The Banking Law Journal

Established 1889

125th Anniversary 1889-2014

An A.S. Pratt™ PUBLICATION

NOVEMBER/DECEMBER 2014

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ISBN: 978-0-7698-7878-2 (print)
ISBN: 978-0-7698-8020-4 (eBook)

Cite this publication as:

The Banking Law Journal (LexisNexis A.S. Pratt)

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An A.S. Pratt™ Publication

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(2014–Pub.4815)

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POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Interpreting and Drafting Indenture "No-Action" Clauses

James Gadsden*

The "no-action" clause in indentures may be drafted to extend to a broad spectrum of claims arising out of ownership of the indenture securities. Indenture trustees and their counsel may prefer to limit the scope of claims arising under the covenants in the indenture. The author of this article discusses interpreting and drafting indenture "no-action" clauses.

The New York Court of Appeals has now provided definitive guidance on the operation of the "no-action" clauses that are a ubiquitous feature in bond indentures. No-action clauses prohibit securityholders from bringing claims until and unless a substantial percentage, typically 25 percent of the security-holders, have made a demand on the trustee to take action, offered the trustee reasonable indemnity and the trustee has failed to take action.[1] Although the Court of Appeals found that only claims arising under the indenture were subject to the clause before it, the opinion approved the cases in which more broadly drafted no-action clauses draw within their scope not only claims based on breaches of covenants in the indenture but also claims for fraud, breach of fiduciary duty and other claims against the issuer, its officers, directors and affiliates that might otherwise be brought directly by the securityholders. From the perspective of the institutions that act as trustee under indentures, the broadest application of the no-action clause would bring within its scope claims that the trustees may prefer that the securityholders pursue independently.

QUADRANT STRUCTURED PRODS. CO., LTD. V. VERTIN

Quadrant Structured Prods. Co., Ltd. v. Vertin[2] was decided on questions certified to the Court of Appeals by the Delaware Supreme Court. In the underlying Delaware litigation, Quadrant Structured Products Company, Ltd.

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[1] *See* American Bar Foundation, *Commentaries on Model Indenture Provisions* § 5–7, p. 232 (1971); *Revised Model Simplified Indenture* § 6.06, 38 Bus. Law. 741, 757 (1983); *Revised Model Simplified Indenture* § 6.06, 55 Bus. Law. 1115, 1137–38 (2000).

[2] *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 2014 NY Slip Op 4114.

("Quadrant"), a holder of senior subordinated notes sued the issuer, Athilon Capital Corp. ("Athilon"), its officers and directors, its shareholder, EFB & Associates ("EFB") and its affiliate, Athilon Structured Investment Advisors ("ASIA"), claiming breaches of fiduciary duty and fraudulent transfers based on the directors' approval of the payment of interest on Athilon junior notes owned by EFB, the shareholder, to the detriment of senior noteholders, and payment of above-market-rate fees to ASIA to manage Athilon's operations.[3]

The Athilon indenture stated that that "no securityholder '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 *under or with respect to this indenture* . . .' "[4] unless the conditions to the no-action clause were met, which, in this case, included the requirement of a demand by 50 percent of the securityholders, in place of the 25 percent threshold appearing in the model indentures.[5] Applying the principle that no-action clauses should be strictly construed[6] the court determined that the clause did not bar claims brought by the securityholders without prior demand to the trustee for fraud, fraudulent transfers and breach of fiduciary duty. In contrast, those claims sounding in breach of contract and arising from the indenture were barred—requiring majority securityholder action to bring those claims through the trustee.[7] The Court of Appeals recognized that a no-action clause is concerned with actions to be taken in the case of a default by the issuer of the securities when the trustee is authorized to decide whether to act; it cannot serve as an outright prohibition on a suit filed by a securityholder in the case where the Trustee is without authorization to act:[8]

> [A] no-action clause which by its language applies to rights and remedies under provisions of the indenture agreement, but makes no mention of individual suits on the Securities, does not preclude enforcement of a securityholders' independent common law or statutory rights.[9]

Importantly, the court contrasted the Athilon indenture to no-action clauses

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[3] *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 2014 NY Slip Op 4114 at *5.

[4] 2014 NY Slip Op 4114 at *9 (emphasis in original).

[5] 2014 NY Slip Op 4114 at *6. *Cf.* Indenture forms cited in Note 1, *supra*, all of which have a 25% threshold.

[6] 2014 NY Slip Op 4114 at *8.

[7] 2014 NY Slip Op 4114 at *14.

[8] 2014 NY Slip Op 4114 at *12.

[9] 2014 NY Slip Op 4114 at *8.

that extend beyond the four corners of the indenture to encompass other claims that were the subject of cases cited by the Delaware courts and earlier cases in New York.

> Where the no-action clause refers to both the indenture and the securities, the securityholders' claims are subject to the terms of the clause, whether those claims are contractual in nature and based on the indenture agreement, or arise from common law and statute.[10]

In cases where the clause includes claims "under the securities," courts have found that the no-action clause extended to fraud and fraudulent transfers[11] or breach of fiduciary duty[12] claims. Such a clause applies to all claims, except those excluded from coverage as a matter of law[13] such as federal securities law claims[14] or claims against the trustee[15] or for past due interest or principal on the securities.[16]

CONCLUSION

Given the court's opinion in *Quadrant*, trustees and their counsel should be careful to have references to "the securities" omitted from the no-action clauses in indentures notwithstanding the inclusion of that language in model indenture forms such as the American Bar Association's Model Simplified Indenture[17] and Revised Model Simplified Indenture.[18] As shown by the requirement that the securityholder notify the trustee of a continuing Event of Default under the indenture, the proper scope of the application of no-action clauses is pursuit of breaches of covenants under an indenture and claims to

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[10] 2014 NY Slip Op 4114 at *10.

[11] *Feldbaum v. McCrory Corp.*, 18 Del. J. Corp. L. 630 (1992).

[12] *Lange v. Citibank, N.A.*, 2002 Del. Ch. LEXIS 101 (Del. Ch. Aug. 13, 2002).

[13] 2014 NY Slip Opinion at *11.

[14] *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044, 1051 (2d Cir. 1995); 2014 NY Slip Op 4114 at *10.

[15] *Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992); 2014 NY Slip Op 4114 at *11–12.

[16] Trust Indenture Act Sec. 316, 15 U.S.C. § 77ppp(b).

[17] 38 Bus. Law. 741, 757 (1983).

[18] 55 Bus. Law. 1155, 1137–38 (2000). The clause in the American Bar Foundation's 1971 Commentaries on Model Indenture Covenants at p. 232 referred only to the Indenture. The comments to the Revised Model Simplified Indenture intended to make the point that no-action clauses apply only to indenture covenants did not persuade the New York Court of Appeals that a clause is so limited in cases where the clause referred to actions under the securities. 2014 NY Slip Op 4114 at *10.

enforce remedies only available collectively such as foreclosure on collateral securing the indenture. Action through the trustee should not be legally required and is not practical for claims such as those asserted in *Quadrant*. A claim for avoidance of a fraudulent transfer is available to any creditor[19] and arises independent of any covenant in the indenture or any other contract. Unlike the enforcement of indenture covenants, the trustee and its counsel have no special expertise in asserting such claims and may be wary of doing so given the nature of the allegations. No part of the claim depends on the interaction between the issuer and the trustee in monitoring compliance with the covenants in the indenture. Requiring concurrence of 25 percent or some higher percentage of the securityholders and a potential 60 day delay for the trustee to react may prevent the securityholders from taking action necessary to protect their interests and can have the effect of protecting wrongdoers.[20] If the claim brought directly by a securityholder is ill founded, the defendants have all the usual remedies available to parties against whom claims are asserted, including motions for sanctions.

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[19] *See e.g.* Uniform Fraudulent Transfers Act sec. 8—remedies are available to creditors and sec. 1(3), (4)—a creditor is "person who has a claim" where a claim is a "right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured. A holder of a security issued under an indenture has at least an unmatured claim against the issuer for the principal of and accrued interest on its security." A default under an indenture is not a necessary element to a fraudulent transfer claim; the basis for the claim is not a breach of an indenture covenant.

[20] James Gadsden, *Indenture "No-Action" Clauses Bar Independent Claims By Securityholders*, 130 Banking L. J. 226 (2013).