New York Court of Appeals Finds an Indenture's No-Action Clause Does Not Preclude Enforcement of All Common Law and Statutory Claims

On June 10, 2014, the New York Court of Appeals answered two questions certified to it by the Delaware Supreme Court, clarifying the language necessary for a trust indenture's no-action clause to preclude enforcement of contractual, common law and statutory claims directly or derivatively by security holders.[1]

I. Background and Procedural History

Quadrant Structured Products Company, Ltd. ("Quadrant") sued several defendants in the Delaware Court of Chancery for alleged wrongdoing related to notes purchased by Quadrant and issued by defendant Athilon Capital Corp. ("Athilon"), a business that Quadrant alleged was insolvent. Athilon was founded in 2004 and was capitalized with $100 million in equity and an aggregate of $600 million of senior, subordinated and junior notes. Athilon was engaged in the business of selling credit derivative products in the form of credit default swaps. Athilon's operating guidelines included a mandate to invest conservatively and a provision that, when certain suspension events occurred, it would enter "runoff mode" (a period during which it could not issue new credit default swaps and was required to pay off existing swaps as claims arose). By 2008, Athilon had undertaken $50 billion in credit default risk, far exceeding its $700 million in capital reserves. In the wake of the financial crisis, the runoff mode was triggered.

Quadrant owned a portion of the $350 million issue of senior subordinated notes which were subject to the terms and conditions of an indenture governed by New York law (the "Indenture"). EBF & Associates, LP ("EBF"), which acquired Athilon in 2010, owned all $50 million of the junior notes issued.

When Athilon entered runoff mode it continued to pay cash interest to EBF on the junior notes notwithstanding its alleged agreement to defer interest and other payments on the junior notes.

In 2011, Quadrant sued Athilon and EBF in the Delaware Court of Chancery asserting claims for breaches of fiduciary duty, seeking damages and injunctive relief, and also asserting fraudulent transfer claims against EBF. Quadrant asserted that EBF controlled Athilon through the 2010 acquisition. Quadrant further asserted that Athilon's Board had failed to preserve Athilon's value in anticipation of liquidation in 2014 when the last credit default swap was set to expire, instead taking actions in contravention of its duties, including the payment of interest on the junior notes to EBF. The defendants moved to dismiss the suit as barred by a no-action clause contained in the Indenture.

The section of the Indenture at issue provided in relevant part the following:

> "Limitations on Suits by Securityholder. No holder of any Security shall have any right by virtue or by availing of any provision of this Indenture to institute any action or proceeding at law or in equity or in bankruptcy or otherwise upon or under or with respect to this Indenture …."

The Court of Chancery dismissed Quadrant's complaint, stating that the no-action language in the Indenture barred suits not only under the Indenture itself, but also under a securityholder's independent common law or statutory claims, relying on Delaware Chancery Court decisions applying New York law.[2]

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[1] *Quadrant Structured Prods. Co., Ltd.* v. *Vertin*, 2014 NY Slip Op 04114 (N.Y. Ct. App. June 10, 2014).

[2] *See*, *Feldbaum* v. *McCrory Corp.*, 18 Del. J. Corp. L. 630 (1992); *see also*, *Lange* v. *Citibank, N.A.*, 2002 WL 2005728, at *1 (Del. Ch., Aug. 13, 2002, Civ.A. 19245 (NC)).

On appeal to the Delaware Supreme Court, Quadrant asserted that the terms of the indentures in the cases relied upon by the Court of Chancery were distinguishable from the no-action clause in the Athilon Indenture. The Delaware Supreme Court remanded the case back to the Delaware Court of Chancery which issued a Report on Remand ("Report") concluding that the language under the Indenture only barred contractual claims. The Delaware Supreme Court certified the questions to the New York Court of Appeals.

II. The Court of Appeals' Decision

At issue was whether, under New York law, the absence of any reference in the no-action clause governing suits by securityholders to "the Securities" permitted enforcement of common law and statutory claims that securityholders as a group might have. Relatedly, at issue was whether the Court of Chancery's Report was a correct application of New York law to the Athilon no-action clause.

The New York Court of Appeals found that the Report was a correct application of New York Law, holding that a trust indenture's "no-action" clause that specifically precludes enforcement of contractual claims arising under the Indenture, but omits reference to "the Securities," did not bar a securityholder's independent common law or statutory claims.

The Court of Appeals' conclusion was based on its analysis and comparison of the Quadrant no-action clause to the language of the no-action clauses at issue in *Feldbaum* and *Lange*. In those cases in which plaintiffs' claims were dismissed, the clauses at issue barred a securityholder's action "with respect to this Indenture *or the Securities* unless [specified conditions are met]."[3]

In contrast, the applicable no-action clause in the Indenture governing the senior subordinated notes held by Quadrant only mentioned claims made under the Indenture. It did not also bar claims made with respect to the securities issued under the Indenture.

Applying New York rules of construction, the Court distinguished the Quadrant language from *Feldbaum* and *Lange* and, by reading the no-action clause to give effect to the precise words and language used, found that, even where there is ambiguity, "if parties to a contract omit terms - - particularly, terms that are readily found in other, similar contracts - - the inescapable conclusion is that the parties intended the omission."[4] As such, the Court found that "the clear import of the no-action clause is to leave a securityholder free to pursue independent claims involving rights not arising from the indenture agreement."[5]

The New York Court of Appeals found that New York decisions also supported this finding.[6]

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[3] *Feldbaum*, 18 Del. J. Corp. L at 641; *Lange*, 2002 WL 2005728 at *5 (emphasis added).

[4] *Quadrant*, at *13.

[5] *Id.*, at *14-15.

[6] *Gen. Inv. Co.* v. *Interbourgh R.T. Co.*, 200 AD 794, 801 (1st Dept., 1922) (The Appellate Division held that the no-action clause did not bar plaintiff's suit because the clause applied to proceedings arising from the enforcement of the indenture and plaintiff's action "is not to affect, disturb or prejudice the lien of the collateral indenture or to enforce any right thereunder"). Also, in *Cruden* v. *Bank of New York*, 957 F2d 961, 968 (2nd Cir. 1992), the Second Circuit, applying New York law, agreed with the District Court's conclusion that plaintiffs' fraud and RICO claims were not made under the indenture and, thus, could not be barred by the no-action clause. *See also*, *Victor* v. *Riklis*, 1992 WL 122911, *7 (S.D.N.Y. May 15, 1992); *McMahan & Co.* v. *Wherehouse Entertainment, Inc.*, 859 F. Supp. 743 (S.D.N.Y. 1994).

III. Significance

New York courts will read a "no action" clause literally and if the clause only bars suits for contractual claims arising under the indenture, suits brought on theories outside the scope of the literal language of the contractual provision may not be barred. Conversely, if a "no action" clause does purport to bar contractual and other claims under the indenture and the securities issued under the indenture, the courts have, to date, enforced the agreed upon bar and dismissed claims coming within the scope of the no-action provision.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Maximilien Pucci-Sisti Maisonrouge at 212.701.3670 or mmaisonrouge@cahill.com.