EFiled: Sep 28 2012 08:56PM EDT
Filing ID 46720005
Case Number 338,2012

IN THE SUPREME COURT OF THE STATE OF DELAWARE

QUADRANT STRUCTURED PRODUCTS COMPANY, LTD., Individually and Derivatively on behalf of Athilon Capital Corp., Plaintiff Below/Appellant v. VINCENT VERTIN, MICHAEL SULLIVAN, PATRICK B. GONZALEZ, BRANDON JUNDT, J. ERIC WAGONER, ATHILON CAPITAL CORP., ATHILON STRUCTURED INVESTMENT ADVISORS LLC, EBF & ASSOCIATES, LP, Defendants Below/Appellees	No. 338, 2012 Case Below: Court of Chancery CIVIL ACTION NO. 6990-VCL

APPELLANT'S CONSOLIDATED REPLY BRIEF

OF COUNSEL:

Harold S. Horwich
Sabin Willett
Samuel R. Rowley
BINGHAM McCUTCHEN LLP
One Federal Street
Boston, MA 02110
(617) 951-8000

Lisa A. Schmidt (#3019)
Catherine G. Dearlove (#3328)
Russell C. Silberglied (#3462)
RICHARDS, LAYTON & FINGER, P.A.
One Rodney Square
920 N. King Street
Wilmington, DE 19801
(302) 651-7700

Dated: September 28, 2012

TABLE OF CONTENTS

TABLE OF CITATIONS

Page(s)

CASES

STATUTES & RULES

OTHER AUTHORITIES

PRELIMINARY STATEMENT[1]

This appeal presents a narrow issue of first impression. Of the dozens of issues presented by Defendants' Rule 12(b)(6) motions to dismiss, the Court of Chancery addressed only one: whether a no-action clause in the trust indenture bars Quadrant from pursuing derivative and direct claims against or on behalf of the obligor. The Court of Chancery held no hearing on the issue (or any other), briefly noting that two Court of Chancery decisions are "directly on point." Because *Feldbaum v. McCrory Corporation*, 1992 WL 119095 (Del. Ch. June 2, 1992), and *Lange v. Citibank, N.A.*, 2002 WL 2005728 (Del. Ch. Aug. 13, 2002), form the exclusive basis for the Order below and neither is an opinion of this Court, they merit a close look. Each contains crucial points of distinction from the case now before the Court. In urging the Court to affirm the Order below, Defendants elide the key distinctions and seek to force the square block of the Amended Complaint into the round hole of *Feldbaum* and *Lange*. Quadrant addresses those distinctions below.

Although the Court of Chancery rested on a single and narrow issue, Defendants urge this Court to affirm on *any* of the complex issues *not* considered below. Defendants offer no reason why the Court should deviate from the usual practice, in which trial courts decide questions of fact and law in the first instance. That principle has particular force where an issue was never even considered below. If this Court is concerned by any of the alternative grounds, it should remand for consideration in the Court of Chancery.

---

[1] Quadrant submits this Consolidated Reply Brief ("Reply Br.") in response to Answering Brief of Appellees Athilon Capital Corp., Athilon Structured Investment Advisors LLC, Vincent Vertin, Michael Sullivan, Patrick B. Gonzalez, Brandon Jundt and J. Eric Wagoner ("Athilon Brief") and Appellee EBF's Answering Brief ("EBF Brief") (together, the "Answering Briefs").

REPLY STATEMENT OF FACTS

A. Defendants Ignore The Unusual Facts Of This Case.

The factual recitation in the Answering Briefs omits the well-pleaded core factual premise from which the claims arise: Athilon formally is in a permanent state of runoff, in which it should preserve capital, minimize expenses, and otherwise prepare for an orderly liquidation (A30, A34). Runoff resulted from the collapse of the *only* business for which Athilon originally was formed (A29-30, A34-35).

Delaware corporations are typically formed for a general purpose, able to pursue any lawful line of business. When the prospective investor lends to the general-purpose company, on terms free from covenants, he assumes the risk that the company may pursue a range of opportunities. That is not the case here. The Answering Briefs ignore the consequences of this unusual fact.[2]

Athilon was formed for the single purpose of providing credit swaps on senior tranches of collateralized debt obligations. Its organizational documents and its debt prospectuses made this clear (Appellant's Opening Brief ("Opening Br.") at 3-4). In obtaining long-dated financing on favorable terms, Athilon marketed itself not as an

---

[2] The Athilon Defendants' "factual" discussion of the "John Doe" counts is remarkable, given the procedural history. The initial complaint contained counts based on Athilon's public disclosures that it had paid an enormous fee to an undisclosed "John Doe" recipient, for undisclosed reasons. Before filing the initial complaint, Quadrant repeatedly sought details from Athilon, and Athilon refused to provide them. On November 1, 2011, Quadrant served document requests seeking this information. Defendants sought to stay discovery. In December, attorneys for the "John Doe" contacted Quadrant's counsel and swiftly provided the documents that the Defendants had withheld. Based on its review of these documents, Quadrant amended its complaint to omit the John Doe counts. It was Athilon's refusal to disclose basic facts that precipitated these counts, which were not the primary focus of the initial complaint.

open-ended investment vehicle, but as a limited-purpose credit derivative product company ("CDPC"), governed by a purposefully narrow and confining charter (A23). When that business premise failed, Defendants made a strategic acquisition, in effect seeking the cheap capital provided for one business in order to undertake a different one. In their Answering Briefs, Defendants turn a turn a blind eye to this critical, and atypical, context.

B. The Credit Rating Upgrade Is Irrelevant, And In Any Event Supports The Allegations Of The Complaint.

Standard & Poor's ratings upgrade noted by Defendants in the Athilon Brief is procedurally irrelevant to whether Quadrant adequately alleged insolvency. Defendants may challenge the factual basis for solvency or insolvency at trial, but not on a motion to dismiss, which should be determined on the allegations in the complaint.

At any such trial Standard & Poor's press release would be evidence for the plaintiff, not the defense. The upgrade (from "BB" to a still speculative grade "BB+") applies only to Athilon's CDS obligations, which are structurally senior to the notes. The ratings on all other debt classes -- *i.e.,* the classes of debt at issue in this case -- remain *unchanged* (B432). Standard & Poor's ratings on these debt classes continue to reflect Athilon's deep distress, as alleged in the Amended Complaint: "B" for the senior subordinated notes, "CCC-" for the subordinated notes, and "CC" for the Junior Notes (B434).

As the press release makes clear, Standard & Poor's believes Athlon is in runoff, without ongoing business (B433). This contradicts a core proposition of Defendants' argument: that Athilon is authorized to use committed capital to pursue ventures not contemplated by its governing documents, operating guidelines, or investors, over the course of a generation.

ARGUMENT

I. *FELDBAUM* AND *LANGE* ARE READILY DISTINGUISHABLE AND DO NOT BAR QUADRANT'S CLAIMS.

The Answering Briefs assert that *Feldbaum* and *Lange* are "directly on point." In its Opening Brief, Quadrant explained the key points of distinction, but Defendants either ignore them or misconstrue *Feldbaum* and *Lange* to manufacture points of similarity. Quadrant summarizes the core differences in Table 1. The distinctions are significant, for the reasons articulated in the Opening Brief and below.

Table 1	Feldbaum	Lange	Athilon
No-Action Clause	"A Securityholder may not pursue **any remedy with respect to this Indenture or the Securities** unless: (1) the Holder gives to the Trustee written notice of a continuing event of default . . . ." *Feldbaum*, 1992 WL 119095, at *5.	"A Securityholder may not pursue **a remedy with respect to this Indenture or the Securities** unless: (i) the Holder gives to the Trustee written notice of a continuing Event of Default . . . ." *Lange*, 2002 WL 2005728, at *5 (emphasis added).	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** . . . unless such holder previously shall have given to the Trustee written notice of default… Indenture § 7.06 (emphasis added).

Contract defaults?	**Yes.** Noteholders a lleged default on principal and interest by one issuer, and increased risk of default by others. *Id.* at *2.	**Yes.** Debentures brought suit post-default by the issuer. *Id*. at *3.	**No.** Default is not anticipated for many years.
Derivative claims?	**No.** Creditor claims for breach of the indentures, fraudulent conveyance, fraud. The court's use of the phrase "hurt derivatively" means "no harm different from that suffered [personally] by their fellow bondholders." *Id*. at *8.	**No.** Creditor claims for fraudulent conveyance and *direct* claims for breach of fiduciary duties. *See* Opening Br. at 22-23 for explanation of why *Lange* was *not* a derivative action.	**Yes.** Quadrant asserts breach of fiduciary duty claims *of* Athilon by virtue of Quadrant's status as a creditor of an insolvent Delaware corporation. *See* Opening Br. at 22-25 and Reply Br., *infra* 10-11.
Post-*Gheewalla* ?	**No**.	**No**.	**Yes.**

A. Defendants' "Common To All Bondholders" Argument Is Irrelevant -- The Trustee Has No Authority To Bring Quadrant's Claims.

Defendants have whisked together the concept of what claims are common to noteholders with the concept of what party has authority to bring claims. In a post-event-of-default setting, there is little doubt that the Indenture Trustee could bring a broad array of claims under the Indenture. But the Indenture in this case gives the Indenture Trustee no litigation rights unless and until a defined Event of Default has occurred.

See Indenture § 7.04. Because there was no *contract* default, the Indenture Trustee can bring no claims -- whether common to noteholders or not. By contrast, in each of *Feldbaum* and *Lange*, a contract default had occurred. *See* Table 1, *supra*.

The question here is whether the Indenture imposes on noteholders the requirement to go to the Indenture Trustee as the gatekeeper, when the Indenture Trustee has no ability to open the gate. This is a question not of policy but of contract interpretation. The Indenture provides the contract's answer: there is no such requirement. By its terms, Article 7 does not address remedies prior to an event of default.

Defendants' error is most pronounced in connection with the derivative claims. Those claims are not claims *of the noteholders* that arise from the Indenture or the securities. They are claims *of Athilon* against those who owe it fiduciary duties. Once the company is insolvent, any creditor of the company (not just a noteholder) has standing to initiate the claim. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-02 (Del. 2007). Construing the no-action provision to bar claims of Athilon is beyond any permissible construction of the Indenture.

Feldbaum actually proves the point. The court there identified a critical limit on the reach of the no-action clause: "[N]o matter what legal theory a plaintiff advances, if the trustee is capable of satisfying its obligations, then any claim that can be enforced by the trustee on behalf of all bonds . . . is subject to the terms of a no-action clause of this type." *Feldbaum*, 1992 WL 119095, at *6. Here the Indenture Trustee is *not* capable of satisfying its obligations because no event of default has occurred.

Defendants argue that the purpose of the no-action clause is to bar unmeritorious and unpopular suits brought by a single noteholder.[3]

---

[3] Defendants have offered no evidence that this suit is unpopular among creditors. No creditors have joined the defense, either. That

But the "purpose" of the contract is expressed in the contract itself:

> [I]t being understood and intended . . . that no one or more holders of Securities shall have any right in any manner whatever by virtue or by availing of any provisions of this Indenture to affect, disturb or prejudice the rights of any other holder of Securities, or to obtain or seek to obtain priority over of preference to any other such holder or to enforce any right under this Indenture, except in the manner herein provided and for the equal, ratable and common benefit of all holders of Securities (A131-32; A229-30).

Thus, the stated goal of the provision is to prevent a race to the courthouse between noteholders. This suit, with its derivative claims, is perfectly consistent with that goal, and with equal, ratable, and common benefit of all creditors. The construction espoused by Defendants would turn the provision upside down by making it impossible for any (or even all) noteholders to bring an action for their collective benefit prior to a contract default. This is not a reasonable construction of the no-action provision of the Indenture and should be rejected.

Defendants argue that "default" under the Indenture could include the non-contractual claims asserted by Quadrant. This is a remarkable contention, unsupported by any authority or citation to the documents. A default, even if not precisely defined as an "event of default," by definition requires some breach of the Indenture. *See, e.g.*, *U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls ("Timberlands II")*, 864 A.2d 930, 939 n.26 (Del. Ch. 2004) ("[a] 'default' [as distinguished from an event of default] basically includes any breach of a provision of the indenture.") (internal quotations and citation omitted). The only case directly to address the situation present here is *Akanthos Capital Management, LLC v. CompuCredit Holdings Corporation*, where the district court held that the no-action clause did not bar a pre-default claim, and the Court of Appeals reversed. *Akanthos Capital*

Quadrant proceeds alone rather suggests that smaller holders in a distressed credit are willing to "free ride" the litigation expense.

Mgmt., LLC v. CompuCredit Hldgs. Corp., 677 F.3d 1289, 1294-95 (11th Cir. 2012). As discussed in Quadrant's Opening Brief, the Court of Appeals' reasoning is not persuasive and should be rejected by this Court. *See* Opening Br. at 18-19. Affirming the Order below would either arrogate to the Indenture Trustee authority it plainly does not possess under the Indenture (and thus would be unlikely to assert), or simply eliminate, as a practical matter, the rights under *Gheewalla* and other remedies under applicable law of the party most likely to assert them -- a financial creditor.

B. Quadrant Has Not Waived the Right To Distinguish *Feldbaum* and *Lange*.

Quadrant did not waive the right to articulate points of distinction with *Feldbaum* and *Lange*. Supreme Court Rule 8 provides that this Court may review questions "fairly presented to the trial court." Supr. Ct. R. 8. The question fairly presented to the Court of Chancery was whether the no-action clause bars Quadrant's lawsuit. Quadrant raised below the argument that *Feldbaum* and *Lange* are distinguishable and do not control here (*See* A286-92). On appeal, Quadrant refines critical distinctions concerning the cases that the Court of Chancery made the sole basis of its ruling. Having raised points of difference with the two (and only) cases on which the Court of Chancery rendered its order, Quadrant has not waived the right to point out nuances of the argument. *See, e.g.*, *Sears, Roebuck & Co. v. Midcap*, 893 A.2d 542, 547 (Del. 2006) (issue fairly presented below where defendant objected generally to a jury instruction and made a more precise argument in support of that objection on appeal).

II. NOTHING IN THE INDENTURE IN THIS CASE BARS EITHER THE DIRECT OR DERIVATIVE CLAIMS.

Quadrant's claims arise out of its ownership of the notes, not out of the provisions of the Indenture. The no-action clause in the Indenture in this case only bars actions that arise out of the Indenture. The reference in Section 7.06 of the Indenture to proceedings at law, in equity, or in bankruptcy is not, as Defendants suggest, a recognition of all rights of noteholders untethered to the Indenture itself. (*See* A131-132; A229-30).

Here the no-action clause bars certain proceedings only by reference to the "Indenture," not to the "Securities." (*See* A131-132; A229-30). Defendants suggest that "Indenture" and "Securities" are essentially synonymous, but a basic rule of construction requires that courts give effect to each contract term to avoid redundancy. *See, e.g.*, *Kuhn Constr., Inc. v. Diamond State Port Corp.*, 990 A.2d 393, 396- 97 (Del. 2010). Plainly the terms "Indenture" and "Securities" are not synonymous. A security is evidence of a debt obligation; it gives the holder, among other things, rights of stewardship under *Gheewalla*. An indenture is a contract among such holders and a trustee, which gives contract rights according to its terms.

Defendants' conflation of "security" with "indenture" would also render the use of "Securities" in the *Feldbaum* and *Lange* indentures redundant. The drafters of the no-action clauses in *Feldbaum* and *Lange* must have meant something by referring to the "Indenture" and the "Securities," and the drafters of the no-action clause at issue here must have meant something different by referring to the "Indenture" but *not* to the "Securities." The only plausible conclusion is that the indentures in *Feldbaum* and *Lange* are more restrictive than the Indenture at issue here. The Indenture in this case controls, and none of Quadrant's claims arises from the Indenture, as distinguished from the Securities.[4]

---

[4] In *Tang Capital Partners v. Norton*, 2012 WL 3072347 (Del. Ch. July 27, 2012), the court's construction of the phrase "by virtue of or by availing of" was not necessary to its decision.

III. NO CASE BARS THE TYPE OF DERIVATIVE CLAIMS BROUGHT BY QUADRANT.

Nowhere in the Indenture did noteholders delegate to the Indenture Trustee their derivative rights to bring claims *on behalf of* Athilon. No case relied on by Defendants or the Court of Chancery holds otherwise. Defendants cling to the adverb "derivatively," used in *Feldbaum* and *Lange*, but those cases did not involve derivative actions, which are claims of a corporation pursued on its behalf by the holder of an interest in that corporation. *Feldbaum* addressed the question of what happens when a contract is in default and a remedy is provided to the holder not by the indenture, but by a fraudulent transfer statute. Noting that in fraudulent transfer cases a creditor can allege no harm different from that suffered by other noteholders, the court concluded that the only sensible reading of the indenture was that such claims must also be channeled through the trustee. *Feldbaum*, 1992 WL 119095, at *8. This is not a holding that claims *of* the company must be, or even can be, channeled through a trustee. *Feldbaum* and *Lange* involved direct, not derivative claims, and therefore do not support Defendants' position.[5]

RBC Capital Markets is similarly off point. Plaintiff ("RBC") held notes issued by an LLC and administered by a trust. *RBC Capital Mkts., LLC v. Educ. Loan Trust IV*, 2011 WL 6152282, at *1-2 (Del. Ch. 2011). RBC alleged that the issuer caused the trust to pay excessive fees to the issuer in breach of the indenture, thereby reducing the amount of interest payments made to RBC by negatively affecting an input to the contractual formula for the interest rate paid on the notes. *Id*. at *1. RBC asserted claims against the issuer and the trust for breach of contract, unjust enrichment, and accounting. *Id*. at *3. Defendants moved to dismiss under the no-action clause.

The issue was whether the statutorily mandated payment-of-interest exception to the no-action clause applied. That exception states

---

[5] Fraudulent conveyance claims are direct claims. *See* 6 *Del. C*. § 1307; *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 199 (Del. Ch. 2006), *aff'd sub nom. Trenwick A. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007) (TABLE).

that suits for recovery of interest on notes may be pursued by noteholders, notwithstanding a no-action clause. RBC contended that because the issuer's breach indirectly reduced interest paid on the notes, the exception applied. *Id.* at *2. Rejecting the argument, the court concluded that to show that interest payments were lower than they should have been, RBC had to prove a breach of the indenture independent of its right to receive timely interest payments. *Id*. at *4. "The violations alleged by RBC did not affect the occurrence of interest payments, but rather directly injured the Trust itself and therefore indirectly affected an input to the calculation of the interest rate." *Id*. at *5. In other words, RBC argued that the issuer "breached the Indenture and thus impoverished the Trust itself." *Id*. at *4. The court thus held that "[w]hen a noteholder must premise its claim for payment of interest on *proving a breach of provisions of the trust indenture* not directly addressing the schedule or amount of interest payments due, it must comply with the no-action clause." *Id*. at *2 (emphasis added). Quadrant's derivative counts assert claims of the Company, and none of *the Company's* claims is premised on a breach of the Indenture.

In *RBC*, the Court of Chancery quoted *Feldbaum*'s reference to noteholders that are "'hurt derivatively,'[who] 'can allege no harm different from that suffered by their fellow bondholders,'" *id*. at *5 n.31 (quoting *Feldbaum*, 2011 WL 6152282, at *8), and noted "the distinction between direct claims made for principal and interest payments and derivative claims brought under an indenture that are properly subject to the approval of a majority of the noteholders and/or the indenture trustee." *Id*. at *6. The Chancellor observed that "[i]n *Lange*, as in [*RBC*], the plaintiff attacked transactions that had a *derivative* effect on principal and interest payments and sought to sue *directly* to recover what principal and interest they believed should have been paid to them." *Id*. (emphasis added). The same then-Vice Chancellor decided *Lange*. As Quadrant argued in its Opening Brief, *Lange* thus involved direct claims of the noteholders -- not claims *of* the issuer -- that "derivatively" harmed the noteholders in the sense of their each suffering a ratable portion of the harm. In short, none of Defendants' authorities supports the proposition that the Indenture Trustee in this case has the power to prosecute derivative claims of the type brought by Quadrant. Defendants simply misconstrue the meaning of the term "derivative," as used in *Feldbaum*, *Lange*, and *RBC*.

IV. THE COURT SHOULD NOT AFFIRM ON ALTERNATIVE GROUNDS.

The Court of Chancery granted Defendants' motions to dismiss without hearing, on a single ground, in a single page, having a care to note that "the Court has not reached any of the other grounds asserted for dismissal." (Opening Br., Ex. A ¶ 2). The parties had filed hundreds of pages of briefing addressing those other grounds, which raised many issues, some unsettled areas of law, and disputes of fact masquerading as Rule 12(b) challenges. Quadrant appealed the Vice Chancellor's ruling. In keeping with his approach, it briefed only the issue that he had considered and decided. Nonetheless, Defendants devoted a third of their briefing to the other issues. Plaintiffs are thus left half a reply brief to address issues that were never considered below or addressed in the Opening Brief.

Under these circumstances, it would be inappropriate for this Court to reach the issues not considered by the Court of Chancery. This is particularly true where the issues raised are matters of first impression or unsettled law.[6] *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Dann*, 953 A.2d 127, 128 (Del. 2001) ("It is preferable as a matter of the orderly administration of justice for the trial courts of this State to decide in the first instance all questions of law, including new and challenging legal questions, so that this Court will have the benefit of the reasoning and analysis of the trial court."). While "[t]here may be compelling instances where there are important and urgent reasons requiring an exception to

---

[6] For example, EBF itself acknowledged that its argument that parent entities do not owe fiduciary duties even upon insolvency is unsettled law. *See* EBF Brief at 10 ("While not entirely clear on the point, Delaware law appears to provide . . . ."). Similarly, EBF acknowledges that its Rule 23.1 argument is by analogy only and has never been applied to a suit initiated by a creditor. *See id.* at 12 ("Rule 23.1's requirements -- which should apply to creditor derivative plaintiffs . . . .) (emphasis added). It also argues by analogy, without citation, concerning the application of controlling stockholder fiduciary duties to creditor initiated derivative suits. *See id.* at 13 ("The same principles apply to creditor fiduciary duty claims.").

this principle when exigencies of time or a strong showing of judicial economy so dictate," *id*., Defendants have not articulated such reasons here, and none exist. Rather than affirm on any of the alternative grounds proposed by Defendants, the Court should remand for consideration by the Court of Chancery.

Quadrant, in the limited space available to it summarizes its responses below to the other arguments, including citations to pages of the Appendix where these arguments were more fully developed. To the extent this Court reaches other grounds, the allegations of the Amended Complaint are adequate.

A. The Amended Complaint Adequately Alleges Insolvency.

Defendants argue for a balance sheet test that has no basis in law, and raise a number of factual disputes inappropriate for resolution on a Rule 12(b)(6) motion to dismiss. Delaware law recognizes that a company is insolvent "*either* when its liabilities exceed its assets, or when it is unable to pay its debts as they come due." *SV Inv. P'rs, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 987 (Del. Ch. 2010) (emphasis added). When insolvency is a required element, a plaintiff need only satisfy one of these two tests. *Id.* At issue here is the first test, the "balance sheet test," which compares a company's liabilities against the fair market value of its assets. *See Timberlands II*, 864 A.2d at 947 (company insolvent "if it has liabilities in excess of a reasonable market value of assets held") (internal quotation marks omitted); *see also Blackmore P'rs, L.P. v. Link Energy, LLC*, 2005 WL 2709639, at *6 (Del. Ch. Oct. 14, 2005) (same).[7]

Insolvency is a fact-intensive issue,[8] and the Amended Complaint

---

[7] The Amended Complaint's fraudulent transfer counts are governed by the balance sheet test codified at 6 *Del. C.* § 1302(a) ("[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation").

[8] *See, e.g.*, *Blackmore*, 2005 WL 2709639, at *3 ("The factual question of whether Link was insolvent . . . is an important one for the

alleges factual detail giving rise to a reasonable inference of insolvency, including that (i) Athilon is a failed CDPC whose business was destroyed by the 2008 financial crisis (A29-30); (ii) Athilon was unable to maintain financial covenants or credit ratings and it was forced into runoff mode, in which it may not engage in any new business and can exist only passively until its Credit Swaps mature (A23-24, A32, A34); (iii) Athilon had to pay $370 million to unwind two Credit Swaps related to residential mortgage-backed securities (A29, A32); (iv) even if it were permitted to engage in new business while in runoff, the industry has collapsed and financial institutions will not enter into Credit Swap contracts with Athilon (or any CDPC) due to lack of adequate collateral or capitalization (A29-30); and (v) Athilon cannot raise new capital, as it is not creditworthy and has sub-investment grade credit ratings (A30, A33). The Amended Complaint includes specific allegations that Athilon has a negative equity value of $660 million (A32-33; Opening Br. at 6-7) and that its assets have a fair value of $426 million, about $175 million short of Athilon's $600 million noteholder debt, which is the *minimum* amount of the Company's liabilities (A32-33; Opening Br. at 6-7).

Runoff, rating declines, credit unwinds, industry collapse, and negative equity values are all non-conclusory allegations of fact. They are more than sufficient to satisfy Rule 8's notice pleading standard. *See, e.g.*, *Joseph v. Frank (In re Troll Commc'ns, LLC)*, 385 B.R. 110, 124 (Bankr. D. Del. 2008) (complaint adequately pleaded insolvency where it alleged that debtor had negative tangible net worth and that debtor's accountant had issued a going concern qualification).

Defendants nevertheless argue that this Court should affirm the Court of Chancery's dismissal on the alternative grounds that the plaintiffs have failed to *plead* insolvency. They propose a balance sheet test that measures a company's assets against only its *short-term* liabilities, but ignoring all non-current liabilities. In other words, to

---

court's final disposition in this case. . . ."); *Teleglobe USA Inc. v. BCE Inc. (In re Teleglobe Commc'ns Corp.)*, 493 F.3d 345, 384 (3d Cir. 2007) ("Whether a corporation is insolvent, and when it becomes so, are issues of fact").

claim that Athilon is not insolvent, Defendants value the Company's $600 million noteholder debt at $0 on the theory that the notes will not come due for many years, and -- who knows? -- perhaps something will turn up.

No case stands for this proposition. Delaware and federal courts recognize that the balance sheet test compares fair value of assets to *face value* of liabilities and that it therefore is inappropriate to discount liabilities. *See Angelo, Gordon & Co, L.P. v. Allied Riser Commc'ns Corp.*, 805 A.2d 221, 224 n.10 (Del. Ch. 2002) ("it cannot ordinarily be true that one should mark debt to market [value] unless the Company has the right to reacquire that debt at that price. Otherwise, companies could always avoid insolvency by the simple device of marking down the …public debt to a market price driven by the company's own financial distress."); *Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.)*, 134 F.3d 188, 197 n.7 (3d Cir. 1998) (citations omitted) (noting "anomalous results" that would occur if companies were permitted to mark down value of liabilities in determining insolvency); *see also Hanna v. Crenshaw (In re ORBCOMM Global, L.P.*), 2003 WL 21362192, at *2-3 (Bankr. D. Del. June 12, 2003) (liabilities must be valued at face value).

Defendants appear to meld the balance sheet test with the cash flow test (which measures a company's ability to pay its current debts as they come due), but Delaware law requires only that *one* of the two tests to be satisfied for a company to be considered insolvent. Under the balance sheet test, the question is not *when* the debt must be paid, but *whether* it must be paid -- if Athilon stopped operating today or, for that matter, six months from now, would it owe a debt to its noteholders, and if so, would it have enough assets to satisfy that debt? If not, then it is balance sheet insolvent.

Defendants cite only one case, which describes the balance sheet test as "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof." *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004). But *Production Resources* nowhere says that the balance sheet test compares assets against only short-term liabilities, nor does the phrase "with no reasonable prospect that the business can be

successfully continued"[9] fundamentally change the test for balance sheet insolvency, allowing a party to ignore all of a company's long-term liabilities. *See* Robert J. Stearn, Jr. and Cory D. Kandestin, *Delaware's Solvency Test: What Is It And Does It Make Sense?* 36 Del. J. Corp. L. 165, 165-68, 174-86 (2011) (tracing the origin of the "no reasonable prospect" test and concluding that the test is actually an amalgamation of two separate tests required by Delaware's receivership statute, Section 291: the standard balance sheet test to determine insolvency, and a separate test to determine whether to displace management of an insolvent corporation in favor of a receiver). This issue is of no consequence in any event, because the Amended Complaint alleges that the Company was in permanent runoff mode, unable to engage in new business, and thus had no reasonable prospect of continuing its business.

Defendants' argument about the Company's future prospects also improperly raises questions of fact that cannot be resolved at this stage of the case. Defendants contend that the Company has increased its range of eligible investments, and that this "new business" demonstrates solvency because Athilon will have years to grow its assets. Assuming for the sake of argument that this were true (which Quadrant does *not* concede),[10] the hypothetical chance that Athilon could in the future generate extraordinary cash on an investment is pure conjecture, and to credit it requires drawing adverse inferences in *Defendants'* favor. This is gambling with house money; and this sort of speculation does not change the fact that Athilon is insolvent *now*. Defendants cite no case that applies the "reasonable prospects" test to hold that a company that possibly could work its way out of insolvency is deemed solvent today -- much less on facts this tenuous.

---

[9] Many Delaware cases describe the balance sheet test without this phrase. *See, e.g.*, *Trenwick*, 906 A.2d at 195 n.74 ("Insolvency in fact occurs at the moment when the entity 'has liabilities in excess of a reasonable market value of assets held.") (citations omitted; *SV Inv. P'rs*, 7 A.3d at 987 (a company is insolvent "when its liabilities exceed its assets").

[10] In the briefing below, Quadrant explained in detail why Defendants' concept that they can turn this limited purpose entity into a new business is wrong. *See* A279-80, A313-16.

Defendants' arguments that Quadrant failed to allege insolvency in 2010, when certain of the challenged transfers were made, *see* EBF Brief at 13, are also unavailing. The Amended Complaint adequately alleges insolvency in 2010, by alleging that Athilon's financial condition was not materially different in 2010 than it was in 2011, when its financial statements demonstrate an inadequacy of fair saleable value (A32-33). These allegations of insolvency dealing specifically with 2011 also demonstrate insolvency at earlier dates under the doctrine of "retrojection." *See, e.g.*, *Shubert v. Lucent Techs., Inc. (In re Winstar Commc'ns, Inc.)*, 348 B.R. 234, 276 (Bankr. D. Del. 2005), *aff'd and modified in part on other grounds*, 554 F.3d 382 (3d Cir. 2009) (trustee meets insolvency burden "by showing that the debtor was insolvent at a reasonable time subsequent to the alleged transfer, accompanied by proof that the debtor's financial situation did not change materially during the intervening period") (citing additional cases).

Athilon was in runoff mode in 2010 as well, and could do no more than passively exist (A23-24, A34-35). It did not engage in new swaps, and its credit ratings were no better in 2010 than in 2011 (A30). Moreover, Athilon's balance sheet insolvency as of September 2011 exceeded almost $175 million. Given that Athilon was carrying on no new business and generating no new institutional debt, the only permissible inference is that its insolvency was the same in 2010 as in 2011 under the doctrine of retrojection. Further, even assuming *arguendo* that Quadrant failed to plead insolvency in 2010, the challenged transfers are recurring transfers over which Quadrant seeks injunctive relief (*e.g.*, interest payments and servicing fees), and pleading insolvency as of 2011 suffices as to all future transfers.

The Amended Complaint contains specific factual allegations giving rise to a reasonable inference of insolvency. It satisfies Rule 8's liberal notice pleading standard.

B. The Amended Complaint Adequately States the Other Claims Against EBF.

The Amended Complaint adequately alleges a derivative breach of fiduciary duty claim against the Athilon Board, an aiding and abetting claim against EBF, and other direct claims against Defendants.

Defendants' argument that Quadrant fails to state a breach of fiduciary duty claim against EBF because a parent corporation does not owe fiduciary duties to its wholly owned subsidiaries or creditors rests wholly on their (factual) contention that Athilon is not insolvent. Quadrant has adequately pled that Athilon is insolvent (Reply Br., *supra* 13-17; A29-30; A293-298). Moreover, as a controlling stockholder, EBF owes Athilon a fiduciary duty to not extract benefits from Athilon to the exclusion of its creditors (A46-47; A321-23). *See Teleglobe*, 493 F.3d at 367 (citing *Trenwick*, 906 A.2d at 204 n.96; *In re Scott Acq. Corp.*, 344 B.R. 283, 286 (Bankr. D. Del. 2006)).

Nor does the contemporaneous ownership requirement bar Quadrant's fiduciary duty claim, as Defendants ignore the fact that the statutory language provides only that *stockholder* derivative plaintiffs must meet the requirement, not *creditor* derivative plaintiffs (A317-18). *See* 8 *Del. C.* § 327 ("it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains"); *see also CML V, LLC v. Bax*, 6 A.3d 238, 242 (Del. Ch. 2010) (stating that Section 327 "limits the subset of derivative suits '*instituted by a stockholder* of the corporation' by requiring that a stockholder plaintiff satisfy the contemporaneous ownership requirement")(emphasis added), *aff'd*, 28 A.3d 1037 (Del. 2010). More practically, even if the contemporaneous ownership requirement applies to creditor plaintiffs, Quadrant has challenged actions taken *after* it became a noteholder (A37, A39; A319).

Defendants argue that Quadrant's fiduciary duty claim fails for other reasons, none of which is persuasive. That EBF, in its capacity as a noteholder, purports to have treated itself equally to other noteholders is beside the point. Refusal by the Athilon Board to exercise deferral rights on the Junior Notes is an affirmative act of preferring one creditor -- an insider junior creditor -- to the interests of the corporation (A36-39; A309-12). Defendants also contend that Quadrant's claims of mismanagement are barred under Athilon's exculpatory provision and 8 *Del. C.* § 102(b)(7) and that EBF, as a controlling shareholder, cannot be liable for a breach of the duty of care if Athilon's directors are exculpated. Section 102(b)(7) cannot shield EBF or the Athilon Board where, as here, Quadrant has adequately alleged that the Athilon Board has acted disloyally (A40; A313-16).

Quadrant has adequately alleged EBF's "knowing participation" so as to state a claim for aiding and abetting. On a motion to dismiss, a court may infer knowing participation from a defendant's control of a board. *See, e.g.*, *IT Litig. Trust v. D'Aniello (In re IT Grp. Inc.)*, 2005 WL 3050611, at *13 (D. Del. Nov. 15, 2005). EBF has installed at Athilon a board of its choice that includes an EBF partner, an EBF employee, and a CEO beholden to EBF for his livelihood (A30-31, A44-45; A323), thus the Amended Complaint adequately alleges knowing participation.

Defendants' arguments that Quadrant failed to state direct claims for fraudulent transfer, intentional interference with contractual relations, constructive dividend, and civil conspiracy are equally unavailing. Quadrant has supported its fraudulent transfer claim against EBF with sufficient allegations of insolvency (Reply Br., *supra* 13-17; A29-30, A32; A293-298). Although Defendants do not explain to this Court the other grounds on which they contend the fraudulent transfer claim should be dismissed, Quadrant's papers in the Court of Chancery fully rebut Defendants' contentions (A326-31).

Quadrant has also properly alleged facts in support of each element of its intentional interference and implied covenant of good faith and fair dealing claims (A25-28, A44-45, A53-55; A334-35) -- and that EBF was a cause of those breaches (A51-54; A335). In addition, the "no recourse" provision bars only contract claims, not an intentional interference with contractual relations claim that sounds in tort (A335-36). *See, e.g.*, *LaSalle Nat'l Bank v. Perelman*, 141 F. Supp. 2d 451, 462 (D. Del. 2001) (holding that under New York and Delaware law "no recourse provisions bar only contract claims"); *Timberlands II*, 864 A.2d at 950-51 ("The reasoning behind [limiting no recourse provisions to contract claims] is clear. The directors of an issuer should not be able to immunize themselves from a future breach of fiduciary duties or fraudulent conduct through a provision in the trust indenture.").

Although Defendants claim that there is no basis for recognizing a constructive dividend claim against EBF based on Athilon's payments of services and licensing fees, courts look to the economic substance of a challenged transaction rather than to form in order to determine whether the transaction's ultimate effect is to transfer an illegal dividend to a

corporation's shareholders (A55-56; A336-38). *See, e.g.*, *In re Buckhead Am. Corp.*, 178 B.R. 956, 969-70 (D. Del. 1994) (denying motion to dismiss claim for illegal constructive dividends for payments from an insolvent subsidiary to its parent where the economic effect was to impair the subsidiary's capital). Here, Quadrant alleges that the economic substance of the payments for services and licensing fees was that of a dividend.

Defendants further contend that Quadrant's civil conspiracy claim should be dismissed because (a) Quadrant failed to allege an underlying wrong, and (b) Quadrant failed to allege EBF's knowing participation in the breach of fiduciary duty. For the reasons previously articulated, Quadrant has sufficiently pled both an underlying wrong and EBF's knowing participation in the fiduciary breaches of other defendants (Reply Br., *supra* 18-19; A30-31, A36-37, A40, A42, A44-45; A338-40).

CONCLUSION

The Court should reverse the Order below.

/s/ Catherine G. Dearlove
Lisa A. Schmidt (#3019)
Catherine G. Dearlove (#3328)
Russell C. Silberglied (#3462)
RICHARDS, LAYTON
& FINGER, P.A.
One Rodney Square
920 N. King Street
Wilmington, DE 19801
(302) 651-7700

Attorneys for
Plaintiff Below/Appellant

OF COUNSEL:

Harold S. Horwich
Sabin Willett
Samuel R. Rowley
BINGHAM McCUTCHEN LLP
One Federal Street
Boston, MA 02110
(617) 951-8000

Dated: September 28, 2012