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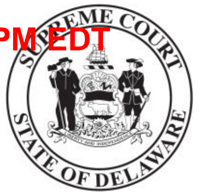

IN THE SUPREME COURT OF THE STATE OF DELAWARE

QUADRANT STRUCTURED PRODUCTS COMPANY, LTD., Individually and Derivatively on Behalf of Athilon Capital Corp., Plaintiff, v. 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., Defendants.	No. 210, 2016 Court below: The Court of Chancery of the State of Delaware, Civil Action No. 6990-VCL

<u>CROSS-APPELLANTS' REPLY BRIEF ON CROSS-APPEAL</u>

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Table of Abbreviations

AAA	Athilon Asset Acceptance Corp.
AGH	Athilon Group Holdings
AGHAP	Athilon Group Holdings Acquisition Partners, LLC
ASIA	Athilon Structured Investment Advisors LLC
Athilon	Athilon Capital Corp. (also known as "ACC")
Athilon Board	Vincent Vertin, Michael Sullivan, Patrick B. Gonzalez, Brandon Jundt, J. Eric Wagoner (also known as "the Directors" or "the Individual Defendants")
Athilon Defendants	The Athilon Board, Athilon, and ASIA
Cournot	Cournot Financial Products LLC
Defendants	The Athilon Defendants and the Merced Defendants
EBF	Merced Capital, L.P., f/k/a EBF & Associates, LLP
Harrington	Harrington Partners, L.P.
Merced	Merced Capital, L.P. (also "Merced Capital")
Merced II	Merced Partners II, L.P.
Merced III	Merced Partners III, L.P.
Merced Defendants	Merced Funds and Merced Capital
Merced Funds	Merced Partners Limited Partnership, Merced Partners II, L.P., Merced III, L.P., Harrington Partners, L.P.
Merced Partners	Merced Partners Limited Partnership

Quadrant	Quadrant Structured Products Company, Ltd.

Preliminary Statement

"Timing: This is really what the law suit is all about. Most of Athilon's book matures early next year, at which point we want them to call the debt and pay us off . . . ."

—B1653 (JX 438) (Quadrant CEO Martin Nance) (emphases added).

Defendants respectfully submit this Reply Brief in further support of their cross-appeal from the Court of Chancery's decision awarding attorneys' fees to Quadrant.

When the Merced Funds bought Athilon, the Company had a deficit, on a GAAP basis, of hundreds of millions of dollars. In just five years, Athilon not only reversed this GAAP deficit, but created positive GAAP equity of more than $150 million. Athilon achieved this remarkable turnaround by making targeted investments in XXX securities, utilizing its expertise in this esoteric and previously undervalued asset class, and improving the Company's financial condition through a combination of contributions from its parent and through repurchases of debt below face.[1] Not even Quadrant disputes Athilon was solvent six months before trial—and has remained solvent ever since.

But Quadrant persisted (and continues to persist) in this suit after Athilon was undisputedly solvent, after its business plan was successful, and after its

[1] As illustrated in Part I.A below, each of the transactions challenged by Quadrant helped improve Athilon's balance sheet.

creditors faced no credible risk of losses—because Quadrant is not, and has never been, interested in maximizing the value of Athilon for the benefit of the Company's stakeholders.

Instead, this litigation has always been the center-piece of Quadrant's business strategy to escape the terms of the Indenture to which it agreed (which calls for payment of interest and principal to Quadrant over decades)—and "to force a liquidation" (Trial Op. at 2) of Athilon. Under Quadrant's scheme, within just 5 years, Quadrant would recover an outsized return on its investment of 230 percent. Quadrant's fee application should have been denied, because Quadrant pursued this litigation for its own individual profit and against the interests of the Company and its other stakeholders (including other noteholders, none of which joined the litigation). Had Quadrant succeeded in its efforts to prevent Athilon's Board from pursuing its long-term business strategy, and forced Athilon to liquidate when Quadrant filed the Complaint, alleging insolvency on the basis of Athilon's September 2011 financial statements, the stockholders would have been totally wiped out and left with zero. *See* Athilon Opening Brief on Cross Appeal at 42-44, 63. While the holders of the Senior Notes would have been paid in full, there would not have been enough to cover the Subordinated Notes or the Junior Notes. *See id.*; B1644.

The fact that Quadrant's interests have always been adverse to the Company is further underscored by the fact that Quadrant vigorously opposed Defendants' mooting of the claims that Quadrant now says benefited Athilon. When Athilon made the mooting payments to Athilon, Quadrant argued that the payments were "unfair to Athilon," and complained that, in reality, "Quadrant received no payment or remedy at all." B1789. Quadrant took this position because Quadrant was pursuing not the interests of Athilon or its stakeholders, but rather only its own self-interest in a 230 percent investment return.

This is not a standard derivative action, and there is no authority to support a recovery of attorneys' fees for a derivative suit brought by a creditor. Nor are the general principles for contingent stockholder litigation applicable here because Quadrant's counsel was not compensated on a contingency basis. Because neither Quadrant nor its attorneys needed any additional incentive to bring this case—they were motivated by the prospect of achieving a 230 percent return on investment at the expense of the Company and its other stakeholders—the Court of Chancery's fee award was in error.

Attorneys' fees should not have been awarded for the additional and independent reason that Quadrant's claims were non-meritorious because Quadrant lacked standing from the outset. Quadrant lacked standing to pursue claims for breach of fiduciary duties because, as Athilon's Opening Brief on Cross Appeal

demonstrated (and Quadrant's Response on Cross Appeal Brief tacitly concedes), Athilon always had reasonable prospects for continued successful operations. Moreover, as was established at trial, Quadrant concealed from the Court that, at the time the Complaint was filed, Quadrant knew that its purported basis for challenging Athilon's solvency was fundamentally flawed: it depended on an insolvency argument that, if applied to Quadrant's own CDPC (Cournot), would mean that Cournot was insolvent by more than $131 million during a time period when Quadrant paid $243 million to acquire Cournot and caused Cournot to issue $40 million in dividends to Quadrant. B314-15 (Nance, Quadrant CEO).

Because Quadrant lacked standing to pursue its derivative claims at the outset—and because Quadrant knew its solvency position was fatally flawed—Quadrant's mooted claims lacked merit.

Argument

I. THE COURT OF CHANCERY ERRED BY REWARDING QUADRANT WITH OVER $9 MILLION IN ATTORNEYS' FEES FOR ITS ATTEMPT TO FORCE ATHILON TO LIQUIDATE

As set forth in Defendants' Opening Brief on Cross Appeal, the Court of Chancery committed two legal errors in granting Quadrant's fee request. First, the Court of Chancery disregarded applicable Delaware law declining to award fees for derivative plaintiffs pursuing an agenda contrary to the best interests of the corporation. Second, the Court of Chancery erroneously held that the mooted claims were meritorious as pleaded, even though (i) Quadrant's Complaint conceded facts demonstrating that Athilon had reasonable prospects for successful operations (and therefore Quadrant had no standing to pursue derivative claims) and (ii) Quadrant withheld facts from the Complaint that demonstrate Quadrant knew Athilon was in fact solvent at the time the Complaint was filed (and therefore Quadrant did not have standing to bring its derivative claims and its fraudulent transfer claims would have been dismissed). Because the Court of Chancery committed legal error in granting Quadrant's attorney fee request, this Court should reverse the Court of Chancery's award.

A. Quadrant Should Not Have Been Awarded Fees Because It Was Pursuing Its Own Self-Interested Agenda

Quadrant recognizes, as it must, that Delaware Courts have declined to award attorneys' fees even where the three prongs of the corporate benefit test are

satisfied. Quadrant Ans. Br. at 38. Specifically, Delaware Courts have denied applications for an award of attorneys' fees where (i) a "litigant's interest [] diverge[s] from those of the class," or (ii) an award is not necessary to "serve public policy goals, such as incentivizing plaintiffs' counsel to police fiduciary wrongdoing." *In re Orchard Enters., Inc. Stockholder Litig.*, 2014 WL 4181912, at *3 (Del. Ch. Aug. 22, 2014); *see also Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 789 A.2d 1216, 1227 (Del Ch. 2001), *aff'd sub nom Mentor Graphics Corp. v. Shapiro*, 818 A.2d 959 (Del. 2003). Although Quadrant attempts to avoid application of these cases, *see* Quadrant Ans. Br. at 38-39, each of these factors is present here. Accordingly, Quadrant should not have been awarded attorneys' fees.

In re Dunkin' Donuts Shareholders Litigation, 1990 WL 189120 (Del. Ch. Nov. 27, 1990), is on point. In that case, one of the plaintiffs, Kingsbridge, was both a stockholder of Dunkin' Donuts and a hostile bidder. There was also a class of stockholder plaintiffs represented by class counsel. Kingsbridge wanted Dunkin' Donuts to remove certain defensive measures. The class plaintiffs wanted a free and open auction process. The litigation caused the removal of the defensive measures and also caused the ultimate sales price to go up. Both Kingsbridge and class plaintiffs moved for their fees. Then-Vice Chancellor Chandler granted the

fee application made by class counsel, but denied the application made by Kingsbridge's counsel.

The reasoning then-Vice Chancellor Chandler applied in denying Kingsbridge's fees applies with full force to Quadrant.

Quadrant's Efforts Were Analogous To Kingsbridge's Efforts. Like Kingsbridge in *Dunkin' Donuts*, which sought to take control of Dunkin' Donuts, Quadrant effectively sought control of the Company by forcing a liquidation. Indeed, Quadrant sought to force Athilon's wind-down and liquidation from the day it filed suit and throughout trial. *See, e.g.*, Trial Op. at 2 ("Through this litigation, Quadrant sought initially to force Athilon to liquidate."); B286 (Tr. 835:2-9) (Nance, Quadrant CEO) ("Q. And meaning that the lawsuit that Quadrant filed was all about forcing Athilon to liquidate so that Quadrant could execute on its investment thesis to more than double its money in five years. Right? A. I'm not sure I'd use the word 'forcing,' but that's what we expected to happen as a result of the lawsuit, yes. "); *see also* B273 (Tr. 783:16-19) (Nance, Quadrant CEO) ("Q. Were you aware that the Athilon indentures that would govern your notes did not contain a mandatory redemption provision? A. We were aware of that."); B413 (Tr. 1341:24-1342:5) (Former Quadrant CEO Gene Park) ("Q. You know that in this lawsuit, Quadrant is taking the position that the Athilon indenture should be

interpreted to require Athilon to redeem and liquidate when the last swap expires. Correct? A. That's correct.").

Quadrant's Economic Interests Conflicted With The Company. As in *Dunkin' Donuts*, Quadrant's economic interests were inherently and structurally adverse to the Company. Had Kingsbridge been successful, it would have minimized shareholder value, because in a sale of Dunkin' Donuts the other stockholders would have received less money. Likewise, had Quadrant been successful in its effort to liquidate Athilon (thereby putting an end to the Board's long-term investment strategy), the stakeholders' holdings in Athilon would have been worth less than they are now. *See* Trial Op. at 2.

Indeed, the resulting economic harm to the other stakeholders would have been far greater than it was in *Dunkin' Donuts*. In the present case, had Quadrant succeeded and forced Athilon to liquidate when Quadrant filed the Complaint, alleging insolvency on the basis of Athilon's September 2011 financial statements, the stockholders would have received not just less, but they would have been totally wiped out and left with zero. *See* Athilon Opening Brief on Cross Appeal at 63, 42-44. At that time, the holders of the Senior Notes would have been paid in full, but there would not have been enough to cover the Subordinated Notes or the Junior Notes. *See id.*; B1644. While wiping out entirely or forcing limited recoveries to these other stakeholders, Quadrant would have pocketed a 230

percent return on its investment within just five years. *See* Athilon Opening Brief on Cross Appeal at 62, 64 (citing Trial Op. at 2; B285 (Tr. 830:10-831:6) (Nance, Quadrant CEO)).

Quadrant sought to wipe out other stakeholders—and obtain an outsized return far beyond what it had bargained for in the Indenture (payment of principal and interest over decades)—even though the Board's long-term investment plan was value maximizing for all stakeholders. *Compare* B1644 (stockholder deficit in September 2011 of about $660 million), *with* B1711 (stockholder equity in December 2014 of about $172 million); *see also* Trial Op. at 2 (Defendants "planned to continue operating Athilon, return the Company to solvency, and then generate returns" for "equity holders" which was the "opposite of a fiduciary wrong; it is the purpose of a for-profit entity"); Athilon Opening Brief on Cross Appeal at 61-64. The plan was successful, and included the following contribution and repurchase transactions, each of which Quadrant challenged as improper.

Quadrant challenged Athilon's payment of interest on its Junior Notes as a breach of fiduciary duty. But as depicted in the chart below, if the Company had deferred interest payments on its Junior Notes, under the Junior Note Purchase Agreement the deferred interest would be required to be "paid-in-kind," which would ultimately require Athilon to pay more in principal payments over the term of the loan. B1777.

$50M Junior Subordinated Deferrable Interest Notes Due 11/15/2046

Scenario Analysis – (Thru 12/10/2013)

	Pay Interest	PIK Interest
Note Face Amount	50 Mil	63.3 Mil
Interest Rate on Note thru Nov. 2013	6.27%	7.27%
Interest Rate on Note after Nov. 2013	3ML + 2.5%	3ML + 3.5%
BMO Swap Matures Nov. 2013	-	-
Debt Service Cost	$2,299,422	$5,270,137
Investment Income on Retained Swap Fixed Payments	$ -	$19,588

Sources: PTO Stipulated Facts, ¶ 23; Junior Note Purchase Agreement, JX-27.0008, 49, 65.

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Instead, Athilon continued to pay interest on the Junior Notes, pursuant to its contractual terms, until December 2013, when the Merced Funds contributed the Junior Notes to Athilon at no cost to Athilon in exchange for AGH preferred equity (subordinate to all creditor claims against Athilon). Athilon Opening Brief on Cross Appeal at 16 (citing A1040; B138 (Tr. 247:4-10) (Athilon CEO Patrick Gonzalez); Trial Op. at 39; A1153). The December 2013 transaction reduced liabilities by $50 million, saved Athilon $1.25 million in annual interest expense, and generated a $7 million tax benefit. *Id.*

Then, in December 2014, the Merced Funds contributed $117.5 million in Senior and Subordinated Notes to Athilon at no cost to Athilon in exchange for AGH preferred equity (subordinate to all creditor claims against Athilon). *Id.* at 17-18 (citing Trial Op. at 20-21; B1732; B1773). The December 2014 transaction reduced Athilon's liabilities by $117.5 million, saved it $3.3 million in annual interest expense, and generated $5 million in tax benefits. *Id.* (citing B1724; B138 (Tr. 247:4-12) (Gonzalez, Athilon CEO)).

In January 2015, Athilon repurchased $194.6 million of Senior Notes from the Merced Funds for $179.032 million, which corresponds to a tax-adjusted price of 78 cents on the dollar. *Id.* at 18 (citing Trial Op. at 21-22; B85 (Tr. 33:7-16, 35:11-19) (Athilon Independent Director Brandon Jundt); B1749). The January 2015 transaction increased Athilon's stockholder equity, reduced its annual interest expense by $5.2 million, and created approximately $7 million in tax savings. *Id.* (citing B138-39 (Tr. 247:24-250:3) (Gonzalez, Athilon CEO)).

The table below shows the cumulative effects of the contribution and repurchase transactions described above, which steadily improved Athilon's GAAP-based balance sheet and created benefits for stockholders and noteholders alike.

Summary of Transactions

	Face Value of Debt Involved in Transaction	Amount Spent by Athilon	Face Value of Outstanding Debt
Total Outstanding Debt (Aug. 2010)			$600,000,000
Junior Note Contribution (Dec. 2013)	$50,000,000	$0.00	$550,000,000
Senior Note Contribution (Dec. 2014)	$21,600,000	$0.00	$528,400,000
Subordinated Note Contribution (Dec. 2014)	$95,900,000	$0.00	$432,500,000
Senior Note Repurchase (Jan. 2015)	$194,600,000	$179,032,000	$273,900,000
Total Reduction in Debt	$362,100,000		

Source: A438-39 (PTO ¶¶ 64, 66, 69)

Quadrant objected to each of these value accretive transactions.

Quadrant Needed No Additional Incentives To Pursue Its Suit—Which Was Part Of Its Investment Strategy. In *Dunkin' Donuts*, then-Vice Chancellor Chandler found that an award of attorneys' fees was not needed to incentivize Kingsbridge's lawsuit. "Rather, Kingsbridge's lawsuit was but one element of its strategy to acquire the target. In other words, Kingsbridge's lawsuit—and the costs associated with it—was part of the price it considered worth paying in the acquisition effort." *In re Dunkin's Donuts*, 1990 WL 189120, at *8. "It [was] a straightforward investment decision." *Id.* at *9.

Likewise, here, Quadrant's lawsuit seeking liquidation and a payout on its Notes decades before maturity was but one element of its investment strategy—and Quadrant considered the price of the lawsuit to be worth paying in order to pursue its investment thesis.

As the Court of Chancery found after trial:

> Quadrant purchased Athilon's publicly traded notes at deep discounts. Quadrant invested in the notes believing that Merced would dissolve Athilon and liquidate its assets. Although in liquidation Athilon's assets might not be sufficient to satisfy all of its creditors, it could pay off the senior notes in full and provide a meaningful recovery on the more junior notes. Creditors like Merced and Quadrant who had purchased the notes at discounted prices would reap healthy returns.

Trial Op. at 2.

The Court of Chancery's findings were well supported by Quadrant's own witnesses. Before Quadrant bought any of its Notes, and before Quadrant filed its lawsuit, Gene Park (then-Quadrant's CEO, who verified the original Complaint), wrote an email recognizing that the lawsuit Quadrant later filed was part of Quadrant's investment thesis from the very outset:

> [Athilon's] Bond Indentures/Operating Guidelines are so loose that shareholders can potentially extend the bonds to their legal maturities which would be a disaster for bondholders. We understand that this is likely to happen. As a result, there is a legally intensive process to get back whatever principal is left earlier.

BR57 (JX 204) (emphases added); *see also* B411 (Tr. 1335:7-20) (Park, former Quadrant CEO).

After Quadrant filed its lawsuit, Quadrant's current CEO and 30(b)(6) witness, Mr. Nance, similarly wrote in an email: "Timing: This is really what the law suit is all about. Most of Athilon's book matures early next year, at which point we want them to call the debt and pay us off." B1653 (JX 438) (emphases added). Mr. Nance further testified as follows:

> Q. And meaning that the lawsuit that Quadrant filed was all about forcing Athilon to liquidate so that Quadrant could execute on its investment thesis to more than double its money in five years. Right?
>
> A. I'm not sure I'd use the word "forcing," but that's what we expected to happen as a result of the lawsuit, yes.

B286 (Tr. 835:2-9); *see also* B285 (Tr. 830:6-19) (Nance, Quadrant CEO) ("Q. And in that scenario [*i.e.* Athilon liquidates when the last swap expires], what Quadrant put down as the base case is that Quadrant would get an annualized return of 28 percent on the seniors and 31 percent on the juniors. Right? A. That's correct. Q. And what that means is in five years, Quadrant would more than double its money. Right? In five years, it would get about 230 percent of its initial investment? A. Yes. Just like EBF will."); B412 (Tr. 1339:10-18) (Park, former Quadrant CEO) ("[Q.] And we can see in the one that's less redacted that Mr. Snyderman wrote to you, '[EBF] bought the company for a reason. I believe they stated their intent to extend the debt/platform.' Right? A. Correct. Q. And you understood 'the company' referred to Athilon and 'they' referred to EBF. Right? A. Correct."); B413 (Tr. 1340:23-1341:10) (Park, former Quadrant CEO) ("Q.

And you see in the second sentence, you wrote, 'We understand that EBF is considering ways to invest cash in higher yielding assets and use the company's [long-term] dated capital to pursue other activities.' Right? A. That's correct. Q. And you didn't write that this violates the Athilon indentures or that it violates any other documents. Right? A. Why would I do that? Q. And—I agree. A. Doesn't make any sense."); B413 (Tr. 1342:14-23) (Park, former Quadrant CEO) ("Q. Okay. Now, let's zero in on the second bullet point. And you see it says, 'Primus's debt indenture requires it to redeem once the last swap matures. <u>Athilon's indentures do not</u> but it might be in the OG [Operating Guidelines] which we don't have.' Now, Mr. Park, when you wrote that about Athilon's indentures, you weren't posturing. You were intending to be truthful and accurate. Correct? A. That's correct.").

As in *Dunkin' Donuts*, "it strains reason to contend that [Quadrant] need[ed] the added incentive of fee shifting." *In re Dunkin' Donuts*, 1990 WL 189120, at *10. Quadrant held over $55 million in face value of Athilon Notes, A446-48 (PTO ¶¶ 113, 115, 118, 120); B1649 (JX 320), and if it succeeded in forcing Athilon's liquidation, it anticipated a "230 percent" return on investment "in five years." B285 (Tr. 830:10-831:6) (Nance, Quadrant CEO). This enormous return was plainly sufficient for Quadrant to pay lawyers to bring suit on its behalf, as

further demonstrated by the fact that Quadrant's attorneys represented Quadrant on a non-contingent basis. B1827 (Willet Aff. ¶ 3).

Quadrant Was Not "Organizationally Disadvantaged." In *Dunkin' Donuts*, then-Vice Chancellor Chandler found that Kingsbridge was not part of a "large and diffused class" that lacked "the organizational ability or funds to seek redress" itself. *In re Dunkin' Donuts*, 1990 WL 189120, at *10. Likewise, here, Quadrant was "well organized and well financed" with "vast resources" it could "tap[] to fund lawsuits necessary to advance [its] investment strategy." *See id.* For example, Quadrant is a sophisticated financial entity and majority owned by funds owned or controlled by Magnetar Capital, a large and sophisticated financial services firm. *See, e.g.*, BR4 (Oligino Dep. Tr. at 21:10-16); BR71 (JX 702); B404 (Tr. 1307:8-11) (Park, former Quadrant CEO) ("[Q.] While you were CEO of Quadrant, for the majority of that time period, who was Quadrant's majority equity holder? A. It was Magnetar Capital.").

Quadrant's Litigation Risk Was Hedged. "This conclusion [that there is no good reason to shift fees] is even more obvious . . . when one considers that the risks associated [with Quadrant's litigation were] largely hedged by [Quadrant] purchasing a substantial block of the [Athilon's Notes]." *In re Dunkin' Donuts*, 1990 WL 189120, at *11. Quadrant bought $55 million in face value of Athilon Notes based on its forced-liquidation investment thesis. *See* A446-48 (PTO ¶¶

113, 115, 118, 120); B1649 (JX 320); BR57 (JX 204) . As a result of Athilon's value-maximizing investment strategy, Quadrant's Notes increased in value. At the time that Quadrant initiated the lawsuit, Athilon's financial statements (on a GAAP basis) indicated that were Quadrant to force a liquidation Athilon would not have had sufficient assets to pay down the outstanding Subordinate Notes and Junior Notes; by trial, Athilon's financial statements (on a GAAP basis) indicated that it owned more than sufficient assets to pay down all outstanding Athilon Notes. *See* Athilon Opening Brief on Cross Appeal at 14-18 (describing Athilon's business strategy and the resulting increase in GAAP-based shareholder equity sufficient to cover all outstanding Athilon Notes in full); Trial Op. at 10, 19-22 (describing Athilon's improvement in GAAP-based shareholder equity from negative $513 million at year-end 2010 to positive $178 million in March 2015). Furthermore, Athilon never missed a single interest payment. B287 (Tr. 838:22-839:5) (Nance, Quadrant CEO) ("[Q.] You're not aware of any instance in which Athilon has ever missed any payments on any of its notes. Right? A. I'm not aware of any. Q. And you're not aware of any instance in which Athilon has failed to pay any debt when it's come due. Right? A. I am not.").

As in *Dunkin' Donuts*, "[h]aving effectively hedged its investment risks, it is not at all clear . . . why this Court should increase the rate of return on [Quadrant]'s investment by shifting part of its costs . . . . All of these considerations are

underscored by the actual fee arrangement in this case. [Quadrant]'s attorneys were not employed on a contingency basis; they were employed on an hourly basis and have already been paid for their services." *In re Dunkin' Donuts*, 1990 WL 189120, at *11. Without any attorneys' fees, and as a result of Athilon's prudent long-term business strategy, Quadrant will receive the benefit of its bargain (contractual interest over time and principal at maturity).

Quadrant nonetheless contends that there was no conflict, because Defendants elected to moot the claims, which resulted in a benefit to Athilon. Quadrant Ans. Br. at 39. But Quadrant overlooks that it vigorously opposed Defendants' mooting of those claims that Quadrant now says benefited Athilon—precisely because Quadrant was concerned with only its own economic interests. *See* B1789 (arguing that mooting would be "unfair to Athilon"; and that "Quadrant received no payment or remedy at all"). In any event, Defendants' mooting of the claims cannot alter the facts that Quadrant's motivation for bringing the lawsuit was its own financial self-interest, divorced from and antithetical to the interests of Athilon and Athilon's other stakeholders, and that Quadrant needed no "incentive to bring the litigation." Any benefit to Athilon was "an incidental by-product of [Quadrant's] self-interested pursuit," *Orchard Enters.*, 2014 WL 4181912, at *12—and directly opposed by Quadrant.

The Court of Chancery overlooked these considerations in favor of a mechanical application of the corporate benefit test and never addressed the *Dunkin' Donuts* line of case law raised by Defendants. Its failure to grapple in the fee award ruling with Quadrant's self-interested agenda, adverse interests, opposition to the mooting payments, and the absence of any need for a fee to incentivize claims, constitute legal error.

B. Quadrant's Mooted Claims Lacked Merit From Inception

Defendants' Opening Brief on Cross Appeal also established that, even if this conflict of interest were not disabling, Quadrant is still precluded from recovering attorneys fees under *Allied Artists Pictures Corp. v. Baron*, 413 A.2d 876 (Del. 1980), because the mooted claims were not meritorious at the outset for at least two reasons. *See* Athilon Opening Brief on Cross Appeal at 64-65.

First, Quadrant's Complaint established that Athilon had reasonable prospects of successful continued operation, and therefore under a proper application of the reasonable prospects prong of the balance sheet insolvency test, Quadrant never had standing to pursue its derivative claims.

Second, at the time Quadrant initiated the action and asserted that Athilon was insolvent, Quadrant knew that its theory of insolvency was deeply flawed. If applied to Quadrant's own CDPC Cournot, Cournot would have been more than $131 million insolvent—during a time period when Quadrant paid $243 million to

acquire Cournot and caused Cournot to issue $40 million in dividends to Quadrant. *See* Part II.B.2. Quadrant never believed Cournot was insolvent, and in the Complaint failed to disclose these facts—facts which should have led to a dismissal of the mooted claims.

1. *Athilon Always Had Reasonable Prospects of Successful Operations*

Defendants' Opening Brief on Cross Appeal established that, from the outset, Quadrant lacked standing to pursue its derivative claims because Athilon always had a reasonable prospect of successful continued operation. *See* Athilon Opening Brief on Cross Appeal at 64 (referring to Section V.C.2).[2]

Critically, <u>Quadrant does not dispute</u> that, as a factual matter, Athilon always had a reasonable prospect of success. *See* Quadrant Ans. Br. at 31-34 (conceding—by omission—that Athilon always had reasonable prospects for

[2] When Quadrant brought suit, Athilon was owed $163 million in contractually guaranteed premiums from outstanding credit default swaps between 2011 and 2016 (when the last swap matured), at which point Athilon would have 10-20 years to reinvest the premiums to generate more than sufficient revenue to repay its debt before it became due. A371, B150 (Tr. 295:20-296:7) (Gonzalez, Athilon CEO) (discussing alternative method for factoring in expected future swap premiums); B169 (Tr. 369:10-20) (Gonzalez, Athilon CEO) ("Q. Now, in 2010, why were you confident that swap counterparties on your corporate book would pay their premiums going forward? A. It's a contractual obligation. If they didn't pay, it would—under the ISDA it would trigger cross-default provisions, and that would basically allow all their swaps—these are large financial institutions. They're going to make good on their payments because they have to. If they don't, they would basically implode themselves. So they were going to make those payments.").

continued success). Accordingly, Quadrant has waived any argument to the contrary. *See, e.g.*, *King v. VeriFone Holdings, Inc.*, 994 A.2d 354, 360 n.21 (Del. Ch. 2010), *rev'd on other grounds*, 12 A.3d 1140 (Del. 2011) ("A party's failure to raise an argument in its answering brief constitutes a waiver of that argument."); *Emerald Partners v. Berlin*, 726 A.2d 1215, 1224 (Del. 1999) ("Issues not briefed are deemed waived.").[3]

Instead, Quadrant contends that the reasonable prospects test only applies in receivership cases to determine whether a court should exercise its discretion to appoint a receiver (once it has already been determined that the company is insolvent). Quadrant Ans. Br. at 32-33. But as set forth in Defendants' Opening Brief on Cross Appeal, Quadrant is mistaken. The cases in which Delaware courts have applied the reasonable prospects analysis did so as part of the <u>first-step</u> solvency analysis. Athilon Opening Brief on Cross Appeal at 57-58. The reasonable prospects test was not part of the second-step of the receivership

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[3] Quadrant misconstrues Defendants' standing argument with respect to attorneys' fees, by claiming that "Defendants illogically argue that Quadrant's [mooted] claims were [] not meritorious because the trial court ultimately denied Quadrant standing to pursue its other derivative claims, which Defendants did not moot." Quadrant Ans. Br. at 40. That is not Defendants' position. Rather, Defendants assert that Quadrant lacked standing to pursue the mooted derivative claims from the outset, because Quadrant's own allegations in the Complaint establish that Athilon had reasonable prospects for continued successful operation.

analysis (whether to exercise discretion and appoint a receiver for the insolvent company). *See id.* at 57-58 & n.12.

Quadrant next contends that the reasonable prospects test should be confined to the receivership context. Quadrant Ans. Br. at 33. Specifically, Quadrant argues that when a company is insolvent, any improvement in the financial condition first benefits the creditors, and so they are the ones properly incentivized to champion the company's interests. Quadrant Ans. Br. at 33-34. But as this case demonstrates, where a company has reasonable prospects of success in the face of a book imbalance, it is the stockholders, and not the creditors, who have the strongest interest in the company—because successful operations redounds to their benefit, not the creditors who are entitled only to their payments under the indenture. Indeed, Quadrant commenced this litigation to force an early liquidation of Athilon, not because a liquidation would maximize enterprise value or benefit all stakeholders, but because Quadrant stood to earn an exponential return on its Athilon Notes. *See* Trial Op. at 2; *supra* I.A.

Quadrant also argues that the reasonable prospects test should be rejected because it "would find insolvency only well after creditors have become the <u>principal</u> constituency injured by any fiduciary breaches" and thereby bar effective judicial review of fiduciary breaches. Quadrant Ans. Br. at 34 (emphasis added). This argument once again presumes that the constituency with the strongest

interests and best incentives to protect the corporation are creditors, and not stockholders, even though it is the stockholders that have the interest in the upside.

Quadrant's argument also ignores all the other means by which creditors can protect their interests, including the terms of the indenture, the price paid for the notes (which reflect risks), fraudulent conveyance law, and bankruptcy law. *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004) ("It is presumed that creditors are capable of protecting themselves through the contractual agreements that govern their relationships with firms. Furthermore, a specific body of law—the law of fraudulent conveyance—exists precisely to protect creditors. And, of course, important elements of federal bankruptcy law also protect creditors."). Indeed, the only benefit a breach of fiduciary duty claim appears to have in this case over a claim for breach of contract or for fraudulent conveyance is the theoretical remedy of liquidation. Quadrant's insistence on continuing to press its breach of fiduciary duty claims demonstrates its true intent—rather than cure the corporate body, Quadrant sought to kill it.

Finally, Quadrant argues that standing decisions should not be made based on "predictions about the future." Quadrant Ans. Br. at 34. But the courts commonly make predictions in deciding insolvency. Indeed, the traditional cash-flow insolvency test itself is forward-looking in nature. *See, e.g.*, *Kipperman v. Onex Corp.*, 411 B.R. 805, 836 (N.D. Ga. 2009) ("'Equitable insolvency,' or

whether a debtor is able to pay its debts as they become due, is a forward looking standard.").

The balance sheet test and the cash flow tests are means to an end—*i.e.*, predicting whether or not the company is defunct and will be unable to pay its debts when they come due—not the end itself. The reasonable prospects test serves the same end. The reasonable prospects test also ensures that a creditor-derivative plaintiff's interests are, from the outset, properly aligned with the interests of the corporation and other stakeholders, and that value maximization remains the directors' focus. *See Prod. Res.*, 863 A.2d at 791 ("The directors [of an insolvent firm] continue to have the task of attempting to maximize the economic value of the firm.").

Taken to its logical conclusion, under Quadrant's argument, a single debtor can force a company to liquidate if the company's assets dip below its liabilities for a single day, even though the creditor does not have that right in the indenture. Delaware law should not be expanded in such an extensive manner.

2. *Quadrant Concealed That Its Assertions Of Insolvency In the Complaint Were Grounded On A Theory It Did Not Believe*

Quadrant's mooted claims were also not meritorious when filed because Quadrant did not possess "knowledge of provable facts which [held] out some reasonable likelihood of ultimate success" as to Athilon's solvency. *Allied Artists Pictures Corp.*, 413 A.2d at 879 (quoting *Chrysler Corp. v. Dann*, 223 A.2d 384,

386 (Del. Ch. 1966)). To the contrary, from its experience valuing CDPCs through its ownership of Cournot, Quadrant knew that Athilon was definitively solvent at the time the Complaint was filed. Therefore Quadrant lacked standing to prosecute its derivative claims.

As the Court of Chancery found:

> Perhaps more importantly, Quadrant's insolvency theories cannot be reconciled with its approach—outside of litigation—to its own credit default products company, Cournot. As Quadrant's witnesses admitted, if Cournot were analyzed using the same standards that Quadrant sought to apply to Athilon, then Cournot would have been insolvent for two years during which Quadrant treated Cournot as solvent. During that period of time, Quadrant paid $243 million to purchase Cournot's equity and caused Cournot to pay a $40 million dividend to Quadrant. Quadrant never believed Cournot was insolvent.

Trial Op. at 39-40.

The Court of Chancery's findings were amply supported by the trial record. As Quadrant's CEO and 30(b)(6) witness Mr. Nance conceded at trial, if Quadrant's solvency valuation theory for Athilon were applied to Cournot, Cournot would have been insolvent by more than $131 million—at a time when Quadrant paid $243 million to purchase Cournot and Cournot issued a $40 million dividend to Quadrant.[4] Quadrant never believed Cournot was insolvent.[5] And

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[4] B315 (Tr. 945:19-23) (Nance, Quadrant CEO) ("Q. But if you replaced the 85.134 million fair value of the Cournot notes that we looked at earlier with the 400 million face value, Cournot's total liabilities would be about 680.4 million; right? A. I assume you're including the derivative contracts at the fair value in

Quadrant never told Cournot's swap counterparties or noteholders that there were concerns about solvency.[6] Nonetheless, Quadrant's CEO Mr. Nance testified at trial that Quadrant "want[s] the Court to apply an approach that [it] believe[s] is inaccurate as applied to Quadrant . . . in this lawsuit, to Athilon." B320 (Tr. 970:4-8).

As set forth in Defendants' Opening Brief on Cross Appeal (at 64-65), had Quadrant's understanding of CDPC solvency and valuation been disclosed in its Complaint, it would have been clear that Quadrant did not have standing to pursue

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that number? Q. Am I right or no? A. If you're including the derivative contracts at fair value, yes. Q. Now, if you take Cournot's assets of 548.9 million and its liabilities at 680.4 million, that results in negative shareholder equity of 131.4 million; right? A. I think that's right. Q. Okay. Now, you didn't believe that Cournot was insolvent at the end of 2008, did you? A. I did not."); B317-20 (Tr. 957:11-967:15) (Nance, Quadrant CEO); BR48 (JX 53.0044).

[5] B315 (Tr. 949:21-23) (Nance, Quadrant CEO) ("Q. Okay. Now, you didn't believe that Cournot was insolvent at the end of 2008, did you? A. I did not."); B315 (Tr. 951:23-952:15) (Nance, Quadrant CEO) ("Q. Now, just to be clear . . . under your expert's theory, Cournot was insolvent; right? A. I don't believe so. Q. In 2008. A. I mean, I haven't done the calculation. The calculation is to do—to take the fair value of—I need to just do the calculation. Q. Okay. So you don't know whether, under the theory, your expert— A. I never looked to ask the question whether, applying that logic, we would— Q. Okay. But in any event, in 2008, 2009, 2010, Cournot didn't believe it was insolvent; right? A. That's correct.").

[6] B320 (Tr. 967:6-10) (Nance, Quadrant CEO) ("Q. Okay. And you certainly never told [Cournot's swap counterparties or Morgan Stanley] that you had any concern that, based on some expert's opinion, that you might be not just insolvent, but wildly insolvent, did you? A. We did not.").

its mooted derivative claims.[7] That Quadrant does not dispute any of this in its Answering Brief speaks volumes.

* * *

Had the Court of Chancery properly dismissed Quadrant's derivative claims at the outset, Defendants would never had made the mooting payment, which was principally designed to prevent the reputational risk associated with a breach of fiduciary duty finding (for claims that Quadrant lacked standing to pursue) from coming to fruition. *See Seinfeld v. Coker*, 847 A.2d 330, 333 (Del. Ch. 2000) (noting "reputational expense of losing in court"). In fact, the reputational cost of a potential fiduciary breach finding was the principal basis for Quadrant's challenge to Athilon's motion to dismiss these claims as moot. B1797-98 (Quadrant Opp. to Mot. to Dismiss as Moot, at 9-10) ("Eliminating the risk of reputational expense undermines Delaware's strong public policy favoring the retention of 'high-quality directors.'"). Because Quadrant's fee award derives from legal error, it should be reversed.

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[7] Applying an appropriate valuation methodology taking into account the unique natures of (i) credit default products companies and (ii) Athilon's long-term, low-interest and covenant-light debt, Athilon's solvency expert valued Athilon at $74,173,000 as of year-end 2010. BR99-100 (JX-843.0027-.0028) (Athilon's solvency expert's report; admitted into evidence at B198 (Tr. 484:20-21)).

Conclusion

For the reasons set forth above, this Court should reverse the order of the Court of Chancery granting Quadrant's fee application.

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CERTIFICATE OF SERVICE

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