ALERTS

New York Court of Appeals Permits Individual Noteholder Suit Despite Indenture's No-Action Clause

June 24, 2014

The New York Court of Appeals, on June 10, 2014, unanimously held that "a trust indenture's 'no-action' clause" barring "contractual claims . . . under the indenture" did "not bar a security holder's independent common law or statutory claims." *Quadrant Structured Products Co. Ltd. v. Vertin*, 2014 WL 2573378, at 6 (N.Y. June 10, 2014). Answering certified questions raised by the Delaware Supreme Court about New York law, the court stressed that "the clear import of the no-action clause [before it] is to leave a security holder free to pursue independent claims involving rights not arising from the indenture agreement." *Id.* at 7.

Relevance

A typical no-action clause provides that a "Security holder may not pursue any remedy with respect to this Indenture or the Securities unless [specified conditions are met]." *Id.* at 7, quoting *Lange v. Citibank, N.A.*, 2002 WL 2005728, at 5 (Del. Ch. Aug. 13, 2002). *See generally Feldbaum v. McCrory Corp.*, 1992 WL 119095, at 7-8 (Del. Ch. June 2, 1992) (plaintiffs who buy bonds "consent . . . to no-action clauses" and thus "waive their rights to bring claims that are common to all bondholders," and that "waiver . . . applies equally to claims against non-issuer defendants as to claims against issuers"; fraudulent transfer claims "could only be brought by the trustee"). Within the past two years, the Eleventh Circuit, applying New York law and relying on the precise language of an indenture's "standard" no-action clause, "barr[ed] [individual] noteholders [(hedge

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funds with a majority ownership of the notes)] from bringing" fraudulent transfer claims against the issuer of notes, its directors and officers. *Akanthos Capital Mgmt., LLC v. Compucredit Holdings Corp.*, 677 F.3d 1286, 1288, 1295 (11th Cir. 2012). The recent *Quadrant* decision shows how effective lawyering by plaintiff's counsel saved the day for the client.

Facts

The plaintiff in *Quadrant* sued several defendants in Delaware "for alleged wrongdoing related to notes purchased by Quadrant and issued by defendant Athilon Capital Corp. ('Athilon')," an allegedly insolvent entity. 2014 WL2573378, at 3. As part of an effort to raise capital, Athilon "incurred debt through the issuance of a series of securities . . . consisting of" senior and subordinated notes. *Id.* Quadrant held certain classes of the subordinated notes. *Id.* As a result of the 2008 financial crisis, Athilon "entered into runoff mode . . . ." *Id.* at 4. Quadrant later sued Athilon, its officers and directors, and another affiliated entity, "asserting various counts directly and derivatively as a creditor of Athilon[, including] claims for breaches of fiduciary duty, seeking damages and injunctive relief, [plus] . . . fraudulent transfer claims against [affiliated entities]." *Id.*

The defendants moved to dismiss the Quadrant complaint, asserting it was "barred by a no-action clause" of the relevant indenture "governing the subordinated notes." *Id.* Specifically, the clause in question provided as follows:

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 for any other remedy hereunder, unless such holder previously shall have given to the [Indenture] Trustee written notice of default in respect of the series of Securities held by such Security holder . . . and unless also the holders of not less than 50 percent of the aggregate principal amount of the relevant series of Securities at the time outstanding shall have made written request upon the trustee to institute such action or proceedings in its own name as trustee hereunder and shall have offered to the Trustee such reasonable indemnity as it may require . . . .

Id. According to the defendants, this clause "permitted only Trustee-initiated suits upon the request of a majority of security holders, and prohibited individual security holder actions." *Id.* They relied on *Feldbaum*

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and *Lange*. The court, however, found that relevant no-action clauses "in those cases barred a security holder's action 'with respect to this Indenture *or the Securities* . . . '." *Id.* at 5 (emphasis added).

After rounds of litigation in the Delaware courts, the Court of Chancery found that the no-action clause applied only to contractual claims arising under the indenture, and "that the majority of Quadrant's claims were not barred under the clause . . . ." *Id.* Thereafter, the Delaware Supreme Court certified questions to the New York Court of Appeals as to "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." *Id.*

Purpose of No-Action Clauses

The court agreed with the defendants "that generally a no-action clause prevents minority security holders from pursuing litigation against the issuer, in favor of a single action initiated by a Trustee upon request of a majority of the security holders." *Id.* at 9. These clauses generally "protect issuers from the expense involved in defending [individual] lawsuits that are either frivolous or otherwise not in the economic interest of the Corporation or its creditors . . . [They] protect against the risk of strike suits, [making] it more difficult for individual bondholders to bring suits that are unpopular with their fellow bondholders." *Feldbaum*, 1992 WL 119095, at 5-6.

New York Court of Appeals

According to the Court of Appeals, "a no-action clause which by its language applies to rights and remedies under the provisions of the indenture agreement, but makes no mention of individual suits on the securities, does not preclude enforcement of a security holder's independent common law or statutory rights." *Id.* at 6. Thus, "the clear and unambiguous text of this no-action clause, with its specific reference to the indenture, on its face limits the clause to the contract rights recognized by the indenture agreement itself." *Id. Accord Gen. Inv. Co. v. Interborough R.T. Co.*, 200 A.D. 794, 796 (1st Dept. 1922) (no-action clause applied only to suit to enforce indenture, but plaintiff's action "is not to affect, disturb or prejudice the lien of the collateral indenture or to enforce

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any right thereunder"); *Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992) (plaintiff's fraud and RICO claims not made under indenture and thus not barred by language of no-action clause). In contrast, the no-action clauses in *Feldbaum* and *Lange* were "broad enough to encompass conditions on enforcement of indenture *and securities based claims*." 2014 WL 2573378, at 7 (emphasis added).

Most significantly, the no-action clause in *Quadrant* dealt only with the issuer's default in payment. *Id.* at 10. It was not "an outright prohibition on" a security holder's suit when "the Trustee [lacks] authorization to act." *Id.* The parties never "intended [to] limit the no-action clause in this way." *Id.*

Comment

Quadrant is a welcome development. In the past few years, courts have stretched to bar suits by individual noteholders despite the flexible language of the indenture. *See, e.g.*, *Beal Sav. Bank v. Sommer*, 8 N.Y. 3d 318, 321, 333-34 (N.Y. 2007) (affirmed dismissal of suit by one lender in syndicated loan because other "required lenders" had settled; they had right to sue through their agent; lenders "intended to act collectively"; but dissent argued majority misread documents to deprive minority lender of right to sue; nothing in documents gave agent exclusive right to sue or showed a "surrender of individual lender's right to sue"; to the contrary, documents recited that "each lender severally agrees to make loans," and that no "right or remedy" given the "Agent . . . is intended to be exclusive of any other right or remedy . . . in . . . other Loan Documents or at law and equity"); *In re Metaldyne Corp.*, 409 B.R. 671 (Bankr. S.D.N.Y. 2009) (agent given authority to release collateral in event of default; overruled single lender's objection to agent's credit bid for collateral); *In re GWLS Holdings, Inc.*, No. 08-12430 (PJW), 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009) (same; unanimous voting requirement for release of collateral and amendments; waivers not applicable).

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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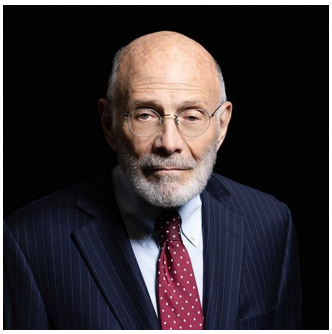

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