Client Alert

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New York Court of Appeals Clarifies Application of No-Action Clauses

A decision from the New York Court of Appeals has clarified New York law on no-action clauses in indentures and similar contracts. The court held that a provision that bars claims brought "upon or under or with respect to" an indenture will not bar all claims by investors against other parties to the indenture. The decision is significant because many indentures and similar instruments (such as RMBS pooling and servicing agreements) include no-action clauses to protect parties from suits by minority investors, and are governed by New York law. This ruling increases the risk that trustees, issuers, servicers and other parties to indentures and PSAs might be subject to suit by minority investors on grounds other than contract claims.

No-action clauses protect trustees and other parties from minority investor suits by requiring an investor to obtain the support of holders of some defined amount of the securities before commencing a legal action against other parties to the indenture or PSA. In *Quadrant Structured Products Co., Ltd. v. Vincent Vertin*, 2014 WL 2573378, Case. No. 112 (N.Y. June 10, 2014), however, New York's Court of Appeals held that under New York law, a no-action clause that applies to any action asserting claims "upon or under or with respect to" an indenture or PSA will bar contract claims based on the indenture or PSA, but will not bar investors' other common law or statutory claims.

The case arose from a suit filed in Delaware's Court of Chancery by Quadrant, which had purchased securities issued by Athilon Capital Corp. that were administered under two different trust indentures. In 2011, Quadrant sued Athilon, its officers, directors and parent company, as well as an affiliate of the parent, alleging that Athilon had breached its duties by paying interest on securities held by its parent to the detriment of Quadrant. It asserted certain claims arising under the indentures — breach of the implied covenant of good faith and fair dealing and tortious interference with Athilon's obligations under the indenture — and also asserted claims for breach of fiduciary duty and fraudulent transfer.

The indentures at issue each contained a no-action clause stating that no securityholder had the 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" without first obtaining consent for the action from holders of 50 percent of the outstanding principal balance. Defendants argued that those clauses barred Quadrant's claims, and cited in support two decisions applying New York law, *Feldbaum v. McCrory Corp.*, 1992 WL 119095 (Del. Ch. 1992), and *Lange v. Citibank, N.A.*, 2002 WL 2005728 (Del. Ch. 2002), that had found the no-action clauses in those cases applied to claims for fraud, breach of fiduciary duty and fraudulent conveyance. The chancery court held for the defendants, noting that *Feldbaum* and *Lange* "are directly on point." *Quadrant Structured Products Co., Ltd. v. Vertin*, 2013 WL 5962813, at *6 (Del. Nov. 7, 2013).

On appeal to the Delaware Supreme Court, Quadrant argued that *Feldbaum* and *Lange* should be distinguished: whereas the Athilon clause applied to actions arising "upon or under or with respect to this Indenture," the no-action clauses in those cases limited securityholders' rights to sue "with respect to this Indenture or the Securities." *Quadrant*, at 9-10 (emphasis added). The supreme court remanded the case and ordered the chancery court to report back to it on the differences between the clauses at issue in *Feldbaum* and *Lange* and the clause in the Athilon indentures. The chancery court concluded that

Quadrant was correct and that the text of the Athilon clause meant that it applied only to actions in which a securityholder brought a contract claim based on the indenture. The chancery court further concluded that while the no-action clauses in the Athilon indentures barred Quadrant's claims that arose under the indentures, they did not apply to the claims that arose under Delaware's fiduciary and statutory law. *Id.* at 10.

On receipt of the report from the chancery court, the Delaware Supreme Court certified two questions to the New York Court of Appeals: (1) did the absence of any reference to "the Securities" in a no-action clause mean the clause applies only to contract claims arising under the indenture? and (2) did the chancery court correctly apply New York law when it found that the Athilon no-action clause barred only contract claims arising under the indenture?

The court of appeals answered both in the affirmative. Regarding (1), the court first reaffirmed prior decisions holding that a no-action clause must be strictly and narrowly construed according to the plain meaning of its terms, and that if a term is omitted from such a clause, the "inescapable conclusion is that the parties intended the omission." *Quadrant*, at 12.

Applying those principles to the Athilon no-action clauses, the court held that the unambiguous meaning of those clauses limited their application to attempts by securityholders to enforce contract rights "recognized by the indenture agreement itself." *Id.* at 14. Like the chancery court, the court of appeals contrasted the text of the Athilon clauses to the texts of the clauses at issue in *Feldbaum* and *Lange*, which it found applied more broadly. *Id.* at 15-16. The court cited several other decisions applying New York law to no-action clauses in which courts similarly found common law and statutory claims were barred only when the clauses expressly referred to actions brought under the indenture or securities. *Id.* at 16-18 (citing *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044 (2nd Cir. 1995) (clause applying to actions "with respect to [the] Indenture or the Securities" barred state law claims); *Cruden v. Bank of New York*, 957 F.2d 961 (2nd Cir. 1992) (clause applying to claims "upon or under or with respect to" the indenture did not bar fraud and RICO claims); *Victor v. Riklis*, 1992 WL 122911 (S.D.N.Y. 1992) (clause applying to actions "with respect to [the] Indenture or the Securities" applied to RICO claims); *Gen. Inv. Co. v. Interborough R.T. Co.*, 193 N.Y.S. 903 (N.Y. App. Div. 1st Dep't 1922) (holding clause applied only to claims arising from indenture, and so did not apply to suit to enforce promissory notes)).

The court also rejected defendants' argument that references to the indentures should be read as referring to the securities as well. Defendants had argued that to allow securityholders to assert common law or statutory claims would undermine the purpose of no-action clauses, which is to prevent individual securityholders from instituting actions that benefit minority holders at the expense of the majority. *Quadrant*, at 20-21. The court acknowledged that no-action clauses generally restrict individual actions by securityholders, but held that the purpose of no-action clauses cannot be to restrict all such individual actions. *Id.* at 22 (citing Trust Indenture Act's prohibition on any indenture provision barring all individual actions against trustees). The better understanding of the purpose of no-action clauses, according to the court, is to restrict individual securityholder actions when the trustee has the authority to decide whether to act, e.g., when the issuer of the securities has defaulted. *Id.* at 23. The court observed that the parties could have further restricted securityholder actions by referring to actions under the securities in the no-action clause. That they did not, however, does not mean the purpose of the clause is frustrated. *Id.* at 24.

The court in *Quadrant* recognized that some uncertainty regarding the application of no-action clauses remains, and expressly declined to decide precisely how narrowly to construe clauses like those in *Feldbaum* and *Lange* that included references to "the Securities." *See id.* at 25. Nonetheless, by reaffirming New York law regarding the importance of narrowly reading the plain text of no-action clauses, *Quadrant* clarifies how no-action clauses will be construed and applied. In so doing, it defines more clearly the extent of possible liability for trustees, issuers and servicers under indentures and other agreements (such as RMBS PSAs) that include no-action clauses. For lawyers drafting no-action

clauses, *Quadrant* serves as a reminder that they must be drafted with considerable care, if the intent of the parties is to restrict claims beyond those based on the agreement itself.

Contacts

Brian V. Otero
botero@hunton.com

Thomas Y. Hiner
thiner@hunton.com