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Case Number 338,2012

IN THE SUPREME COURT OF THE STATE OF DELAWARE

QUADRANT STRUCTURED PRODUCTS CO., LTD., Individually and Derivatively on behalf of Athilon Capital Corp.,	§	No. 338, 2012
	§	Court Below: Court of Chancery of the State of Delaware
Plaintiff Below, Appellant,	§	C.A. No. 6990
v.	§	
VINCENT VERTIN, MICHAEL SULLIVAN, PATRICK B. GONZALEZ, BRANDON JUNDT, J. ERIC WAGONER, ATHILON CAPITAL CORP., ATHILON STRUCTURED INVESTMENT ADVISORS LLC, EBF & ASSOCIATES, LP,	§	
Defendants Below, Appellees.	§	

Submitted: October 23, 2013
Decided: November 7, 2013

Before **HOLLAND**, **BERGER**, **JACOBS** and **RIDGELY**, Justices, and **SCOTT**, Judge* constituting the Court *en Banc*.

Upon appeal from the Court of Chancery. **CERTIFICATION OF LEGAL QUESTIONS TO THE NEW YORK COURT OF APPEALS.**

Lisa A. Schmidt, Catherine G. Dearlove, and Russell C. Silberglied, Esquires, Richards, Layton & Finger, P.A., Wilmington, Delaware; Of Counsel: Harold S. Horwich, Sabin Willett (*argued*), and Samuel R. Rowley, Esquires, Bingham McCutchen LLP, Boston, Massachusetts, for Appellants.

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* Sitting by designation pursuant to art. IV, § 12 of the Delaware Constitution and Delaware Supreme Court Rules 2 and 4(a) to constitute the quorum required.

Collins J. Seitz, Jr., Garrett B. Moritz, and Eric D. Selden, Esquires, Seitz Ross Aronstam & Moritz LLP, Wilmington, Delaware; for Appellees EBF & Associates, LP.

Philip A. Rovner, Esquire, Potter Anderson & Corroon LLP, Wilmington, Delaware; Of Counsel: Philippe Z. Selendy, Nicholas F. Joseph (*argued*), and Sean P. Baldwin, Esquires, Quinn Emanuel Urquhart & Sullivan, LLP, New York, New York, for Appellees Athilon Capital Corp., Athilon Structured Investment Advisors LLC, Vincent Vertin, Michael Sullivan, Patrick B. Gonzalez, Brandon Jundt and J. Eric Wagoner.

JACOBS, Justice:

Pending before this Court is an appeal from an order of the Delaware Court of Chancery dismissing a complaint. The plaintiff below, appellant, Quadrant Structured Products Company, Inc. ("Quadrant"), holds certain Notes issued by Athilon Capital Corp. ("Athilon"), an allegedly insolvent Delaware corporation. The Notes are long term obligations covered by two separate trust indentures that are governed by New York law. The defendants-below are EBF & Associates, LP ("EBF"), which indirectly owns 100% of Athilon's equity;[1] Athilon Structured Investment Advisors ("ASIA"), an affiliated EBF entity, Athilon's board of directors, and (as a nominal defendant) Athilon.

In a two paragraph order issued on June 5, 2012, the Court of Chancery granted the defendants' motion to dismiss Quadrant's complaint, on the ground that all claims alleged therein were barred for failure to comply with the "no-action" clauses in the Athilon trust indentures. The dismissal order, a copy of which is attached to this Certificate as Exhibit A, cited two Court of Chancery decisions that the court found "directly on point": *Feldbaum v. McCrory Corp.*, 1992 WL 119095 (Del. Ch. June 1, 1992) and *Lange v. Citibank, N.A.*, 2002 WL 2005728 (Del. Ch. Aug. 13, 2002). In both cited cases the Court of Chancery, applying New York law, held that those bondholder actions were barred by the no-action clauses of the respective trust indentures that governed the bonds at issue.

[1] EBF disputes that it is the ultimate parent of Athilon.

The plaintiff, Quadrant, appealed to this Court. By order dated February 12, 2013, this Court remanded the case to the Court of Chancery with directions to analyze the significance under New York law (if any) of the differences between the wording of the no-action clauses at issue in the two cited cases and in this Athilon case. A copy of this Court's remand order is attached to this Certificate as Exhibit B.

On June 20, 2013, the Court of Chancery, in a detailed and highly textured analysis of relevant New York case law, issued a Report on Remand, a copy of which is attached to this Certificate as Exhibit C. In its Report, the Court of Chancery held that: (i) "the language of the Athilon no-action clause distinguishes this case from *Feldbaum* and *Lange,*" and (ii) the motion to dismiss should be denied except as to two (and part of a third) of the ten Counts of the Quadrant complaint. The matter was then returned to this Court, and was re-argued before us on October 23, 2013.

Section 500.27(a) of the Court of Appeals Rules of Practice authorizes certification of cases to the New York Court of Appeals "[w]henever it appears to . . . a court of last resort of any other state that determinative questions of New York law are involved in a case pending before that court for which no controlling precedent of the Court of Appeals exists . . . ."[2] We have concluded that a

[2] N.Y. COMP. CODES R. & REGS., tit. 22 § 500.27(a) (2013).

resolution of the appeal before us depends on dispositive and unsettled questions of New York law that, in our view, are properly answered in the first instance by the New York Court of Appeals. Our reasons for so concluding are set forth below.

I. STATEMENT OF FACTS[3]

A. Nature of the Case

Athilon, a Delaware corporation, was formed in 2004 and (through a subsidiary) sold credit derivative products—in the form of "credit default swaps"[4] covering senior tranches of collateralized debt obligations to large financial institutions. To finance those activities, Athilon raised (in addition to its initial equity capital) $600 million of debt capital consisting of $350 million in senior subordinated notes, $200 million in subordinated notes, and $50 million in junior notes (collectively, the "Notes"). The Notes are long term obligations covered by two separate indentures; one created in 2004 between Athilon and Deutsche Bank Trust Company Americas as Indenture Trustee; and the other, created in 2005 between Athilon and The Bank of New York, as Indenture Trustee. Because for

[3] The facts are drawn from the allegations of the complaint filed in the Court of Chancery.

[4] Athilon and its subsidiary are referred to collectively as "Athilon." Credit swaps are contracts in which a credit derivative product company, such as Athilon, promises to make one or more defined payments should a specified degree of losses be sustained on a reference portfolio, as a result of defaults or other "credit events" by one or more designated obligors during a specified (typically, multi-year) period of time.

present purposes the indentures are substantively identical, they are referred to singly as "the Indenture."

Athilon's organizational documents limit its permissible lines of business to selling credit default swaps, and require compliance with strict operating guidelines. Those guidelines mandate that if a "Suspension Event"[5] occurs and remains uncured, then Athilon must enter into "runoff" mode, meaning that Athilon cannot write new business and must pay off existing credit default swaps as they mature.

Before the financial crisis of 2008, Athilon underwrote over $50 billion in nominal credit default risk, but on a highly leveraged basis. Measured against Athilon's equity, Athilon's leverage ratio was a stratospheric 506:1. At that level, a 0.2% loss on the collateralized debt obligations covered by Athilon's credit default swaps would wipe out its equity cushion and render Athilon insolvent, at least on paper. Even so, the rating agencies gave Athilon "AAA/Aaa" counterparty credit ratings and investment grade debt credit ratings.

In 2008, Athilon found itself in distress and by the end of that year had lost its AAA/Aaa ratings. By 2010, Athilon had unwound two credit default swaps at a cost of approximately $370 million—more than three times Athilon's equity

[5] Generally, a Suspension Event involves, *inter alia*, capital shortfalls, leverage ratios, or insolvency.

capital. By August 2010, Athilon no longer held any investment grade debt or counterparty credit ratings. Under its operating guidelines, Athilon entered permanent "runoff" mode.

With Athilon in distress, the trading prices of its debt securities fell precipitately. That enabled EBF to acquire a large position in the junior notes at a significant discount. In August 2010, EBF acquired control of 100% of Athilon's equity, and installed Athilon's current board of directors. Those directors, the complaint alleges, are dominated and controlled by EBF. Quadrant acquired its position in the Notes in May 2011, nine months after EBF took control.

In its complaint Quadrant alleges that as of September 30, 2011, Athilon's shareholders' equity, measured according to GAAP, stood at a negative $660 million. Quadrant alleges that Athilon is insolvent and has no prospect of returning to solvency, because it can only sell credit default swaps and because the market for that business has collapsed for enterprises, like Athilon, that hold no collateral.

At the heart of Quadrant's lawsuit is its claim that in these circumstances, a properly motivated board of directors would preserve Athilon's value for orderly liquidation in 2014, when the last credit default swap expires. The EBF board designees, however, are (according to Quadrant) pursuing strategies designed to benefit EBF and its affiliates at the expense of the remaining classes of Note

holders. Specifically, the directors have caused Athilon to continue paying interest on the junior notes (which EBF holds), even though Athilon had a contractual right to defer those interest payments and those notes would receive nothing in an orderly liquidation. Athilon's directors also allegedly agreed to pay ASIA above-market fees to manage Athilon's day-to-day operations. The Court of Chancery characterized Quadrant's claim thusly:

> Together, the EBF designees and ASIA have embarked on a high-risk investment strategy, contrary to the terms of Athilon's governing documents, that amounts to a "heads EBF wins, tails everyone else loses" bet. If the high-risk investments succeed, then the underwater Junior Notes and equity will benefit. If the investments fail, then the more senior tranches of Notes will bear the loss."[6]

In October 2011, Quadrant filed this Court of Chancery action against EBF and its affiliates and against Athilon and its officers and directors. As amended, the complaint contained ten Counts. For present purposes, the relevant fact is that only two of those Counts—Counts VII and VIII—and part of a third, Count X, seek to enforce rights under the Indenture.[7] The balance of Quadrant's claims for relief are based on either Delaware fiduciary or statutory law.

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[6] Report on Remand, Exhibit C, at p. 5.

[7] Count VII claimed that Athilon breached the Indenture's implied covenant of good faith and fair dealing, and Count VIII asserted that EBF had tortiously interfered with Athilon's obligations under the Indenture. Count X charged EBF and ASIA with civil conspiracy for actions taken in concert with the individual defendants.

B. Circumstances Out of Which The Questions of New York Law Arise

The circumstances out of which the questions of New York law arise are as follows: The basis of the defendant's motion to dismiss the complaint was (and is) that all of the claims asserted in Quadrant's complaint are barred by the no-action clause of the Indenture, which is governed by New York law. The no-action clause pertinently provides that:

> No holder of any Security shall have any right by virtue or by availing of any provision of this Indenture to institute any action or proceeding at law or in equity or in bankruptcy or otherwise upon or under or with respect to this Indenture, or for the appointment of a trustee, receiver, liquidator, custodian or other similar official or for any other remedy hereunder, unless such holder . . . [complies with specified conditions].

It is undisputed that Quadrant did not comply with the conditions set forth in the Athilon no-action clause before filing suit. In support of their motion to dismiss the complaint, the defendants relied on the two cases previously cited, *Feldbaum v. McCrory Corp.* and *Lange v. Citibank, N.A.* In those cases, the Delaware Court of Chancery, applying New York law, dismissed both actions on the ground that they were barred by the respective indenture no-action clauses. In its June 5, 2012 order (Exhibit A to this Certificate), the court granted the motion to dismiss, citing *Feldbaum* and *Lange* as "directly on point," but without engaging in any analysis.

On appeal to this Court, Quadrant argued that the no-action clauses in *Feldbaum* and *Lange* indentures were "substantially different" from the no-action clause in the Athilon Indenture. Specifically, the no-action clauses in *Feldbaum* and *Lange* barred actions to enforce not only rights arising under the respective indentures, but also "any remedy with respect to this Indenture *or the Securities*."[8] In contrast, the Athilon no-action clause bars only actions to enforce rights "upon or under or with respect *to this Indenture*."[9] Absent from the Athilon no-action clause is the phrase "or the Securities"—language that was contained in the no-action clauses in the *Feldbaum* and *Lange* indentures.

By Order dated February 12, 2013 (Exhibit B to this Certificate), this Court determined that the current record was insufficient for appellate review, and remanded the case to the Court of Chancery with instructions "to issue an opinion analyzing the significance (if any) under New York law of the differences between the no-action clauses in the *Lange* and *Feldbaum* indentures and the Athilon Indenture." The Remand Order further instructed that "[t]he analysis should include a discussion of decisions by New York courts, and other courts applying New York law, that bear on the issue presented here." This Court retained jurisdiction to consider the implications of the Report on Remand.

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[8] Italics added.

[9] Italics added.

On June 20, 2013, the Court of Chancery issued its 55 page Report on Remand (Exhibit C to this Certificate). In that Report the Court of Chancery, after extensively analyzing the New York case law, concluded—contrary to its earlier conclusion—that:

> [A]s a matter of New York law, the differences between the Athilon [no-action] [c]lause and the *Feldbaum/Lange* clause are significant. . . . the Athilon Clause does not apply to Counts I through VI and IX of the Complaint, or to Count X to the extent it seeks to impose liability on secondary actors for violations of the other counts. The clause applies to Counts VII and VIII of the Complaint, subject to the outcome of Quadrant's other arguments on appeal.[10]

The case was then returned to this Court, which held a supplemental oral argument on October 23, 2013, to enable the parties to argue the implications of the Report on Remand. Quadrant argued that the Report on Remand correctly decided the dispositive New York law issues, and that the order of dismissal should be modified to conform to the conclusions in that Report. The defendants, however, maintained that that Report was legally incorrect and that the Court of Chancery's June 5, 2012 order of dismissal reflected the correct construction of New York law. Neither party was able to identify any decision by the New York Court of Appeals (or any lower New York court) that directly addresses, let alone disposes, of the questions of New York law this Court is being asked to decide.[11]

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[10] Exhibit C to this Certificate, at 54-55.

[11] *Gen. Inv. Co. v. Interborough Rapid Transit Co.*, 193 N.Y.S. 903 (N.Y. App. Div. 1922) *aff'd*, 139 N.E. 216 (N.Y. 1923), which was decided before the adoption of the Trust Indenture Act,

Those questions are not controlled by precedent. Moreover, however those questions may be resolved, the answers will be determinative of the case before us. For those reasons, and because of the need for certainty in the law controlling the instruments that govern publicly traded bonds, this Court unanimously determined that the New York Court of Appeals should have the opportunity to decide those questions in the first instance.

II. *THE QUESTIONS OF NEW YORK LAW, NOT CONTROLLED BY PRECEDENT, THAT MAY BE DETERMINATIVE*

A resolution of the appeal before us depends upon the answer to two questions of New York law that are not controlled by precedent. This Court certifies the following questions to the New York Court of Appeals:

(1) A trust indenture no-action clause expressly precludes a security holder who fails to comply with that clause's preconditions, from initiating any action or proceeding upon or under or with respect to "this Indenture," but makes no reference to actions or proceedings pertaining to "the Securities."

The question is whether, under New York law, the absence of any reference in the no-action clause to "the Securities" precludes enforcement only of contractual claims arising under the Indenture, or whether the clause also precludes enforcement of all common law and statutory claims that security holders as a group may have.

(2) In its Report on Remand (Exhibit C), the Court of Chancery found that the Athilon no-action clause, which refers only to "this

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addressed whether a no-action clause with no reference to "the Securities" precluded a security holder's action to collect outstanding principal and interest due under the securities.

Indenture," precludes enforcement only of contractual claims arising under the Indenture. The question is whether that finding is a correct application of New York law to the Athilon no-action clause.

III. *WHY THESE ISSUES SHOULD BE ADDRESSED BY THE COURT OF APPEALS AT THIS TIME*

In our national securities markets, the law governing many (if not most) publicly traded debt securities is a creature of New York law. Important rights and requirements pertaining to those securities are expressed in indentures that are, and for over a century have been, governed by New York law. As a consequence, New York has a very strong interest in assuring that those markets function properly. An important requirement for properly functioning public debt security markets is that the rights pertaining to those securities be certain and predictable to both investors and issuers. The New York Court of Appeals is the most authoritative tribunal empowered to adjudicate definitively the rights and requirements contained in indentures governed by New York law. For that reason, and because New York has the stronger interest in this issue, in contrast to that of Delaware, it is appropriate that the Court of Appeals be afforded the opportunity to adjudicate the certified issues in the first instance.

Moreover, the certified questions, which test the boundaries of a no-action clause's coverage, are most frequently raised in actions asserting non-contractual claims that arise under the law of the issuer's state of organization. As a consequence, those questions are often decided by non-New York courts—as

evidenced by the Delaware cases interpreting the no-action clauses contained in New York bond contracts. Because the certified questions have not been raised directly before New York courts (as the dearth of case law suggests)—but are raised frequently before courts in sister states—it is particularly important that the New York Court of Appeals give guidance to those latter courts by addressing these questions on certification at this time.

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We direct the Clerk of this Court to send this opinion to the Clerk of the New York Court of Appeals, as our certificate, together with the parties' briefs and appendices. We will take no further action in this appeal until after the New York Court of Appeals acts on this certification request.