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"No-action" Clause in Indenture Strictly Construed by New York's Highest Court

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The importance of careful drafting was recently reiterated by the New York Court of Appeals in Quadrant Structured Products Co. v. Vertin *(2014 NY Slip Op 04114). The Court held that a no-action clause missing any reference to "Securities" was held to apply exclusively to contractual claims arising from the indenture. The contested no-action clause only precluded claims arising under the indenture and did not apply to common law and statutory claims relating to "the Securities."*

The Indenture's No-Action Clause

As part of its business model, Athilon Capital Corp. ("Athilon") sold credit derivative products designed to give credit protection to financial institutions. Quadrant and other investors purchased notes issued by Athilon. In connection with the issuance of the notes, Athilon entered into trust indentures with two trustees. These indentures describe Athilon's duties, as well as the rights of the securityholder in the event of default. Each indenture also contains a no-action clause which provides: "No holder of any Security shall have any right by virtue or by availing of any provision of this Indenture to institute any action or proceeding at law or in equity or in bankruptcy or otherwise upon or under or with respect to this Indenture…" unless certain conditions were first met (*i.e.*, notice of default given to trustee, holders of the majority of notes request that the trustee initiate action and offer trustee indemnity in connection therewith, and trustee fails to take action within 60 days, etc.).

The Delaware Court's Preliminary Decision

By 2008, Athilon had undertaken $50 billion in nominal credit default risk, far exceeding its $700 million capital reserves. In October 2011, Quadrant, a minority security holder, brought claims in the Delaware Court of Chancery against Athilon and its parent company for breach of fiduciary duty and fraudulent transfer. Quadrant alleged wrongdoing in connection with notes it had purchased from Athilon. Quadrant further alleged that Athilon paid interest on its parent company's junior notes, to the detriment of Quadrant's senior notes, despite an agreement that mandated deferral of these payments.

In its motion to dismiss, Athilon argued that Quadrant's claims were precluded by the no-action clause in the indenture. The Delaware Chancery Court dismissed Quadrant's claims. Quadrant appealed to the Delaware Supreme Court, which remanded the case, ordering the Court of Chancery to analyze the significance under New York law of the differences between the no-action clauses contained in the two cases relied on by Athilon and the no-action clause contained in the Athilon indentures. The Chancery Court found that the no-action clause in the Athilon indentures was different and only prevented actions where the securityholder claimed a right based on a provision in the indenture.

New York Law Questions Certified to the New York Court of Appeals

After the Chancery Court issued its report, the Delaware Supreme Court certified two questions to the New York Court of Appeals: (i) whether a no-action clause lacking the term "Securities" prohibits only contractual claims under the indenture or also bars common law and statutory claims arising under the securities; and (ii) whether the Chancery Court's finding was a correct application of New York law.

New York Court of Appeals Strictly Construes the No-Action Clause

The New York Court of Appeals "strictly construed" the no-action clause and gave "effect to the precise words and language used." The Court looked at similar agreements whose no-action clauses typically referenced claims arising out of both the "Indenture" and the "Securities". Given the decision of the drafters to omit the usual exclusion of claims arising out of the Securities in the Athilon indentures, the Court found that "the clear import of the no-action clause is to leave a securityholder free to pursue independent claims involving rights not arising from the indenture."

No-Action Clauses Likely to Be Area of Increased Attention

As a result of this decision, potential litigants will be looking closely at their governing agreements and the no-action clauses contained within. Plaintiffs with common law and statutory claims arising under their securities might have previously assumed (incorrectly) that their claim would be barred by a no-action clause. Moreover, issuers and underwriters will have to negotiate no-action clauses to reflect whether they want statutory and common law claims arising under the securities to be barred by the no-action clause.

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If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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