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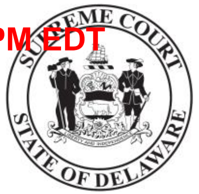

**IN THE SUPREME COURT OF THE STATE OF DELAWARE**

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| QUADRANT STRUCTURED PRODUCTS COMPANY, LTD., Individually and Derivatively on behalf of Athilon Capital Corp.,<br><br>Plaintiff Below Appellant/Cross-Appellee,<br><br>v.<br><br>VINCENT VERTIN, MICHAEL SULLIVAN, PATRICK B. GONZALEZ, BRANDON JUNDT, J. ERIC WAGONER, ATHILON CAPITAL CORP., ATHILON STRUCTURED INVESTMENT ADVISORS LLC, MERCED CAPITAL, L.P., MERCED PARTNERS LIMITED PARTNERSHIP, MERCED PARTNERS II, L.P., MERCED PARTNERS III, L.P., and HARRINGTON PARTNERS, L.P.,<br><br>Defendants Below Appellees/Cross-Appellants. | No. 210, 2016<br><br>Case Below:<br><br>Court of Chancery of the State of Delaware<br>C.A. No. 6990-VCL |

**APPELLANT'S AMENDED OPENING BRIEF**

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## NATURE OF PROCEEDINGS

Athilon Capital Corporation ("Athilon") was organized in 2004 to sell a narrow type of uncollateralized derivative contract. That product vanished from the marketplace with the global financial crisis in 2008, and by 2010 the company was insolvent and had no business, except to collect premiums (and in the event of default pay claims) on the derivatives it had earlier sold. Secondary market participants like Merced[1] and the Funds bought Athilon debt at steep discounts. In 2010, the Funds also purchased Athilon's equity. Soon after, they used that control to make self-interested transfers to affiliates in the form of over-market fees and interest.

Plaintiff-Appellant Quadrant Structured Products Company, Ltd. ("Quadrant") also bought debt. In 2011, it filed a Verified Complaint and then a Verified Amended Complaint (the "Complaint") in both an individual and derivative capacity on behalf of Athilon. The Complaint asserted claims for breach of fiduciary duties, fraudulent transfers, aiding and abetting, and breach of the implied covenant of good faith and fair dealing. It challenged certain 2010 and 2011 transactions, but urged more fundamentally that the Funds had a duty to maximize the value of Athilon's defunct enterprise by liquidating the company's

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[1] Merced Capital, L.P. ("Merced"), formerly known as EBF & Associates, LP, manages four funds now known as Merced Partners Limited Partnership, Merced Partners II, L.P., Merced Partners III, L.P., and Harrington Partners, L.P. (together, the "Funds"). Merced, the Funds, and the other defendants-below are referred to herein as "Defendants."

assets and distributing them to creditors as soon as the portfolio of derivative contracts permitted. Defendants, Quadrant alleged, were depleting corporate value through fees, interest payments, and risky investments. Before trial, the trial court rejected the challenge to this strategy, holding that fiduciaries, even of an insolvent entity, might decide to expose it to a "risk-on" strategy in the good faith exercise of business judgment. Ex. A at 51.[2]

Appellate disputes delayed the progress of the litigation,[3] and it was not until late 2014 that Quadrant obtained discovery. It emerged that Defendants' scheme was more audacious than originally imagined. The plan was not merely to engage in a risky strategy for Athilon—but rather, to cash out the insiders' debt holdings, leaving a diminished Athilon to face the risks imposed by the insiders on the balance of the company. Conceived during insolvency in 2010, Defendants' plan was to partially liquidate Athilon's assets as soon as the derivative portfolio permitted, using the proceeds to pre-pay insider-held notes. Only Athilon itself and its unaffiliated creditors would be left to "risk-on." This plan culminated in a December, 2014 debt cancellation and January, 2015 debt redemption (the "January Transaction," and together the "Debt Transactions"). When the details of

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[2] Exhibits A, B, and D to Appellant's Opening Brief are cited to herein as "Ex. _." Exhibit C, the trial court's post-trial opinion, is cited to herein as "Op."

[3] *See Quadrant Structured Prods. Co., Ltd. v. Vertin*, 2013 WL 8858605 (Del. Feb. 12, 2013); *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 106 A.3d 992 (Del. 2013); *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 93 A.3d 654 (Del. 2014) (TABLE); *Quadrant Structured Products Co., Ltd. v. Vertin*, 23 N.Y.3d 549 (N.Y. 2014).

the partial liquidation plan were finally revealed in discovery, Quadrant filed a second amended and supplemental complaint (the "SAC"). A199.

After trial, the Funds paid $40.7 million into Athilon, mooting certain of Quadrant's claims (Counts IV-V and portions of Counts I-III and X of the SAC) challenging Athilon's payments to Affiliates of excessive service fees and continued interest payments on the Junior Notes. Op. 3.[4] The trial court's post-trial opinion rejected Quadrant's challenges to the Debt Transactions as an express breach of the governing indenture (Count VII) or, alternatively, as a breach of the implied covenant of good faith and fair dealing (Counts VIII-IX). *Id*. at 33. It also rejected Quadrant's challenge to the Debt Transactions as fraudulent transfers (Count VI). *Id.* at 43. On the breach of fiduciary duty claims relating to the partial liquidation strategy, and specifically the Debt Transactions, the trial court held that Quadrant lacked standing to bring derivative claims (and related claims for aiding and abetting) (Counts I-III). *Id.* at 46.

Quadrant noticed its appeal of the Court of Chancery's post-trial opinion and Order and Final Judgment, as well as certain earlier interlocutory rulings. This is Appellant's Opening Brief.

[4] As a result of this payment, the trial court awarded Quadrant a mootness fee of $9.6 million. A1486. Defendants have noticed a cross-appeal of that fee award.

## SUMMARY OF ARGUMENT

1. **Contract:** The trial court erred by rejecting the claim that the January Transaction breached Article 4 of the Indenture. Section 4.04 prohibited Athilon's Affiliates from participating in partial redemptions. Athilon nevertheless redeemed more than half of its outstanding senior notes ($194.6 million in face value) from Affiliates for cash, excluding outsiders from the transaction. The January Transaction constituted a prohibited redemption under the Indenture. New York law, together with the text chosen by the drafters, confirms that "redemption" means the reacquisition of a security by an issuer, followed by its cancellation, as occurred here. Departing from the text of the Indenture, the trial court relied on its view of the meaning of differing redemption provisions in model forms.

2. **Implied Covenant:** If this Court rejects the first ground for appeal, then it should hold that the Debt Transactions breached the implied covenant of good faith and fair dealing inherent in every contract. Given the express terms of the Indenture, including its prohibition on insider participation in partial redemptions and in the auctions designed to ensure liquidity for creditors, any reasonable party would conclude that a covenant prohibiting partial liquidation of assets to fund the pre-payment of insider-held debt was implied and necessary to creditors' enjoyment of their express contract rights.

3. **Fraudulent Transfer:** The trial court erred by rejecting Quadrant's claim that the Debt Transactions constituted transfers made with an actual intent to hinder, delay, or defraud creditors. Designed to shift all of the insiders' repayment risk to the outsiders, the Debt Transactions were (i) concealed, (ii) made to insiders only, (iii) at an unfair price, and (iv) after litigation was commenced. Colored by its erroneous view that DUFTA did not provide creditors the right to "interfere with" the management of a solvent firm absent a contractual right to do so, the decision below failed to give appropriate effect to these badges of fraud and the intent of the Debt Transactions.

4. **Derivative Standing:** Concluding that Athilon regained solvency before Quadrant filed the SAC, the trial court erred by holding that Quadrant lacked standing to pursue the claim that the self-interested Debt Transactions breached the Defendants' duty of loyalty owed to Athilon. The claim properly relates back to the period of Athilon's deep insolvency, for it arises from the "risk-on" strategy originally challenged that, as discovery revealed, was applied only to outsider and not to insider, debt interests. Alternatively, derivative standing was warranted under, and consistent with, equitable principles. Affirmance would allow controlling fiduciaries to shield valid corporate claims from review by divesting stakeholders of standing through manipulation of the balance sheet.

# STATEMENT OF FACTS

### Formation of Athilon

Athilon was formed as a credit derivatives product company ("CDPC") for a narrow purpose: writing credit default swaps ("CDS" or "swaps"), in effect, insurance against third-party issuer defaults on senior tranches of highly rated debt. A432; A546; A556; A622. Athilon was subject to Operating Guidelines (the "OGs") set with ratings agencies. The OGs controlled operations, minimizing the risk of default on CDS, although notional exposure in the billions of dollars created a contingent liability in the hundreds of millions in 2011. A966; Op. 6. Prior to 2008, this business model was viable, and Athilon received "AAA/Aaa" credit ratings. Op. 8.

Athilon's original charter limited its permissible business to "guaranteeing or providing other forms of credit support for the obligations of its subsidiaries" and related activities. Op. 6; A546. The charter required that it conduct business "in compliance with the [OGs]," and barred amendments of its corporate purpose and the OGs except in compliance with the OGs themselves. A548; A553. The OGs lock down Athilon's capital when in financial distress. A535. After the occurrence of "suspension events," Athilon could no longer write new business. Op. 6. When suspension events were uncured, Athilon entered "runoff," where the ban on engaging in swaps, its sole business purpose, became permanent, *id.*, and Athilon

could not issue dividends or redeem debt. A578; A911; A914. In "runoff," a CDPC ceases writing new policies or paying dividends, pays out claims on its portfolio of existing contingent obligations as they mature, and then liquidates. A823; A543.

In private placement memoranda ("PPMs") distributed to market its debt, Athilon emphasized its structurally limited business. A622. The PPMs reserve only a limited path for business expansion. *Id.* Athilon might establish "related and complementary" *subsidiaries*, but only with rating agency confirmation. *Id.* Under all circumstances, Athilon "intend[ed] to operate our business in a manner that maintains Triple-A Ratings." *Id.*

**Capitalization**

Athilon raised $600 million in debt, issuing $350 million in Senior Subordinated Deferrable Interest Notes (the "Senior Notes"), $200 million in Subordinated Deferrable Interest Notes (the "Subordinated Notes"), and $50 million in Junior Subordinated Deferrable Interest Notes (the "Junior Notes"), each with maturities between 2035 and 2047. Op. 4. Reflecting Athilon's stated limitations and controlled risk, the Senior and Subordinated Notes were issued as AAA-rated auction-rate securities; that is, liquid securities that could be remarketed every 28 days. Op. 5; A533. Interest rates were extremely low,

reflecting the notes' credit quality, liquidity, and the limited and low-risk purpose to which Athilon had bound itself. A533.

The indenture for the Senior Notes (the "Indenture"), discussed in depth below, prohibited control parties from obtaining special benefits on their own notes. A720. Section 4.04 barred partial redemptions of notes held by Affiliates of Athilon.[5] A764 (excluding "from eligibility for selection from redemption," securities "owned of record and beneficially by . . . an Affiliate of the Issuer"). Section 3.06(i) precluded Affiliates from participating in the auctions. A755 ("Neither the Issuer nor any of its Affiliates may submit an Order . . . in any Auction.").

The Indenture did contemplate that Athilon or its Affiliates might acquire notes and hold them for resale. A744 ("[a]ny Security that is purchased or owned by the Issuer or any Affiliate thereof may not be resold by the Issuer or such Affiliate unless [registered under the Securities Act or other defined conditions are met]"). To permit the Issuer to trade in its own notes without triggering the prohibition against insider redemption, section 2.09 provides, "If the Issuer shall acquire any of the Securities, such acquisition shall not operate as a redemption or satisfaction of the indebtedness represented by such Securities *unless and until the*

[5] The Indenture defines "Affiliate" at A726 and "Issuer" at A731.

*same are delivered to the [Indenture] Trustee for cancellation.*" A746 (emphasis added).

**Collapse of the CDPC Business, Failure, and Runoff**

The auctions failed in 2007. Op. 5. In 2008, the CDPC industry vanished, never to return. A515-16. Athilon lost its AAA/Aaa ratings, failed to cure suspension events under the OGs, and entered permanent runoff. Op. 8. By late 2010 it had no investment grade debt or counterparty credit ratings. A434. As a result of the failed auctions, the interest rate on the Senior Notes was fixed at the one-month LIBOR (nearly zero) rate plus 2.5%. Op. 5.

**The Funds Become Creditors**

In late 2009, while Athilon was deeply insolvent and out of business, and the CDPC industry was gone, the Funds became creditors, buying more than $200 million of Senior and Subordinated Notes, at 24% and 10% of face value, respectively. Op. 8. Merced partner Vince Vertin valued the equity of Athilon at "[p]robably zero," but advocated internally at Merced that "control[ling] the destiny of [Merced's] current bond ownership" justified "over-paying for this company," A848-49, because of "*the 'benefit' that would accrue to our bonds* if we also own the equity." A838 (emphasis added). The approach, as Merced later wrote, "[a]ssumes [Merced] affiliated senior and subordinated debt extinguishment in 2014 coupled with a cash distribution in 2015, which will be applied to senior

debt then subordinated debt." A895. The plan was simple: use Athilon's treasury to pre-pay the Funds' noteholdings—and *only* the Funds' holdings.

To carry out the plan, the Funds acquired the Junior Notes, which contained control rights. A519. Then, in August, 2010, the Funds purchased equity control. Op. 9.[6] Through control, Merced planned to avoid the long maturity date of the Funds' notes either through early redemption or by exchanging them for preferred stock that could be cashed out decades earlier through "a really large dividend." A838; A524-25. The payoff could not occur while CDS were outstanding (lest it trigger CDS defaults), but the CDS would roll off decades before debt maturity. A838; A841; A856.

Merced installed a board of directors (the "Board") suited to its creditor strategy, appointing outside directors who understood their focus would be extracting value for creditors of the Funds. A485; A506-08; A512. Merced would buy as much Athilon debt it could acquire at a sufficient discount, then use insider control and Athilon's assets to advance the effective maturity of that debt. A four to five year horizon on the ebbing CDS portfolio matched nicely with the Funds' internal "harvest" obligations to investors. The central objective to pre-pay the insiders' notes was a "persistent and consistent" strategy from 2010. A528; A512.

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[6] The Funds purchased the equity of Athilon Group Holdings, Inc., the parent entity ("AGH"). A438.

The Board never created any business plan for Athilon other than the planned pre-payment from a liquidation of Athilon's assets. A182; A508; A992.

**Athilon's Insolvency**

Athilon was massively insolvent in 2010, when Merced launched its strategy to use control to pre-pay the Funds' notes, *see* Op. 10, and insolvent when the action was commenced in 2011, Op. 1, and the trial court's opinion adopted July, 2014 as the date Athilon returned to solvency. Op. 39. Ignoring contingencies, Athilon had about $427 million in assets and $600 million in liabilities in 2010, Op. 10, and no operations to make up this shortfall. In the short term, Athilon mitigated the imbalance somewhat by converting cash to risky insurance-related securities ("<u>XXX Securities</u>"), *see id.*, but because it never wrote any new CDS, and over time its portfolio of revenue-generating CDS dwindled, it could not make up the difference on the asset side. However, the partial liquidation strategy permitted Defendants to manipulate Athilon's balance sheet on the debt side.

**Excessive Management Fees and Non-Deferral of Interest**

Merced saw management fees as a pipeline of equity "dividends." A835; A838. Its analyses valued the asset management and license fees as "equity distributions," *see* A847, and predicted that management fees (referred to as "contractual equity payments"), together with interest payments on the notes, would cover the "majority" of its "cost basis" in the total Athilon investment.

A893. Over four years, Athilon overpaid $24,128,760 for management services, despite the contraction in Athilon's business. A942; A1362; A869; A967; A1026; A1131.

The Funds extracted value during Athilon's insolvency in other ways, too. Athilon had the right to defer interest payments on the Junior Notes (then out-of-the-money and held by the Funds), but refused. Op. 14-15. For the three years that the Funds held the Junior Notes (and Merced controlled Athilon), deferral would have benefited Athilon because the interest would never have been paid.

**Quadrant's Noteholdings and Demand**

In 2011, Quadrant purchased Senior and Subordinated Notes. Op. 13. Vertin told Quadrant's CEO, Eugene Park, that once Athilon's last swap rolled off, Merced would have in Athilon a "SPAC" or a "blank check" to repurpose the company. A534-35; A841. Park and COO Martin Nance nevertheless concluded that as a structurally limited vehicle in permanent runoff under the OGs, Athilon had no alternative but to liquidate when the last swap matured, returning capital to stakeholders in the order of priority. A513-15; A535-36. At minimum, Park believed that the Funds' significant debt investment would incentivize Merced to monetize the debt at the end of runoff, and that *pari passu* creditors like Quadrant would enjoy a ratable benefit. A535-36. He was half right. Merced did intend to monetize its *own* debt investments by liquidating corporate assets, but the evidence

showed a plan to leave all others exposed to Athilon's high-risk investments.

In 2011, Quadrant demanded that the Board reduce the management fee to market levels. A947-62. The Board rejected Quadrant's demand. Op. 15.

**2010-2013: The Board Sets the Stage for Note Pre-Payment**

Because Athilon notes are subordinate to CDS, Merced's pre-payment plan had to abide swap termination, but Merced set the plan in motion from early days. Soon after the 2010 acquisition, Merced outlined the "extinguishment/dividend" pre-payment strategy for the Funds' notes. A897. "*All* [Merced] debt holdings extinguished at the end of 2014, and subsequently, Athilon makes dividend to [Merced]," the Merced team wrote, which would provide the Funds with the "[b]est simple cash return" for their debt. A860-61 (emphasis added).

With a "risk-off" strategy to cash the Funds out of their notes within four to five years, Merced initiated the flip side of the plan—"risk-on" for outsiders. The Funds traded their own holdings of risky "XXX Securities" for Athilon's cash, leaving enough cash in place to support the insider pre-payment in 2015. In 2012 and 2013, Athilon husbanded cash and other liquid investments to execute the insider "risk-off" play. A1386; A521.

**The Junior Note Cancellation**

In December, 2013, shortly after the rate on the Junior Notes dropped from 6.27% to LIBOR + 2.5%, and after the Funds had received an amount of interest

sufficient to cover the purchase price for the Junior Notes, the Funds cancelled them. Op. 5, 18; A497; A502; A530. The "cancellation" added $50 million of nominal balance-sheet "solvency," Op. 37, but the Funds merely exchanged the notes for preferred AGH shares with a liquidation preference and preferred dividend designed to replicate the terms of the Junior Notes. A1122. As Merced explained to the Funds' advisory board, its equity control would ensure that the Funds would receive distributions on the shares, effectively pre-paying the "cancelled" notes long before their stated maturity. A1055; A528-30. The Board rubber-stamped the transaction, forming no special committee to assess its merit. A1056-59.

**Merced Proposes to Accelerate the Plan Before it Is Discovered**

After years of appellate dispute, the action came alive on July 3, 2014 when the Court of Chancery opened discovery. Vertin rushed to present to the Board an informal proposal that Athilon acquire *all of the Funds' noteholdings*, a face amount of $351 million at premium prices. A1159. This would have left outside noteholders entirely at risk of Athilon's portfolio of XXX Securities, eliminating all such risk for the self-dealing Funds. Vertin's gambit belied the premise (later advanced at trial) that Athilon had become an "asset manager" profiting on the spread between its cheap capital and returns on more risky securities, for Vertin wanted to strip out more than half of that capital at a stroke. In Merced's hands,

Athilon had become a mine from which assets could be stripped to pre-pay insider debt.[7]

Counsel had explained to the Board that discovery would soon begin and the facts likely would become known. A481; A523. The Board resolved that if Merced were to present a formal debt proposal, the Board would form a special committee of independent directors and encourage it to hire an investment bank and a law firm. A1165. No such committee was ever formed. No one questioned whether Athilon would generate better profits by eliminating two-thirds of its "best asset" (its "cheap" capital). Half of the notes Vertin proposed to redeem carried no tax benefit and thus were no different than the notes held by outsiders, but no one questioned that either. A522. In October, Merced made a formal proposal that Athilon redeem all $216.2 million (face) of Senior Notes held by the Funds for $198,904,000, and all $95.9 million (face) of their Subordinated Notes for $77,679,000. A1166. The redemption would liquidate $276.5 million of Athilon's low-interest capital for the benefit of insiders.

**Dividing the Proposal into Steps**

Director Brandon Jundt was nervous about the Merced proposals precisely because of Athilon's financial distress. *See* Op. 20; A332. He told Vertin the problem could be "fixed" by splitting the transaction into two steps. A337-38. In

[7] Athilon's CEO described the low-interest, long-dated notes as Athilon's "best asset." A348. At a stroke, it abandoned a large stake of that "asset" to the Funds.



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the first, the Funds would cancel $117.5 million in Senior and Subordinated Notes (exchanging them for preferred shares of AGHAP and AGH). This "cancellation" would again boost notional balance-sheet solvency to clear the way for the second step, by which the Funds would receive pre-payment of $194.6 million (face) of Senior Notes, A1381 (handwritten note "solvency clear"). It would also leave the Funds in position to later receive pre-payment of the exchanged notes as well, through preferred distributions. A1073; A1088; A1095. Defendants also believed, and intended, that the cancellation would "dramatically weaken litigation plaintiff's case." A1381. Vertin and Jundt referred to the solution as the "one pocket to another" strategy. A482; A488.

On December 22, 2014, Vertin launched step one, soliciting the members' approval "***<u>TODAY.</u>***" A1097 (emphasis in original). The Board obliged immediately. It never formed a "special committee," hired no consultants, and never met to assess the fairness of the exchange or determine what promises of future dividends had been made. A487; A499. The Funds exchanged $117.5 million in Senior and Subordinated Notes for preferred AGH shares on terms indistinguishable from the "cancelled" notes, except that the shares contained an early redemption feature that permits immediate redemption *once the swaps terminate*. A1182; A1194. The December "cancellation" cleared the way for step two, the note pre-payment that Vertin had pursued since 2010. A492 ("[T]he

December transaction fits. You know, the stumbling block that, you know, I personally had as, you know, one of the independent directors, that the company had negative GAAP book value equity. By doing this, it was fixed.").

**The January Transaction**

On January 8, 2015, the Funds "offered" to accept $179,032,000 in Athilon cash for Athilon's reacquisition of Senior Notes held by the Funds, in the face amount of $194,600,000. A1250. Four Board members convened a perfunctory call and unanimously approved the January Transaction. A1254.

Merced "offered" 92% of face. Brokers were offering to sell the same notes in the marketplace at 52% of face, A1257, and *the morning that Merced made its "offer,"* its *CEO, Mr. Gonzalez, received an unsolicited offer to sell Senior Notes to Athilon at "70-something" percent of face.* A498; A1252. Gonzalez did not disclose this offer to the Board. A498. The Board prepared no solvency analysis, did no diligence, convened no special committee, hired no advisors, and did not negotiate the price or terms. A180; A483; A498. Negotiation "wasn't worth the brain damage." A498. The redemption closed in January, 2015, and almost a third of Athilon's "best asset" (its low-interest capital) was swept to the Funds. The Senior Notes were delivered to the indenture trustee for cancellation. Op. 29; A1256. The indenture trustee raised no concerns and complied. A500.

**Holders Pursue Remedies**

Athilon did not warn noteholders (or the rating agencies) of the Debt Transactions and concealed them in discovery, disclosing them only after their consummation and a successful motion to compel. A187-96. In March and April, pursuant to section 7.06 of the Indenture, Quadrant and other holders (holding more than 50% of the relevant notes) requested that the indenture trustee pursue remedies for breach of the Indenture. Op. 29; A1258; A1304. No doubt realizing too late the implications of its own acceptance of the notes for cancellation, the indenture trustee declined. Op. 29; A1350; A1352.

**The Rating Agencies React**

In March, 2015, Moody's learned of the December debt "cancellation" and the January Transaction. A344. After an inquiry, on April 20, 2015, *Moody's withdrew its ratings on the remaining Senior and Subordinated Notes* because of "decisions . . . to distribute capital . . . to selected investors in connection with the cancellation and retirement of $312 million of Senior Subordinated and Subordinated notes . . . *in a manner that is not contemplated by the deal documentation.*" A1355 (emphasis added). Standard & Poor's issued a similar statement on May 14, 2015. A1377.

**Athilon Today**

Athilon carried out one phase of insider note pre-payment in January, 2015, and has been readied by the insiders to execute the next upon termination of the swaps, through liquidation of assets and distribution of the proceeds as preferred "dividends." Athilon remains in permanent suspension under the OGs, and the last swaps expire in June, 2016. A507; A914. Since Merced's takeover, the Board has never formally considered any new line of business for Athilon. A992; A508; A182.



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# ARGUMENT

## I. THE TRIAL COURT ERRED BY REJECTING THE CLAIM THAT THE JANUARY TRANSACTION BREACHED THE INDENTURE'S REDEMPTION RESTRICTIONS.

### A. Question Presented.

Whether Article 4 of the Indenture prohibiting Athilon from redeeming notes held by Affiliates barred a transaction in which (i) Athilon's controlling shareholders caused it to reacquire Athilon debt securities from Affiliates (and only Affiliates) decades in advance of maturity, with cash obtained from liquidating Athilon's assets; and (ii) Athilon then delivered the reacquired notes to the indenture trustee for cancellation, eliminating the debt from Athilon's balance sheet. Preserved at A456; A399-404; A1421-26; A1476-79.

### B. Scope of Review.

The question presented turns on interpretation of the Indenture based on the facts as found by the trial court, and is therefore a legal issue subject to this Court's *de novo* review. *SI Mgmt. L.P. v. Wininger*, 707 A.2d 37, 40 (Del. 1998). The Indenture is governed by New York law. A798.

### C. Merits of Argument.

Athilon's January, 2015 reacquisition of Senior Notes from the Funds for $179 million of Athilon's cash, and immediate delivery of the same to the indenture trustee for cancellation, *see* Op. 29; A1256, breached Article 4 of the Indenture.

### 1. The Trial Court Imported a Meaning of "Redemption" that Contradicts New York Law and the Text of the Indenture.

Section 4.04 excludes "from eligibility for selection from redemption" securities "owned of record and beneficially by . . . an Affiliate of the Issuer," where the issuer chooses to redeem fewer than all of the securities of any series. A764. The Indenture also delegates to the indenture trustee the *sole* power to select participants in any partial redemption. A763.

The Court of Chancery appeared to agree that the January Transaction, *if a redemption*, would have breached the Indenture, but the court described the January Transaction as a permissible "voluntary transaction," contrasting it with "mandatory redemption[s]" that it said were governed by Article 4. *Id.*

The Indenture uses "redemption" frequently, but never defines the term. *See* A720. Nor does it use the term "mandatory" (or any similar term) to modify any class of redemptions. *Id.* Citing no authority, the trial court apparently thought that "redemption" could only mean Athilon's *forcing* of a noteholder to give up its notes on contractually mandated terms. Op. 26.[8] To be sure, redemption often is "mandatory," occurring when an issuer takes a security—generally in the money—that the holder would prefer to retain. But under New York law, "redemptions" are not limited to that class of transactions.

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[8] "As I read it, Article IV authorizes one type of mandatory redemptions and excludes treasury securities from the universe of Notes available for mandatory redemption." *Id.*

Because the Indenture does not define "redemption," courts begin with the term's customary meaning under New York law, construing the text in light of the contract as a whole, not in isolation. *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 23 N.Y.3d 549, 559-560 (N.Y. 2014); *Kass v. Kass*, 91 N.Y.2d 554, 566-67 (N.Y. 1998). Standing alone, the word "redemption" means no more and *no less* than the "reacquisition of a security by an issuer." *Chesapeake Energy Corp. v. Bank of N.Y. Mellon Tr. Co., N.A.*, 773 F.3d 110, 116 (2d Cir. 2014) (citation and internal quotation marks omitted); *see also Blue Ridge Invs., LLC v. Anderson-Tully Co.*, No. 04-3777, 2005 WL 44382, at *1 n.1 (S.D.N.Y. Jan. 10, 2005). *Black's Law Dictionary*, which gives the root meaning of the word as "to buy again," defines "redemption" in the context of securities this way: "3. Securities. The reacquisition of a security by the issuer." BLACK'S LAW DICTIONARY 1468 (10th ed. 2014). In *Chesapeake Energy*, the Second Circuit, construing New York law, explored the "normal meaning" of "redemption:"

> "Redeem" (in the verb form) or "redemption" (in its noun form) refers to "[t]he reacquisition of a security by the issuer." *Black's Law Dictionary* 1390 (9th ed. 2009) (defining "redemption" as "[t]he reacquisition of a security by the issuer"); *Barron's Dictionary of Finance and Investment Terms* 587 (8th ed. 2010) (defining "redemption" as "repayment of a debt security or preferred stock issue, at or before maturity"); *Webster's New International Dictionary* 2085 (2d ed.1934) (defining "redeem" as "[t]o regain possession of by payment of a stipulated price; to repurchase").

773 F.3d 110 at 116. The trial court opinion did not address these authorities.

Section 2.09 confirms this meaning. The key phrase of Section 2.09 begins: "If the Issuer shall acquire any of the Securities, such acquisition shall not operate as a redemption or satisfaction of the indebtedness represented by such Securities *unless and until* . . . ." This shows that the Indenture begins with the root concept of *acquisition* by the issuer: absent the modification following the "unless and until" clause, *acquisition* ordinarily would be "redemption." In the balance of the clause, the parties modify common-law rule by carving back a class of Issuer acquisitions that are not redemptions. The full phrase is:

> If the Issuer shall acquire any of the Securities, such acquisition shall not operate as a redemption or satisfaction of the indebtedness represented by such Securities *unless and until the same are delivered to the [Indenture] Trustee for cancellation.*

A746 (emphasis added). Thus, had Athilon reacquired the Senior Notes and held them for resale (so that the corporate indebtedness continued to exist), there would have been no redemption. But the opposite was also true. An acquisition of Athilon's notes *would* be a redemption if the securities were delivered to the indenture trustee for cancellation. "Unless" means "except on the condition that: under any other circumstance than." *See* "*Unless*," MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY (11th ed. 2004), www.merriam-webster.com.[9] Athilon's

[9] So, too, with "until." *See Until*, OXFORD ENGLISH DICTIONARY (3d. ed. 2009), *available at* www.oed.com ("until" usually implies the cessation or reversal of the negative condition at the specified time).

acquisition would not be a redemption "except on condition that" the securities were cancelled.

The conjoined phrase worked on several levels. First, it let Athilon buy and sell its notes in the market (whether or not from Affiliates), provided that it did not "deliver them to the Trustee for cancellation." A746. Second, read in conjunction with section 4.04, it ensured fairness in any partial redemption by prohibiting pre-payment of any insider-held debt prior to payment of debt held by outsiders. And third, the section responded to New York's "delivery rule."[10]

Athilon reacquired the securities from Affiliates, A726, and on December 23, 2014 and January 13, 2015, Athilon delivered its debt securities to the indenture trustee "for cancellation." A1249; A1256. The January Transaction was a partial redemption of Senior Notes held by Affiliates and breached section 4.04 the Indenture.

**2. The Trial Court Departed from the Text of the Indenture in Favor of Model Forms.**

Ignoring both the plain meaning rule and the rule that ambiguity in an indenture should be construed against the issuer, *see Prescott, Ball & Turben v. LTV Corp.*, 531 F. Supp. 213, 217 (S.D.N.Y. 1981), the trial court instead relied on the Model Debenture Indenture Provisions, American Bar Foundation,

[10] At common law, delivery of debt to the issuer with the intent to discharge the obligation cancels that debt. *See Concord Real Estate CDO 2006-1, LTD. v. Bank of Am. N.A.*, 996 A.2d 324, 332 (Del. Ch. 2010) *aff'd*, 15 A.3D 216 (Del. 2011).

*Commentaries on Model Debenture Indenture Provisions* (1971) ("*Commentaries*") to adopt a more restrictive definition of "redemption." Op. 25-30. The *Commentaries* "are no substitute for construing the agreement." *See Concord Real Estate CDO*, 996 A.2d at 331; *Quadrant*, 23 N.Y.3d at 564-65 (discounting the *Commentaries'* explanation of what parties typically intend, in favor of the words actually used). Reviewing this very Indenture, the New York Court of Appeals held that "where the language of the contract is clear," courts may not look beyond "the terms of the document to give effect to the parties' intent." *Quadrant*, 23 N.Y.3d at 564. The trial court erred in using the model form to impose a meaning that is inconsistent with the plain language of the Indenture and New York law.[11]

**a. The Model Rules**

Even if they were properly considered, the model indentures do not support the trial court's decision. The model indentures address partial redemptions. Notice must be given to the trustee (for it, not the issuer, selects the notes to be redeemed), and a variety of rules may govern the selection process. *See, e.g.*, *Commentaries* at 492-502. The customary practice is for "treasury debentures"—notes held by the issuer—to be *eligible* for a partial redemption. Op. 28; *Commentaries* at 494. Atypically, "where treasury debentures are not eligible for

[11] In the briefing below, neither Quadrant nor Defendants made any argument based on section 3.09 of the *Commentaries*.

redemption," the *Commentaries* provide, "they may nevertheless be discharged by delivery to the Trustee with a request for cancellation, *as provided in [model] Section 309*." *Commentaries* at 494 (emphasis added). The opinion highlighted this comment, but did not examine the actual text of section 309:

> All Debentures and coupons surrendered for payment, conversion or *redemption* shall, if surrendered to the Company . . . be promptly cancelled by it. The Company may at any time deliver to the Trustee for cancellation any Debentures . . . the Company may have acquired in any manner whatsoever, and all Debentures so delivered shall be promptly cancelled by the Trustee.

*Commentaries* at 191-92 (emphasis added). The first sentence provides that securities surrendered to the Company, whether for payment, conversion, or redemption, *shall* be delivered to the trustee and cancelled. The second specifically grants the issuer an additional right to deliver for cancellation securities that it may have "acquired in any manner whatsoever." The *Commentaries* explain that where an indenture excludes insider-held notes from redemption, model section 309 nevertheless allows the issuer to deliver to the trustee for cancellation "debentures acquired by purchase on the market that the Company desires to render no longer outstanding." *Commentaries* at 192, 494. The conclusion that an issuer may cancel notes acquired on the market without

effectuating a redemption thus turns on the second sentence of section 309 of the model form.[12]

Section 2.09 is worded differently. It provides no similar authority for cancellation of securities "acquired in any manner whatsoever." Instead, it equates delivery of reacquired securities for cancellation with *both* redemption *and* debt satisfaction. The trial court noted the reference to "satisfaction," and concluded that section 2.09, like model section 309, was merely an administrative provision intended only to overcome the delivery rule by imposing a note cancellation prerequisite before "satisfaction of the indebtedness." Op. 30.

Section 2.09 indeed accomplishes that result. *See, e.g.*, A744 § 2.07(d). But that is not all the text accomplishes. The trial court's decision renders redundant the word "redemption" in the same phrase.[13] By including that word—absent from the model—the drafters *also* ensured that limits on redemption (including section 4.04's atypical prohibition against Affiliates participating in partial redemptions) could not be circumvented by dubbing a transaction a "repurchase." The text of section 2.09, unlike the different text used in model section 309, confirms that reacquisition by Athilon of its Affiliates' securities is both a redemption *and* a

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[12] The cancellation provision of the Revised Model Simplified Indenture published in 2000 (which largely mirrors that of the 1983 ABF Model Indenture) is similar to section 309. *See Revised Model Simplified Indenture*, 55 BUS. LAW. 1115, 1130 (2000) (section 2.12); *see also Model Simplified Indenture*, 38 BUS. LAW. 741, 753 (1983) (section 2.11).

[13] The trial court's attempt to reconcile section 2.09 as merely defining when a redemption is "complete," Op. 30, is also inconsistent with section 4.03 of the Indenture. A763.

satisfaction, if that acquisition is followed by delivery for cancellation, as occurred here. Had Athilon acquired its notes (from Affiliates or third parties) and held them as outstanding debt in its treasury, the transactions would not have been redemptions and would not have breached section 4.04. But the debt would have remained outstanding, and Athilon would have remained insolvent on a balance-sheet basis. Such a transaction would not have accomplished Defendants' goal of avoiding judicial review by eliminating Quadrant's standing, *see* A1380-85, and its outside directors were unwilling to engage in a self-dealing debt repurchase while Athilon was balance-sheet insolvent.

The Court of Chancery's reading was illogical in two more respects. If "redemption" means only a transaction forced on the noteholder by the issuer, there would be no need to exempt Affiliates from redemptions, particularly where, as here, the Affiliates control the company. By definition, the Issuer is never going to "force" its own Affiliate. Because redemption means any reacquisition by the issuer of its own securities (forced or unforced), then in light of the issuer's exclusive control of whether to pursue a redemption, section 4.04 is properly understood as a protective provision that prevents insiders from engineering a redemption for their own benefit unless all unaffiliated creditors have first been redeemed.

The second point flows from the terms of the Senior Notes.[14] The maturities of the Senior Notes are extremely long and, with "relatively few covenants," the notes are "borrower-friendly," but the auction feature ensured investors a measure of liquidity. Op. 5. Consistent with the overall contractual design, the Indentures sought to ensure liquidity for outside creditors through the auctions, and to preclude Athilon from manipulating the pricing of the notes or shortening their maturity for Affiliates. Absent amendment of the Indentures, insiders could not receive a priority return of debt capital. *See supra* Facts at 7.[15]

### 3. The January Transaction Breached the Indenture.

Athilon *redeemed* $194.5 million in face amount of Senior Notes in January, 2015 upon reacquiring and delivering the securities to the indenture trustee for cancellation. The redemption violated section 4.04 of the Indenture. The trial court's decision should be reversed and the case remanded for the determination of the appropriate remedy.

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[14] In the Commentaries to the Revised Model Simplified Indenture published in 2000 by the American Bar Association, the authors note that "[r]edemption provisions, like subordination provisions, are now more likely to be negotiated in light of specific facts relevant to an issuer than was true in 1983." *Revised Model Simplified Indenture*, 55 Bus. Law. 1115, 1181 (2000).

[15] It was foreseeable that the Issuer might condition a redemption on amendment to permit ratable participation by insiders. Quadrant never objected to ratable payment. A958.

## II. ALTERNATIVELY, DEFENDANTS BREACHED THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING BY PRE-PAYING ONLY AFFILIATED CREDITORS THROUGH PARTIAL LIQUIDATION.

### A. Question Presented.

Whether the Court of Chancery erroneously rejected Quadrant's alternative claim that if the Debt Transactions did not expressly violate the Indenture, it breached the implied covenant of good faith and fair dealing, which prohibited the Issuer from effecting a partial liquidation of its assets to pre-pay debt held by Affiliates at prices above fair market value. Preserved below at A456-57; A404-06; A1428; A1480.

### B. Scope of Review.

The trial court failed to address Quadrant's alternative implied covenant claim in any meaningful way, thus the Court should review the claim *de novo*. *Ceccola v. State Farm Mut. Auto. Ins. Co.*, 58 A.3d 982 (July 26, 2012) (TABLE), *aff'd*, 58 A.3d 982 (Del. 2012) (TABLE).

### C. Merits of Argument.

If the January Transaction was not a "redemption" within the express meaning of section 4.04, the Debt Transactions nevertheless violated the implied covenant of good faith and fair dealing in the Indenture.

As a New York contract, the Indenture contains an implied covenant that "neither party shall do anything which will have the effect of destroying or injuring

the right of the other party to receive the fruits of the contract." *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389 (N.Y. 1995) (citation and internal quotation marks omitted). A covenant is fairly implied in an agreement when a reasonable person, reviewing the express terms, would understand an implied term to be necessary to the enjoyment by each party of its rights under the express terms. *511 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 98 N.Y.2d 144, 153 (N.Y. 2009).

Quadrant argued, in the alternative, that the Indenture should be interpreted to include an implied covenant precluding Athilon from partially liquidating its assets to fund preferential debt pre-payments for insiders. A404. This implied covenant flows from the express terms of the Indenture. The notes had thirty- and forty-year maturities but were intended to be highly liquid. The express terms show a contractual intent to bar insiders and their Affiliates from gaining any special liquidity benefit for their debt, and an intent that liquidity be allocated fairly and ratably, whether through the auctions, *see* A755 § 3.06(i) (prohibiting the issuer and its affiliates from submitting orders in any auction), A751 § 3.05(ii) (auctions must be conducted "competitive[ly]" and "in a commercially reasonable manner"), or through early payment of maturities. *See* A764 § 4.04 (prohibiting "either (a) the Issuer or (b) an Affiliate of the Issuer" from participation in redemptions); A762 § 4.02 (vesting the trustee with power to allocate partial redemptions).

This Court has explained that a party may "invoke the [implied] covenant's protections" if the terms of the parties' express agreement demonstrate that the parties "would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter." *Dunlap v. State Farm Fire and Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) (citation and internal quotation marks omitted). Thus the question posed by the implied covenant is this: Had the drafters of the Indenture thought to address the challenged conduct with an express contractual provision, how would they have addressed it, consistent with the express terms of their agreement? The evidence showed that (a) the Senior Notes' long maturities originally were notional, because an auction scheme gave outside holders (but not insiders) liquidity every twenty-eight days, Op. 5; A533; (b) this liquidity (and high credit quality) was reflected in the low pricing of the notes, A533; (c) the auctions had failed and thereafter there was no significant liquidity for holders of the bonds, *see supra* Facts at 9; (d) the tightly-constricted business model described in the PPMs had failed and Athilon had permanently lost its AAA ratings, *see id.*; (e) insiders had acquired 100% of the equity and a majority of the debt, at extremely low prices, and converted Athilon into an investment company holding illiquid and risky securities, *see* Op. 10; A534-35; (f) insiders proposed to sell off the most liquid of Athilon's assets—amounting to a third of the company—

and use the funds to *pre-pay* only their own debt, *see supra* Facts at 15; and (h) they proposed to do so at prices well above market value, *see supra* Facts at 17.

The drafters of the Indenture, who prohibited insider creditors from participating in the auctions designed to provide liquidity to noteholders, A755 (section 3.06(i)), and from participating in any partial redemption, A764 (section 4.04), would hardly have permitted insiders to liquidate Athilon's assets and pay themselves a premium for their notes simply because dubbed a "repurchase." Nor would any reasonable investor believe such conduct would be permitted. Quite the opposite, the benefit of the express covenants in sections 3.06(i) and 4.04 is that liquidity is to be afforded first to outsiders and allocated fairly and equitably.

The trial court apparently rejected the claim simply because there was no express prohibition. *See* Op. 24. That logic is circular. A proper analysis of Quadrant's alternative implied covenant argument should have acknowledged that inherent in section 4.04's restriction on self-interested redemptions and the other terms of the Indenture was the reasonable expectation that Athilon would not liquidate assets to pre-pay Affiliates' debt at premium prices while unaffiliated holders were required to hold Athilon's risky long-term debt to maturity.

There can be no dispute that the Debt Transactions violated this implied covenant. They were conceived to benefit insiders by allowing them to harvest their investment in Athilon's debt while denying the same liquidity to unaffiliated

investors. A860-61; A482; A488. Defendants improperly self-dealt even as they urged in litigation that the Indenture gave outside creditors no right to immediate liquidity. Their public claim that they had the legal right to subject Athilon to a "risk-on" strategy, coupled with their concealed plan to "risk-off" for themselves, was the height of bad faith. A reasonable person, interpreting the Indenture, would conclude that a prohibition on such preferential treatment of Affiliates was necessary to the unaffiliated creditors' enjoyment of their bargained-for contractual rights, including the right be redeemed before any insider redemption may occur and the right to fair and ratable treatment in debt transactions. If relief is denied on the express covenant, this Court should reverse the trial court and find that the Debt Transactions breached the implied covenant of good faith and fair dealing in the Indenture.

## III. THE TRIAL COURT ERRED IN CONCLUDING THAT DEFENDANTS DID NOT INTEND TO HINDER, DELAY, OR DEFRAUD ATHILON'S CREDITORS.

### A. Question Presented.

Whether, when it concluded that the Debt Transactions were not transfers made with actual intent to hinder, delay, or defraud creditors, the trial erred by: (i) ruling that "[u]nless a creditor bargains for an applicable contract right, the creditor does not have the ability to interfere with the operations of a solvent firm," Op. 43, (ii) failing to give effect to the rebuttable presumption of intent applicable to insider transactions, and (iii) failing to consider and properly apply each of the badges of fraud established at trial. Preserved at A455; A459; A415-18; A1431-34.

### B. Scope of Review.

The trial court's application of an erroneous legal standard is a question of law, which this Court reviews *de novo*. The trial court's conclusion that Defendants lacked the requisite intent under DUFTA was based on its application of an erroneous legal standard and its failure to properly apply legal principles to the facts. Whether viewed as a question of law or a mixed question of law and fact, the standard of review is *de novo*. *See SmithKline Beecham Pharm. Co. v. Merck & Co.*, 766 A.2d 442, 448 (Del. 2000); *Zirn v. VLI Corp.*, 681 A.2d 1050, 1055 (Del. 1996).

### C. Merits of Argument.

The trial court found that through the Debt Transactions, Defendants intended to reduce Athilon's cash and "arguably" increased the risk of default faced by unaffiliated creditors. Op. 43. It ruled that this conduct was not an actionable claim under DUFTA because, "[u]nless a creditor bargains for an applicable contract right, the creditor does not have the ability to interfere with the operations of a solvent firm." *Id.* This ruling reads out of existence 6 *Del. C.* § 1304(a)(1), which permits the avoidance of a transfer made "[w]ith actual intent to hinder, delay or defraud any creditor of the debtor," and requires neither a finding of insolvency nor proof of breach of contract. Rather, Section 1304(a)(1) provides an independent statutory basis available to remedy any transaction entered into with a purpose to harm creditors, regardless of contract or solvency. The evidence showed such a transfer.

The trial court's legal error prejudiced its application of the statutory badges of fraud. Where a transfer takes place between a company and its insiders, the burden of proof shifts to the insiders to overcome a presumption of fraud. Op. 41-42. Thus that burden rested with Defendants here. The trial court failed to give effect to it, and further erred by failing to consider or give appropriate effect to each of the applicable badges of fraud established by the record.

Because defendants rarely admit to bad intent, courts rely on "badges of fraud" to prove intent indirectly. DUFTA enumerates possible badges of fraud, including whether the transfers were concealed, made to insiders, made for unfair value, made while the company was insolvent, or made while litigation was pending. 6 *Del. C.* § 1304(b). "The confluence of several of these factors, without the presence of all of them, is generally sufficient to support a conclusion that one acted with the actual intent to defraud." *See Kilber v. Wooters*, 2007 WL 1756595, at *4 (Del. Ch. June 6, 2007).

The trial court considered two badges of fraud: that the Debt Transactions (i) were offered to insiders only, and (ii) occurred after the commencement of litigation. Op. 42. Two more badges were not considered or improperly rejected. First, the January Transaction was unfairly priced. Athilon paid its affiliates $.92 on the dollar for Senior Notes, when (a) the record reflected a market price of 52% of face, A1107, and (b) Athilon received an unsolicited offer to sell Senior Notes at roughly 70% of face on the day before the Board approved the 92% repurchase, and failed to disclose that offer to the outside directors. A498; A1252. The Board conducted no diligence, hired no advisors, and did not negotiate Merced's terms. A180; A483; A498. As a consequence, the price paid was inflated by at least 25%. The trial court gave no consideration to this badge.

Second, the trial court did not properly consider Defendants' active concealment. The opinion acknowledged that Defendants hid their plans after being served with discovery requests, improperly withholding discovery until *after* the January Transaction closed. Op. 42 (finding Defendants "were neither open nor forthright about their preparations for the January 2015 Repurchase").[16] Yet the trial court did not treat this concealment as a badge of fraud, because it thought the concealment was remedied through discovery sanctions. This was plain error. Active concealment in the face of a legal obligation to disclose reflects the transferor's fraudulent intent at the time of the transfer, regardless of whether its concealment is subject to a later judicial remedy. The trial court also commented that Athilon's concealment seemed "driven more by" Defendants' attorneys. *Id.* No evidence supported this supposition, but even if accurate, it provides no excuse, because a party "must be deemed bound by the acts of his lawyer-agent." *See Gebhart v. Ernest DiSabanto & Sons, Inc.*, 264 A.2d 157, 160 (Del. 1970).

Section 1304(a)(1)'s actual intent standard leaves open a class of transactions that injure the creditor body outside proof of insolvency.[17] Here the harm to

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[16] The trial court earlier characterized the objections used to conceal the planned January Transaction from Quadrant and the trial court as "screwball" and "silly stuff." A133.

[17] Whether Athilon was insolvent at the relevant time was hotly disputed at trial. The trial court, while agreeing that Athilon had previously been insolvent, rejected Appellant's evidence that Athilon continued to be insolvent as it launched the two-step Debt Transactions in December, 2014. Because this determination was fact intensive, Appellant has not appealed the rejection of the constructive fraudulent transfer counts.

creditors was a shifting of repayment risk. Every obligor imposes on its creditors some risk of nonpayment. Having departed from its disclosed business model with long-dated, illiquid notes, Athilon had considerable risk, reflected in the discounts to its note pricing. Prior to the January Transaction, its repayment risk—the risk that it would not be able to repay principal in thirty years—was borne equally by insiders and outsiders. That risk was mitigated to some extent by Athilon's most reliable assets—such as cash. In the January Transaction, the insiders took substantially all the cash and eliminated all of their payment risk. The outsiders were left with all of the repayment risk and access to none of the less-risky assets.

Defendants understood the Debt Transactions would shift risk from Affiliates to outside creditors. The transfer was (i) concealed, (ii) made to insiders only, (iii) at an unfair price, (iv) after litigation was commenced. Rather than giving appropriate weight to these four factors and to the flexibility in DUFTA, which permits courts to impose an equitable remedy for intentional fraudulent transfer without regard to insolvency,[18] the trial court rejected the fraudulent transfer claims based apparently on its incorrect belief that the intent to reduce a company's cash position did not constitute improper intent under DUFTA. Op. 43.

[18] The trial court could unwind the transfers altogether or, if it found the Indenture did not bar the insiders from participation, order the terms to be offered ratably to insiders and outsiders alike.

In short, the trial court's conclusion was based on an erroneous legal premise, failed to give effect to the presumption of fraud applicable to insider transactions, and improperly ignored the other indicia of intent established at trial. Had the trial court properly considered these badges of fraud, Defendants would not have overcome the presumption of fraud. The trial court's failure adequately to address or give weight to those badges proven at trial, and thereby to hold Defendants to their burden of proof, was reversible error. *Cf. Homestore, Inc. v. Tafeen*, 886 A.2d 502, 506 (Del. 2005) (reversible error "when a relevant factor that should have been given significant weight is not considered"). Accordingly, this Court should reverse and remand for the entry of an appropriate remedy.

## IV. THE COURT OF CHANCERY ERRED BY CONCLUDING THAT QUADRANT LACKED STANDING TO PURSUE BREACH OF FIDUCIARY DUTY CLAIMS.

### A. Question Presented.

Whether the trial court erred in holding, after trial, that Quadrant lacked standing to challenge Defendants' partial liquidation scheme on a finding that the SAC was filed after Athilon regained balance-sheet solvency, where the evidence showed that balance-sheet solvency was itself part of the self-interested "risk-on" scheme challenged in Quadrant's original complaint filed when Athilon was indisputably insolvent. Preserved below at A453; A382-85; A1440-43; A1458-61; A1483-85.

### B. Scope of Review.

The question of standing to pursue derivative claims is a legal one, and this Court reviews questions of law *de novo*. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 48 (Del. 2006).

### C. Merits of Argument.

The trial court never reached the question of whether Defendants' partial liquidation scheme breached their fiduciary duty of loyalty to Athilon. The claim was that Athilon's fiduciaries had harmed the corporation by imposing upon it a "risk-on" strategy, while at the same time stripping a third of its cash so that their own creditor interests could enjoy a "risk-off" pre-payment. The court determined that solvency had been regained during the litigation before Quadrant filed the

SAC, and thus that derivative standing to bring the claim was lost.

The trial court's standing decision appears to have been colored by a fundamental error about the claims. It began its analysis with a caution, noting that "fiduciary duties to protect creditors should be a final resort, not a first response." Op. 22. It cited two cases, *Production Resources* and *Trenwick*, which addressed assertions by plaintiffs that the courts should recognize direct causes of action by creditors—for breach of a fiduciary duty owed to *creditors*, *see Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 788 (Del. Ch. 2004), or for "deepening insolvency," *see Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Tr. v. Billett*, 931 A.2d 438 (Del. 2007). But this case did not involve any direct fiduciary duty claim on behalf of creditors, nor did Quadrant seek to impose "fiduciary duties *to protect creditors*," as the Court of Chancery framed the question.

The claim was that Athilon's fiduciaries breached fiduciary duties of loyalty owed *to Athilon*, and that *Athilon itself* was harmed by these breaches. Judicial relief for this sort of breach has never been a "final resort." Relief has always vindicated a fundamental duty, and is available precisely because contract and statute can never adequately safeguard against an abuse of trust. *See Guth v. Loft, Inc.*, 5. A.2d 503, 510 (Del. 1939) ("A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has

established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation . . . ."); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("This is merely stating in another way the long-existing principle of Delaware law that [directors] still owed . . . an uncompromising duty of loyalty.").

Standing arises not because there is magic about balance-sheet insolvency snapshots, but because "insolvency" more generally describes a situation that makes the creditor the residual stakeholder with incentive to protect the corporation. Quadrant shows below that it is not the only thing that does. Quadrant turns first, however, to the trial court's misapplication of the relation-back doctrine, through which it should have found that Quadrant had standing to challenge Defendants' scheme on behalf of Athilon.

#### 1. Appellant's Fiduciary Claim Relates Back to the Period of Athilon's Indisputable Insolvency.

The trial court's rejection of Quadrant's standing was error under familiar relation-back principles. Earlier, the trial court correctly held that creditor derivative standing must be determined at the time the action is commenced. A329. The trial court found that Athilon was deeply insolvent in 2010 and remained insolvent on a balance-sheet basis until at least December, 2013. Op. 10,

37. Quadrant thus had standing to pursue derivative claims on behalf of Athilon in 2011, when it filed suit.

An amendment relates back to the original filing if the claim arose out of the conduct alleged or attempted to be alleged in the original pleading. Ct. Ch. R. 15(c)(2).[19] "[I]f the amendment merely expands or amplifies what was alleged in the support of the cause of action already asserted, it relates back to the commencement of the action[.]" *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC*, 2012 WL 3201139, at *17 (Del. Ch. Aug. 7, 2012) (citation and internal quotation marks omitted). The determinative factor is "whether a defendant should have had notice from the original pleadings that the plaintiff's new claim might be asserted against him." *Id.* (citation and internal quotation marks omitted). Particularly where the evidence of ongoing fiduciary wrongdoing is discovered in the course of the litigation, public policy requires that notice be broadly construed to ensure that fiduciaries not benefit from concealment of their wrongdoing.

Merced was on notice from 2011. The Complaint—prepared before discovery—alleged that Merced was employing a "risk-on" strategy for Athilon and that this strategy breached fiduciary duties of loyalty. *See* A147-48; A152-53.

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[19] Such amendments are permitted even after trial. Ct. Ch. R. 15(b), and a supplemental pleading may include events that have happened since the date of the original pleading. Ct. Ch. R. 15(d).

The same claim persisted through trial and was realleged in the SAC, although by that time discovery had shown the plan to be a far more self-interested one. A256-57. Merced was indeed employing a "risk-on" strategy for Athilon itself and Athilon's unaffiliated stakeholders, but, as it concealed for as long as it could, *not for Merced's own interests in Athilon*. Merced caused Athilon to pre-pay its affiliates' notes in January, 2015 with approximately one-third of Athilon's assets, leaving behind a shrunken company and all of the outsider debt claims. This conduct proved Quadrant's economic thesis: when it came to its *own* debt interests, Merced agreed with Quadrant that the value-maximizing proposition was to implement a "risk-off" strategy. It also showed that Defendants' strategy was designed to benefit the Funds *as creditors,* by pre-paying insider-held debt.

The original claim—that the fiduciaries should not advance a "risk-on" strategy for Athilon—was thus strengthened by powerful evidence that Merced had exempted their own debt interests from risk. Risk, these fiduciaries thought, was for outsiders only. By the time of trial, whether a fiduciary facing Athilon's unusual facts might in good faith pursue a disinterested "risk-on" strategy rather than liquidate for creditors was a question the trial court no longer needed to consider. The question that remained was one the trial court appeared to have reserved in denying reconsideration of its earlier dismissal ruling: whether such a fiduciary would be permitted to adopt a *self-interested* strategy to liquidate only for

the benefit of insider creditors, leaving only outside creditors to "risk-on." Ex. B at 11. The trial court erred by declining to reach this question after trial on standing grounds. Op. 46.

Defendants understood that Quadrant sought to challenge this self-dealing "risk-on" strategy, and that Quadrant would have standing, based on the trial court's decision on the motion to dismiss, to challenge any self-dealing transactions that involved any transfer of value from Athilon to insiders or their affiliates. *See* Ex. A at 33-34; A1381. Defendants admittedly were keenly aware that the suit would challenge *any* transaction identified in discovery that transferred value from Athilon to Merced or its affiliates, to the exclusion of unaffiliated creditors. A198 ("[Merced] has to keep looking over its shoulder to wonder how Quadrant is going to misconstrue anything it does."). When discovery, previously stayed, was about to commence in 2014, Vertin immediately proposed a plan to pre-pay all $351 million of the Funds' notes. *See supra* Facts at 14. The Board initially balked, precisely because of the concerns raised by Quadrant's pending litigation challenges. Op. 20. Merced then conceived the "one pocket to the other" strategy for the very purpose of shielding the transaction from legal scrutiny. A1381 (noting that the Debt Transactions would "dramatically weaken [Quadrant's] case"). Until the partial liquidation was a *fait accompli*, Defendants actively hid their plans by asserting discovery objections that the trial court later characterized

as "silly." A185. These facts conclusively evidence Defendants' awareness that the partial liquidation was within the ongoing scheme of self-dealing that was always the subject of this action. The trial court therefore erred in concluding that the allegations of the Complaint, including the allegations challenging the "risk-on" business strategy, did not put Defendants on notice that the XXX Securities purchases and the partial liquidation would be challenged, if and when they were disclosed.

**2. Defendants Should Not Be Allowed to Divest Quadrant of Standing by Manipulating Solvency.**

Even if this were not a relation-back case, reversal would be warranted under *Schoon v. Smith*, 953 A.2d 196 (Del. 2008), and *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). Below, a self-dealing scheme evaded judicial review because of the lower court's reflexive view of "snapshot" insolvency, a view neither mandated by nor even consistent with either decision.

Derivative actions play a vital policy role, serving to police the conduct of fiduciaries. *Agostino v. Hicks*, 845 A.2d 1110, 1116-17 (Del. Ch. 2004). In *Schoon*, this Court explained that standing doctrine is a venerable creature of equity, developed to prevent the "complete failure of justice" that would result if, through control of the corporation, conflicted fiduciaries could block review of valid corporate claims. 953 A.2d at 200-02. Chancellor Wolcott once remarked

that "a director of an insolvent corporation should not be allowed as it sinks to take advantage of his position by rushing ahead to a place in the life boat . . . ahead of his fellow passengers." *Pa. Co. for Ins. on Lives & Granting Annuities v. S. Broad St. Theatre Co.*, 174 A. 112, 116 (Del. Ch. 1934). The Court of Chancery's ruling ignored the rule of lifeboats: if they are lowered for creditors of a sinking enterprise, insiders cannot be the first and only ones allowed aboard.

Creditor derivative standing is simply one branch of this equitable doctrine. It recognizes that creditors will sometimes become the "principal constituency" of the corporation, with the primary interest and incentive, and sometimes (as here) the only interest in protecting it from fiduciary breach. *Gheewalla*, 930 A.2d at 101-02. In *Gheewalla*, the Court described the test for when interest and incentive first coexist in creditors' hands as "insolvency," but the case did not present an opportunity to elaborate. Certainly the Court did not hold that the equitable test is one that a controlling creditor may switch on and off by using its equity control to move part of its creditor interest into the preferred equity column.

Creditors, not stockholders, have been the only real stakeholders of Athilon since its business failed in 2008. Athilon has never paid (and could not have paid) an equity dividend, but it has pre-paid almost $200 million solely to affiliated creditors. The Funds began as creditors, acquiring debt of an insolvent company at a steep discount. They bought equity control later, for the purpose of using it to

heap benefits on their debt holdings. A512; A524-25; A528; A838; A848-49; A895. They manipulated solvency itself by converting their debt holdings into equity or debt-like equity securities, in order to insulate their scheme from judicial review. A1381. Then they used equity control to cause an above-market pre-payment of their own debt holdings.

The trial court saw the balance sheet as a shield. In fact, it was an instrument of the corporate harm. By manipulating it, controlling creditors carried out the plan they conceived during Athilon's deep insolvency: to strip assets out of the corporation and pay them over to Funds' debt before that debt was legally payable. Given the identity of interest between the equity holders and the favored creditors, and the absence of an independent Board, an outside creditor was literally the only stakeholder in any position to protect the company from self-dealing by insiders.

If the Court affirms the trial court's rulings on Counts VII-IX, the Court should hold that Quadrant indeed had derivative standing, and remand the fiduciary duty claims for the trial court to consider whether the scheme to liquidate Athilon only for the benefit of insiders was entirely fair to the corporation. *See, e.g., Weinberger*, 457 A.2d at 711 (fiduciary standing on both sides of a transaction bears the burden to prove the fairness both of the process and the terms of the transaction).

## CONCLUSION

The Court should (i) reverse and render judgment for Quadrant on Count VII (Breach of the Indenture: Express Covenants) of the Second Amended Complaint, and/or (ii) reverse and render judgment for Quadrant on Count VIII (Breach of the Indenture: Implied Covenant of Good Faith and Fair Dealing) of the Second Amended Complaint, (iii) reverse and remand Count IX (Intentional Interference with Contractual Relations) in light of any relief granted on Counts VII or VIII, (iv) reverse and remand Count VI for fraudulent transfer, and (v) reverse and remand derivative Counts I-III (Breach of Fiduciary Duty and Aiding and Abetting Breach of Fiduciary Duty) and the derivative portion of Count X (Civil Conspiracy).

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