holding that New York law governed the swap transaction due to the choice of law provision of the Master Agreement between Morgan Stanley and NEMC.

To be a security under Commercial Code § 8–102, an interest rate swap must fulfill the requirements of subparagraphs (i) (the transferability test), (ii) (the divisibility test) and (iii) (the functional test). The court concluded that the swap fulfilled none of the tests, much less all three. Consequently, the swap was not a security, and thus the Securities Exclusion did not apply.

The court also noted that the swap would not be a security for purposes of either Rhode Island, or Federal, law.

Lastly, the court found that even if the interest rate swap was a "arising out of, or in any way relating to any purchase or sale of securities," there would be coverage because of the tax-exempt bond debt exception to the exclusion. Exclusion 4(m) states that it "shall not apply to the issuance by the Organization of tax exempt bond debt or Claims brought by tax exempt bond debt holders." The interest rate swap, as described by the court in the underlying suit, was "a bond refinancing proposal" presented to NEMC by Morgan Stanley. Based on these facts from the underlying suit, Lifespan had met its burden to show that the interest rate swap's refinancing of the tax-exempt bond debt of non-profit NEMC was part of "the issuance … of tax-exempt bond debt." Consequently, even if the interest rate swap was "arising out of, or in any way relating to any purchase or sale of securities," there was insurance coverage because of the tax-exempt bond debt exception to Exclusion 4(m).