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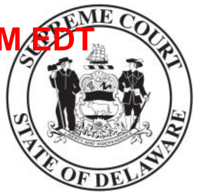

IN THE SUPREME COURT OF THE STATE OF DELAWARE

QUADRANT STRUCTURED PRODUCTS COMPANY, LTD., Individually and Derivatively on Behalf of Athilon Capital Corp., Plaintiff, v. VINCENT VERTIN, MICHAEL SULLIVAN, PATRICK B. GONZALEZ, BRANDON JUNDT, J. ERIC WAGONER, ATHILON CAPITAL CORP., ATHILON STRUCTURED INVESTMENT ADVISORS LLC, MERCED CAPITAL, L.P., MERCED PARTNERS LIMITED PARTNERSHIP, MERCED PARTNERS II, L.P., MERCED PARTNERS III, L.P., and HARRINGTON PARTNERS, L.P., Defendants.	No. 210, 2016 Court below: The Court of Chancery of the State of Delaware, Civil Action No. 6990-VCL

APPELLEES' ANSWERING BRIEF ON APPEAL AND CROSS-APPELLANTS' OPENING BRIEF ON CROSS-APPEAL

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Table of Abbreviations

ASIA	Athilon Structured Investment Advisors LLC
Athilon	Athilon Capital Corp. (also known as "ACC")
AAA	Athilon Asset Acceptance Corp.
AGH	Athilon Group Holdings
AGHAP	Athilon Group Holdings Acquisition Partners, LLC
Athilon Board	Vincent Vertin, Michael Sullivan, Patrick B. Gonzalez, Brandon Jundt, J. Eric Wagoner (also known as "the Directors" or "the Individual Defendants")
Athilon Defendants	The Athilon Board, Athilon, and ASIA
Cournot	Cournot Financial Products LLC
Defendants	The Athilon Defendants and the Merced Defendants
EBF	Merced Capital, L.P., f/k/a EBF & Associates, LP
Gonzalez	Patrick Gonzalez, CEO and Member of Athilon Board of Directors
January Purchase	Athilon's January 14, 2015 repurchase of Senior Notes held by the Merced Funds, *see* A440-41 (¶ 69)
Jundt	Brandon Jundt, Independent Member of Athilon Board of Directors
Merced	Merced Capital, L.P. (also "Merced Capital")
Merced Partners	Merced Partners Limited Partnership
Merced II	Merced Partners II, L.P.
Merced III	Merced Partners III, L.P.
Harrington	Harrington Partners, L.P.
Merced Defendants	Merced Funds and Merced Capital

Merced Funds	Merced Partners Limited Partnership, Merced Partners II, L.P., Merced III, L.P., Harrington Partners, L.P.
Nance	Martin Nance (current CEO of Quadrant)
Park	Eugene Park (former CEO of Quadrant)
Primus	Primus Financial Products
Quadrant	Quadrant Structured Products Company, Ltd.
Sullivan	Michael Sullivan, Member of Athilon Board of Directors
Vertin	Vincent Vertin, Chairman of Athilon Board of directors
Wagoner	J. Eric Wagoner, Independent Member of Athilon Board of Directors

Compl.	Quadrant's Verified Complaint, dated October 28, 2011 (B1)
FAC	Quadrant's Verified Amended Complaint, dated January 17, 2012 (A127)
Fee Op.	Court of Chancery Order Granting Fee Award, March 9, 2016 (Defendants' Ex. B)
Final Judgment	Court of Chancery Final Order and Judgment (Plaintiff's Ex. D)
MR Op.	Court of Chancery Decision on Plaintiff's Motion for Reconsideration, October 28, 2014 (Plaintiff's Ex. B)
MSJ Op.	Court of Chancery Decision on Defendants' Motion for Summary Judgment, May 4, 2015 (Defendants' Ex. A)
MTD Op.	Court of Chancery Decision on Defendants' Motion to Dismiss, October 1, 2014 (Plaintiff's Ex. A)
SAC	Quadrant's Verified Second Amended and Supplemental Complaint, dated April 14, 2015 (A199)

Trial Op.	Court of Chancery Post-Trial Opinion, October 20, 2015 (Plaintiff's Ex. C)

Nature of Proceedings

In seeking to overturn the Court of Chancery's reasoned post-trial decision issued after a five-day trial ("Post-Trial Decision"), Quadrant attempts to use the judicial process to renege on the contractual terms to which it agreed and deny Athilon and its other stakeholders the benefit of their contractual bargain. In May 2011, recognizing that Athilon was on solid financial footing and that its debt was undervalued, Quadrant purchased long-dated Athilon notes ("Notes") at a steep discount from face value. Then, in October 2011, Quadrant filed this lawsuit in an attempt to force Athilon to liquidate and repay its Notes decades earlier than maturity, so that Quadrant could reap a windfall on its investment.

Quadrant claimed that Athilon was obligated to liquidate because it was insolvent on a GAAP balance sheet basis and its operating guidelines did not permit it to engage in any business other than the credit derivative product company ("CDPC") business, which had dried up with the financial crisis. But (1) Athilon's charter expressly permitted the Board to change the operating guidelines to allow Athilon to engage in non-CDPC businesses, which the Board had done; (2) Athilon's Notes did not mature for approximately 30 years and most of Athilon's other "liabilities" were illusory and would never need to be paid (as Quadrant's own Complaint alleged); and (3) Athilon's assets, invested pursuant to its amended operating guidelines, were more than sufficient to ensure it could repay its debts

when they came due. The Court of Chancery dismissed Quadrant's claim that the Board was obligated to liquidate, but allowed claims as to Athilon's payment of allegedly excessive servicing and licensing fees and junior note interest payments to proceed.

Athilon's business strategy proved so successful that eventually even Quadrant no longer disputed its solvency. The Court of Chancery later found at trial that Athilon had returned to solvency by no later than July 2014—and "likely was solvent" much earlier. Quadrant does not contest that finding.

Nine months after Quadrant concedes Athilon had regained solvency, Quadrant filed a SAC attacking Athilon's January 2015 repurchase of Notes from the Merced Funds (the "January Purchase"), even though this transaction took place at a discount to face value and followed the forgiveness of $162 million of Athilon debt by the Merced Funds. The SAC also attacked Athilon's investment in so-called "Regulation XXX" securities. Each of these transactions dramatically improved Athilon's balance sheet. Despite this, and despite Athilon's conceded solvency, Quadrant pursued trial with the goal of forcing liquidation and early repayment of its Notes (which, again, it had purchased at a steep discount) at par. Defendants moved for summary judgment based on Athilon's solvency, but the Court of Chancery denied the motion and the case proceeded to trial.

After trial, the Court of Chancery entered judgment against Quadrant on each of its remaining claims. The court dismissed the claims relating to servicing and licensing fees and junior note interest payments as mooted by the Merced Funds' payment of the disputed amounts back to Athilon (in which the Merced Funds ultimately owned 100% of the equity). And the court rejected Quadrant's claims relating to XXX transactions and the January Purchase.

Quadrant filed this appeal of the Post-Trial Decision in a final effort to force Athilon's early liquidation rather than receive its contractually bargained-for interest payments for the next thirty years. The Appellees cross-appealed the Court of Chancery's award of attorneys' fees on the mooted claims. This is Appellees' Answering Brief on Appeal and Opening Brief on Cross-Appeal.

Summary of Argument

1. ***Contract***: Denied. In the Post-Trial Decision, the Court of Chancery correctly held that the January Purchase did not breach the Indenture. It was a *voluntary* reverse-inquiry transaction at a price below par—not a redemption, which, as Article IV of the Indenture shows, is a transaction in which Athilon exercises its contractual privilege to *compel noteholders* to accept payment of their Notes, at par plus accrued interest, prior to maturity. Section 4.04 restricts the exercise of the privilege to compel early retirement of debt, but it does not address, much less restrict, Athilon's ability to purchase debt when a Noteholder voluntarily initiates a sale of Notes to Athilon at below-par prices. To the contrary, such voluntary transactions are expressly authorized by the Indenture. Section 2.09 does not retroactively convert a voluntary transaction into a redemption, but is merely an administrative provision that addresses when securities are formally cancelled after Athilon acquires them either by Article IV redemption or by purchase. Trial testimony confirms this plain-language reading.

2. ***Implied Covenant***: Denied. In the Post-Trial Decision, the Court of Chancery correctly held that the express provisions in the Indenture permit transactions like the January Purchase. Also, Quadrant seeks improperly to add a conflicting substantive covenant not present in the Indenture. Further, Quadrant's implied

covenant claim is improperly duplicative of Quadrant's express breach claims challenging the January Purchase.

3. ***Fraudulent Transfer***: Denied. Based on its assessment of live testimony at trial, the Court of Chancery made the factual finding that Defendants did not act with intent to defraud in entering into the January Purchase. Quadrant improperly asks this Court to consider two statutory badges of fraud that the Court of Chancery appropriately evaluated in the Post-Trial Decision. There was substantial evidence to support the Court of Chancery's determination that the January Purchase was for reasonably equivalent value and that Defendants did not intentionally conceal the January Purchase.

4. ***Derivative Standing***: Denied. The Court of Chancery correctly found that Quadrant lacked standing to bring derivative claims with respect to the January Purchase and Athilon's XXX Securities purchases, because Athilon was indisputably solvent at the time Quadrant filed the SAC and those claims challenged different transactions than those challenged in the Complaint and FAC and thus did not relate back. Further, Defendants did not improperly "manipulate" Athilon's balance sheet, but rather executed actual transactions that benefited Athilon and erased any potential for doubt as to the strength of Athilon's financial position (*i.e.*, its solvency).

In addition, the dismissal of the derivative claims should be affirmed on the alternative ground that Quadrant lacked standing to maintain any of its derivative claims, including those alleged in Quadrant's Complaint. First, Quadrant lost standing to pursue derivative claims when Athilon became indisputably solvent even on a GAAP balance sheet basis. Thereafter Quadrant was no longer the residual claimant and did not have a cognizable injury that could be redressed by the derivative suit. Second, Quadrant neither pled nor proved that Athilon lacked a reasonable prospect of successfully continuing its business in the face of a deficit of assets below liabilities, a requirement to establish insolvency under the balance sheet test. To the contrary, the Complaint alleged facts sufficient to demonstrate that Athilon did have such a reasonable prospect.

5. ***Attorneys' Fees***: The Court of Chancery erred by awarding Quadrant over $9 million in attorneys' fees for its attempt to force Athilon to liquidate. Quadrant is not entitled to a fee award for seeking to diminish, rather than maximize, the value of Athilon. By seeking to force Athilon to liquidate by means of non-meritorious derivative claims, Quadrant pursued interests adverse to Athilon's.

At bottom, Quadrant's lawsuit is not, and has never been, about protecting the creditors of a purportedly insolvent company against self-dealing by the company's owner. Athilon has always paid its debts when due. And there has never been any meaningful doubt that it would continue to do so. Instead of protecting Athilon and

its stakeholders, Quadrant brought this lawsuit in an attempt to force Athilon's liquidation, contrary to the interests of Athilon and its other stakeholders. Quadrant's purpose was to obtain early repayment of long-dated Notes that it acquired shortly before filing suit with full knowledge of their terms. Rather than protect the benefit of its contractual bargain, Quadrant seeks to destroy that bargain and to deny Athilon and its other stakeholders the benefit of *their* bargain. The Court of Chancery's Post-Trial Decision correctly rejected Quadrant's misguided efforts to do so.

Statement of Facts

A. Athilon's Formation and Business

Athilon was formed in 2004 with the initial purpose of providing workers' compensation reinsurance and of selling credit protection—through credit default swaps ("CDS" or "swaps")—on tranches of corporate bonds. Trial Op. at 4; B107, 110 (Tr. 121:15-122:13, 133:11-22) (describing workers' compensation business); B667 ("Athilon is a financial operating company (having ***initially*** limited purposes)."); B670. To finance its operations, Athilon issued $600 million of long-term debt in three tranches between 2005 and 2007: $350,000,000 of Senior Notes maturing in 2035, 2045, and 2047, A429-30 (¶¶ 19, 21), A720; $200,000,000 of Subordinated Notes maturing in 2045 and 2047, A429-30 (¶¶ 18, 21); and $50,000,000 of Junior Notes maturing in 2046, A430 (¶ 20), B761 (together, the "Notes"). Trial Op. at *2. The Notes paid low interest rates, had few covenants, and were subordinate to Athilon's CDS liabilities. Trial Op. at 3; A431 (¶ 22).

Athilon was one of several companies formed in the early 2000s whose business included the sale of credit protection in the form of CDS. Others, including Primus and Cournot, were formed *solely* for this purpose, Trial Op. at 33, B107 (Tr. 123:7-124:12), and issued debt instruments pursuant to indentures that (a) limited their business to the sale of CDS, and (b) required them to redeem their debt once their CDS expired. Trial Op. at 33; B1580; B1587; B953; B960. Athilon's

Indentures were drafted by the same attorneys that drafted the Primus indentures. Trial Op. at 7-8; B109 (Tr. 130:16-131:3) (Davis Polk drafted Athilon and Primus indentures for Lehman Brothers, which arranged the debt issuance); B309-10 (Tr. 928:17-929:1). But because Athilon was formed to engage in lines of business beyond CDS, Athilon's Indentures did not contain provisions requiring Athilon to engage only in the CDS business, or to redeem its debt if it stopped writing protection on CDS or no longer had any swaps outstanding. Trial Op. at 6-7; B578; A720. The offering memoranda for Athilon's debt ("PPMs") also disclosed that "while [Athilon's] business will initially be limited . . . [Athilon] intend[s] to expand the scope of [its] business." B482; A622.

To support its CDS business, Athilon sought AAA ratings from credit rating agencies. Trial Op. at 5; B108-09 (Tr. 128:6-129:1) (explaining Athilon corporate structure); B667. To obtain these ratings, Athilon negotiated and adopted operating guidelines that had been approved by the ratings agencies ("Operating Guidelines"). Trial Op. at 5; B121 (Tr. 180:2-6); B671 (Moody's Operating Guidelines); B724 (S&P Operating Guidelines). Because the Operating Guidelines were for the benefit of Athilon's swap counterparties (not Noteholders), swap counterparties—but not Noteholders—could enforce the Operating Guidelines. Trial Op. at 5. The Operating Guidelines initially restricted Athilon's business to guaranteeing CDS issued by AAA, Athilon's triple-A rated subsidiary, and its investments to a list of

permissible securities, but permitted amendments with rating agency confirmation. Trial Op. at 7; A539; B122 (Tr. 181:18-184:5). The PPMs for Athilon's debt disclosed that the Operating Guidelines could be "amended . . . without the approval of the holders of the Notes, to permit activities not currently contemplated by the Operating Guidelines." B482; A623.

Under the Operating Guidelines, certain credit events, such as a downgrade of a counterparty credit rating or of Athilon's subsidiary, could trigger a "Suspension Event." Trial Op. at 6; B691-93; B739-40. If a Suspension Event continued for more than six months, Athilon would no longer be permitted to write CDS and would "run off" its existing CDS transactions. Trial Op. at 6; B691-93; B739-40. Because the Operating Guidelines were written for the benefit of swap counterparties, the Operating Guidelines did not specify any requirements after Athilon ran off its swap book. Trial Op. at 6.

Athilon was initially successful. By 2008, Athilon had written protection on $45 billion notional of credit default swaps. A884; B150 (Tr. 294:18-295:1). However, Athilon also wrote protection on two swaps referencing two separate RMBS CDO transactions that suffered significant losses. Trial Op. at 8; B121 (Tr. 177:17-179:2). Athilon commuted the first of these swaps in 2008 for $50 million. Trial Op. at 8; B114-15 (Tr. 152:7-18, 153:22-154:5).

B. Merced's Acquisition of Athilon

During the second half of 2009, Merced, then known as EBF & Associates, began to explore a potential investment in Athilon. Trial Op. at 8; B339 (Tr. 1044:12-1045:22). Merced determined that Athilon's corporate swaps were "money good" and highly unlikely to cause any realized losses, and that the remaining RMBS CDO swap (the "Calyon Swap") was its only major liability. Trial Op. at 8; B344 (Tr. 1064:21-1065:14). If the Calyon Swap were commuted, Merced viewed Athilon as a good investment because its Notes were long-dated, paid a low coupon, and had "virtually non-existent" covenants, and because its governing documents did not require liquidation when the swap portfolio matured. Trial Op. at 9; A845; B1744; B346 (Tr. 1073:7-21). Merced anticipated that it could reposition Athilon's capital into higher yielding, long-dated investments once the CDS portfolio had run off. Trial Op. at 10; B348-49 (Tr. 1082:3-23, 1085:24-1086:16).

Merced acquired approximately $200 million of Athilon Notes in 2009. A438 (¶¶ 60-61); B1643; B340 (Tr. 1050:1-6). In August 2010, it purchased all of Athilon's equity for $47.4 million and appointed the members of the Athilon Board named in the Complaint. Trial Op. at 9; B121 (Tr. 177:14-17); A428-29 (¶¶ 15-16). At the time, there were two competing bids for Athilon's equity, which valued the company at $60 and $75 million, respectively. Trial Op. at 35-36 & n.6; B118 (Tr. 166:9-17); B120 (Tr. 174:8-17); B1290. Shortly after Merced's acquisition, Athilon

commuted the Calyon Swap for approximately $325 million, leaving it with no substantial liabilities that had near-term maturity dates. Trial Op. at 10, 36; B121 (Tr. 177:23-179:16).

After Athilon commuted the Calyon Swap, its GAAP balance sheet showed negative stockholder equity. Trial Op. at 10; B1329. However, neither Mr. Vertin nor Mr. Gonzalez believed that this measure accurately reflected Athilon's financial condition. Trial Op. at 10; B117 (Tr. 161:20-164:15); B342 (Tr. 1051:24-1053:18). Both recognized that Athilon's remaining swaps would not suffer any losses and it did not need to repay the principal on its debt for thirty years. Trial Op. at 10; B108 (Tr. 125:14-126:5); B114 (Tr. 150:19-151:12) (explaining the low-risk nature of swap coverage); B342 (Tr. 1056:9-17) (noting that Athilon would have equity value once the Calyon Swap was commuted).

C. Quadrant's Investment in Athilon and Attempt to Force It To Liquidate

Quadrant owned and operated a CDPC, Cournot, that, unlike Athilon, issued debt pursuant to indentures that included provisions requiring it to liquidate when its last swap matured. B953; B960; B417 (Tr. 1357:1-1358:22). After the market for uncollateralized CDS with CDPCs disappeared in late 2008, Cournot stopped writing new swaps. B721 (Tr. 775:6-19). Quadrant sought other investments to which it could apply its CDPC expertise.

In late 2010, Quadrant, like Merced, began to consider investing in Athilon. Through its experience with Cournot, Quadrant knew that Athilon's corporate swap book was unlikely to suffer any losses. B284-85 (Tr. 825:6-13; 830:6-23; 831:3-16). Quadrant also expressly recognized—based on its own analysis of the Senior Note Indenture, and prior to purchasing a single Note—that Athilon's Senior Note Indenture did not contain a covenant requiring Athilon to redeem its Notes after its last swap matured. Trial Op. at 13; B310 (Tr. 931:10–932:17); B402 (Tr. 1299:17-20). Mr. Vertin also told Quadrant that Athilon did not intend to liquidate Athilon upon expiration of the last swap. Trial Op. at 13; B402-03 (Tr. 1299:21-1300:3); B1639. Nonetheless, Quadrant purchased Athilon Notes, which were still trading at deep discounts, in May 2011, and continued to do so through December 2011. Trial Op. at 13; A446-48.

Quadrant's goal was not to receive its contractual bargain of payments of principal and interest through maturity. Instead, from the time it bought its first Athilon Note, Quadrant's plan was to force Athilon to wind-down operations, liquidate, and prepay the Notes in full decades ahead of maturity, so that Quadrant could more than double its money within 5 years. Trial Op. at 2; B286 (Tr. 835:2-9) (Quadrant "expected" to force liquidation by litigating); B285 (Tr. 830:6-23) ("In five years, [Quadrant] would get about 230% of its initial investment); B1653; B1654. In July 2011, Quadrant made a written demand on the Athilon Board to

cease making interest payments on Athilon's Junior Notes (which were wholly owned by the Merced Funds), to reduce Athilon's payment of service fees to ASIA (Athilon's affiliated investment services provider), to conserve capital, and to liquidate once its swap book matured in 2016. Trial Op. at 14; A936. Athilon's Board rejected Quadrant's demand, and, in October 2011, Quadrant filed its Complaint.

D. Athilon's Business Plan Ensures GAAP Balance Sheet Solvency

XXX Securities are structured by term life insurance companies to fund capital reserve requirements imposed by Regulation XXX of the National Association of Insurance Commissioners. Trial Op. at 10-11; B329 (Tr. 1003:22-1005:2). Many XXX Securities were initially treated as cash and cash-like investments because they traded on an auction held every 28 days, providing investors with sufficient liquidity to exit the position. Trial Op. at 11-12; B332 (Tr. 1016:20-1017:4) (XXX had "28-day liquidity"). When the auction rate market collapsed, these securities began to trade at a significant discount due both to the complex structure of the securitizations and the lack of liquidity. Trial Op. at 12; B1044 (Tr. 1043:4-10) (banks "didn't know what they owned"); *id.* (Tr. 1045:2-4) (Merced acquired XXX Securities for "40 cents on the dollar"). But Merced had significant experience in valuing life insurance policies and recognized that these securities were undervalued. Trial Op. at 12; B328 (Tr. 1002:10-23) (Merced "knew

about . . . life insurance securities”); B332 (Tr. 1017:7-1021:19); B373 (Tr. 1181:16-1182:5) (XXX prices were the result of “massive misunderstanding of risk”). Merced recognized that XXX Securities were a good investment for Athilon because, like Athilon’s debt, they had long-dated maturities and floating rate coupons. Trial Op. at 12; B352 (Tr. 1097:16-1098:15). In May 2011, Athilon obtained rating agency confirmation to amend its Operating Guidelines to allow further investments in XXX Securities (Athilon already held some XXX Securities). Trial Op. at 13; A898; B1641.

In August 2011, Merced decided to sell the Merced Funds’ holdings of XXX Securities to lock in their profits on the securities and because one of the Funds was nearing the end of its life cycle. Trial Op. at 17; B1651; B358 (Tr. 1119:21-1120:2). However, because Merced believed that its XXX Securities would continue to increase in value, Merced decided to sell these securities to Athilon, which was in a better position to hold these securities over a longer period because their long-dated maturity and floating rate coupons matched Athilon’s debt. B330 (Tr. 1008:11-1014:5); B123 (Tr. 185:17-186:19). Athilon was thus capable of capturing greater value from these securities, in which the Merced Funds would share through their ownership of Athilon. Trial Op. at 17; B123 (Tr. 186:7-14). Over a period of about 18 months, Merced sold Athilon $294.5 million in par value of XXX Securities. *Id.*; B1748. To ascertain the market price for each transaction, either Athilon executed

a market purchase of the same security, or Merced obtained a bid for the security from third parties. Trial Op. at 18; B1766-71. Athilon then paid Merced the market price or lower. *Id*.

By December 2013, Athilon's swap portfolio, which previously reflected illusory mark-to-market losses, began to show a gain. Trial Op. at 18; A1130. In December 2013, Merced contributed its Junior Notes to Athilon and received in exchange preferred equity in Athilon's parent, AGH. Trial Op. at 18; A1153. The December 2013 contribution cost Athilon nothing, reduced its liabilities by $50 million, saved it $1.25 million in annual interest expense, and generated a $7 million tax benefit. A1040; B138 (Tr. 247:4-10). The AGH preferred equity that Merced received in exchange was subordinate to all creditor claims against Athilon and because AGH has no assets other than its shares of Athilon, is effectively subject to the DGCL's prohibition on making dividend payments at any time while a corporation is insolvent. Trial Op. at 39; A1153.

After the contribution, Athilon held $553 million in cash and securities against $550 million in outstanding debt obligations. Trial Op. at 19; A1130. However, due primarily to a non-current tax liability of $170 million, Athilon's liabilities still exceeded its assets on a GAAP basis. Trial Op. at 19; A1130. After an IRS audit which resulted in the issuance by the IRS of a "no change" letter for Athilon's 2011

tax returns, Athilon's external auditors allowed the removal of the non-current tax liability from Athilon's balance sheet. Trial Op. at 20; B1699.

E. Athilon's Repurchase Of Debt From Its Parent

In July 2014, Merced proposed that Athilon repurchase Notes held by the Merced Funds at 92% of par for $240.6 million Senior Notes and 83% of par for $111.0 million of Subordinated Notes. Trial Op. at 20; B362 (Tr. 1135:4-24); B1693. Although the Board unanimously agreed that the proposal benefitted Athilon and believed Athilon to be solvent, it rejected the proposal out of concern that Quadrant would use Athilon's GAAP financials as a hook to challenge the transaction. Trial Op. at 20; B82-83 (Tr. 24:2-25-14). In October 2014, Merced obtained a solvency opinion stating that Athilon was solvent, and proposed that Athilon purchase $312 million face value of Notes held by the Merced Funds for $276.5 million. Trial Op. at 21; A1166; B1707. Again, the Board rejected the proposal. Trial Op. at 21; B84 (Tr. 31:4-5).

In December 2014, the Merced Funds contributed $117.5 million in Senior and Subordinated Notes to Athilon in exchange for AGH preferred equity. Trial Op. at 21; B1732; B1773. This contribution cost Athilon nothing, reduced its liabilities by $117.5 million, saved it $3.3 million in annual interest expense, and generated $5 million in tax benefits. B1724; B138 (Tr. 247:4-12). The AGH equity that Merced received in exchange was also structurally subordinate to all creditor claims against

Athilon. Trial Op. at 39; B1773. After the contribution, Athilon's December 2014 GAAP balance sheet showed positive stockholder equity of $173 million. Trial Op. at 21; B1711.

In January 2015, Merced proposed a sale of $194.6 million face amount of Senior Notes for $179 million. Trial Op. at 22; B85 (Tr. 33:7-16). Recognizing that Athilon was indisputably solvent, even on a GAAP balance sheet basis, the Athilon Board approved this transaction. Trial Op. at 21-22; B85 (Tr. 35:11-19). The January Purchase increased Athilon's stockholder equity, reduced its annual interest expense by $5.2 million, and created tax savings of approximately $7 million. B138-39 (Tr. 247:24-250:3). Adjusting for the tax savings realized from the repurchase that Athilon would have not received had it purchased Notes from an unrelated party, the effective price paid was equivalent to a price paid to an unrelated party of approximately 78 cents on the dollar. B1749. The same day, Mr. Gonzalez received an unsolicited offer to sell an odd-lot of an unspecified class of Athilon Notes for "70-something" of face. B139 (Tr. 250:14-251:10); A1252. In May 2015, *Quadrant* "believed that its senior Notes [were] worth more than []82.75 [of face]." B296-97 (Tr. 876:24-877:3).

After the January Purchase, Athilon's quarterly financial statements showed positive stockholder equity of $178 million. Trial Op. at 22; B1740. In February 2015, Appellees filed a motion for summary judgment, arguing that Quadrant lacked

standing to bring derivative claims because (1) at the time Quadrant filed its original Complaint, Athilon was solvent since it had a reasonable prospect of successfully operating its business and paying all debts when due; and (2) even if Quadrant had standing at the time of filing, it lost standing and its claims became moot when Athilon achieved GAAP balance sheet solvency. B40. The Court of Chancery denied this motion. MSJ Op. at 2.

Quadrant sought to challenge the January Purchase. As required by the Indenture, it contacted the Indenture trustee, who declined to intervene. A1350, A1352. Quadrant's former CEO, Eugene Park, also contacted the rating agencies. B1739. Both rating agencies withdrew Athilon's credit ratings as a result, but S&P did so because the Operating Guidelines did not contemplate the January Purchase, B76 (Tr. 64:22-65:4), and Moody's testified that was not presented with any information showing that the Indenture specifically prohibited the January Purchase, B73 (Tr. 43:4-14).

In April 2015, Quadrant filed a SAC challenging the January Purchase and XXX Security acquisitions. Trial Op. at 22.

F. Merced's Payment Mooting Certain Claims

The five-day bench trial was held before Vice Chancellor J. Travis Laster. Following trial, on July 14, 2015, the Merced Defendants transferred to Athilon the full amount of damages claimed by Quadrant arising from the alleged overpayment

of service fees and payment of interest on Junior Notes. B1781. The same day, Appellees filed a motion seeking to dismiss as moot Quadrant's claims related to the service fees and interest payments on Junior Notes. B1779. Quadrant objected to this mooting payment as "unfair to Athilon." B1789. The Court of Chancery granted Defendants' motion and dismissed the service fees and interest payment claims as moot.

G. The Court of Chancery's Post-Trial Decision

After trial, the Court of Chancery rejected Quadrant's remaining claims. It held that the January Purchase was not prohibited by Article IV of the Indenture. Trial Op. at 26-30. It held that the Indenture lacked an implied covenant to "return capital to its stakeholders, and . . . not return capital only to its insiders." Trial Op. at 30-33. It found that Athilon returned to solvency by July 2014, which foreclosed Quadrant's claim that the January Purchase was a constructively fraudulent transfer. Trial Op. at 34-40. It found that the January Purchase was not an intentional fraudulent transfer because the Defendants lacked the requisite intent to hinder, delay, or defraud. Trial Op. at 40-43. Last, it held that because Athilon returned to solvency by July 2014 but Quadrant did not file the SAC until April 2015, Quadrant could not challenge the January 2015 Repurchase and XXX transactions derivatively. Trial Op. at 43-50.

Argument

I. THE COURT OF CHANCERY CORRECTLY HELD THAT ARTICLE IV OF THE INDENTURE DID NOT BAR THE JANUARY PURCHASE

A. Questions Presented

Did the Court of Chancery correctly hold that a noteholder's *voluntary* sale of Notes to Athilon in a reverse-inquiry at a price below par was not barred by Section 4.04 of the Indenture—given that Section 4.04 applies only to transactions in which Athilon exercises its contractual privilege to *compel* holders to sell Notes at the Redemption Price of 100% of par plus accrued interest?

B. Scope of Review

Issues of contract interpretation are reviewed *de novo*. *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1212 (Del. 2012). However, "[t]o the extent the trial court's interpretation of the contract rests upon findings extrinsic to the contract, or upon inferences drawn from those findings, [the Supreme Court's] review requires [it] to defer to the trial court's findings, unless the findings are not supported by the record or unless the inferences drawn from those findings are not the product of an orderly or logical deductive process." *AT&T Corp. v. Lillis*, 970 A.2d 166, 170 (Del. 2009). The Court must "defer to the Court of Chancery's findings as to the significance of the extrinsic evidence." *Id.*

C. Merits of Argument

The Court of Chancery correctly held that Section 4.04 is not applicable to the January Purchase. Trial Op. at 26. Section 4.04, and the whole of Article IV, apply only to "redemption[s]"—which occur only when a holder is *compelled* to sell at the "Redemption Price" of par plus accrued interest. Trial Op. at 26. Because the January Purchase was a *voluntary* transaction initiated by the seller at a discount to par—and not an exercise by Athilon of the Article IV privilege to redeem—the transaction fell outside the scope of Section 4.04. *Id*. at 30.

1. *The January Purchase Was a Voluntary Transaction At a Discount To Par, Not a Redemption Governed By Article IV of the Indenture*

Article IV "redemptions" refer only to transactions in which a holder is compelled to sell his shares at the "Redemption Price" of par plus accrued interest. As the Court of Chancery correctly recognized, "[i]n the absence of special provisions in [an Indenture], a [holder] cannot be compelled to accept payment of his [note] prior to its stated maturity date." Trial Op. at 27. The Court of Chancery also correctly recognized that Article IV, which is entitled "Redemption of Securities," is a "special provision" that gives Athilon the right to acquire its Notes from holders prior to maturity, at Athilon's option and without noteholder consent, at the Redemption Price of par plus accrued interest—even when the Notes are trading at a higher price. *Id*. at 28. This privilege is made plain in the very first

sentence of Article IV, which states "[t]he issuer *at its option* may . . . redeem . . . at a redemption price" equal to par plus accrued interest. A762 (§ 4.01).

The Court of Chancery's holding accords with the Model Commentaries, which New York law endorses as useful aids in interpreting indentures. *Bank of N.Y. v. First Millennium, Inc.*, 598 F. Supp. 2d. 550, 564-65 (S.D.N.Y. 2009), *aff'd* 607 F.3d 905 (2d Cir. 2010) (collecting cases). The Model Commentaries explain that redemption provisions grant the issuer the contractual "privilege to repay before maturity" by "compell[ing] [the holder] to accept payment of his [note] prior to its stated maturity date"—and that "[t]he redemption price is the principal amount of the debentures to be redeemed plus interest from the most recent interest payment date to the redemption date, together with any applicable negotiated premium." American Bar Foundation, *Commentaries on Indentures*, 475, 478 (1971).

The Court of Chancery's reading is the only plausible reading of the text of Section 4.04, which by its terms applies only to redemptions, and not voluntary below-par repurchases. The entirety of Section 4.04 states as follows:

> Section 4.04. *Exclusion of Certain Securities from Eligibility for Selection for **Redemption***. Securities shall be excluded from eligibility for selection for **redemption** if they are identified by registration and certificate number in a written statement signed by an Officer of the Issuer and delivered to the Trustee at least 20 days prior to the **Redemption** Date, as being owned of record and beneficially by, and not pledged or hypothecated by, either (a) the Issuer or (b) an Affiliate of the Issuer.

A764 (bold emphases added). Thus, Section 4.04 refers to redemption not only in the title, but also twice in the text of the single-sentence provision.

Section 4.04 conspicuously omits other terms such as "repay," "repurchase," and "purchase"—terms that appear elsewhere in the Indenture—and that encompass situations in which Athilon buys Notes in *voluntary* transactions. For example, Section 3.03 provides that Athilon may elect to defer interest on its Notes for up to five years, A748 (§ 3.03(a)), but that it may not "*repay, repurchase or* redeem" certain Notes during the deferral period, A749 (§ 3.03(d)(ii)) (emphasis added). Section 2.06(d) requires that securities "presented for registration of transfer, exchange, redemption, *or payment*" be endorsed by the noteholder. A740. Section 2.07(d) creates requirements for the sale of Notes "*purchased*" by Athilon. A744. And Section 2.09 provides that securities may be "surrendered" to Athilon for "redemption" *or* "*payment*," and sets forth the process by which the "redemption *or satisfaction of indebtedness*" becomes effective. A746. Because the parties to the Indenture omitted the terms "repay," "repurchase," and "purchase" from Section 4.04, "the inescapable conclusion is that the parties intended the omission." *Quadrant Structured Prods. Co. v. Vertin*, 23 N.Y.3d 549, 560 (2014); *see also Bank of N.Y. Mellon Trust Co., N.A. v. Morgan Stanley Mortg. Capital, Inc.*, 821 F.3d 297, 306 (2d Cir. 2016) (rejecting contention that cure request was a condition precedent

because "the sophisticated drafters [of the contract] elsewhere employed precisely such language [in the contract] to establish undoubted conditions precedent.").

The parties also chose to omit additional language. Had they sought to restrict large affiliate transactions like the January Purchase, they easily could have included a covenant directly addressing those transactions, rather than barring them cryptically and indirectly through a contorted definition of "redemption." For example, the ABA's *Model Negotiated Covenants and Related Definitions* includes an example of such a provision. 61 Bus. Law. 1439, 1529 (2006) (Section 4.09, titled "LIMITATION ON AFFILIATE TRANSACTIONS") ("The Company shall not . . . enter into . . . any transaction . . . with, or for the benefit of, any Affiliate unless" certain conditions are met). Again, "the inescapable conclusion is that the parties intended the omission." *Vertin*, 23 N.Y.3d at 560.

In addition to the plain language of the Indenture, Quadrant's argument is foreclosed by the relevant case law. The Court of Chancery has previously squarely rejected an argument that a voluntary transaction below par constituted a redemption. In *Katz v. Oak Industries, Inc.*, 508 A.2d 873 (Del. Ch. 1986), the plaintiff alleged that a "coercive" tender offer for Notes at a price below par breached the indenture's redemption provisions. The plaintiff argued that the defendant issuer sought to "effectuate . . . a redemption" through the below-par transaction, and that the issuer was "supposed to pay face value" when it redeemed. *Katz*, No. 8401, Dkt.

No. 21 Oral Argument Tr. at 69 (Mar. 7, 1986). Chancellor Allen rejected this claim because "*the present offer is not the functional equivalent of a redemption which is, of course, an act that the issuer may take unilaterally*." *Katz*, 508 A.2d at 881 (emphasis added). New York case law is to the same effect. *See Snyder v. Memco Eng'g & Mfg. Co.*, 23 A.D.2d 671 (N.Y. 2d Dep't 1965) ("[I]t was error to hold that . . . independent purchases at different times and at discount prices constituted redemptions of [preferred shares]," because "defendant had the option either to redeem all such [preferred shares] at one time at the redemption price or pursue a plan that would be more advantageous to it" by purchasing shares in voluntary transactions below par). These decisions confirming that the word "redemption" refers to a compelled sale were on the books for years before the Indenture was prepared and issued in 2005. Quadrant points to no decision holding that a redemption can occur at less than par, or that a voluntary repurchase of Notes can constitute a redemption.[1]

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[1] The two cases upon which Quadrant relies, *Chesapeake Energy Corp. v. Bank of N.Y. Mellon Trust Co.*, 773 F.3d 110 (2d Cir. 2014) and *Blue Ridge Invs., LLC v. Anderson-Tully Co.*, 2005 WL 44382 (S.D.N.Y. Jan. 10, 2005), do not address whether a voluntary purchase at a price not defined by an indenture constitutes a "redemption" under New York law. Moreover, two of the three dictionaries cited in *Chesapeake Energy* support Defendants' construction. *See Barron's Dictionary of Finance & Investment Terms* 587 (8th ed. 2010) ("redemption" is the "repayment of a debt security or preferred stock issue, at or before maturity, *at PAR or at a premium price*") (emphasis added); *see also Chesapeake*, 773 F.3d at 116 ("redeem" means "to regain possession by *payment of*

Section 4.04 benefits Athilon and its affiliates by excluding affiliates' Notes from partial redemptions and allowing Athilon to call debt held by unaffiliated creditors when it is economically rational to do so (*e.g.*, when the Notes are trading above par), but leave its affiliated debt outstanding. Section 4.04 does not restrict, or even relate to, Athilon's ability to buy Notes offered for sale below par voluntarily by affiliated sellers. *See* 6A Fletcher Cyc. Corp. § 2731 (2015) ("[A] provision entitling a mortgagor to call the bonds for redemption before maturity at a stated premium upon their par value in addition to the principal and interest *is intended for the sole benefit of the mortgagor*, and therefore, *a bondholder cannot enjoin the company from going out into the open market and purchasing its bonds for less than the price at which they are subject to call*.") (emphasis added).

2. *Section 2.09 of the Indenture Does Not Transform a Voluntary Purchase Into a Redemption*

The Court of Chancery correctly rejected Quadrant's argument based on Section 2.09. Quadrant *admits* that when Athilon bought the Notes the acquisition did *not* constitute a redemption. Appeal Br. at 23 ("[H]ad Athilon reacquired the Senior Notes and held them for resale . . . there would have been no redemption."). Quadrant argues that the reacquisition *later* was *converted* into a redemption by Section 2.09, when Athilon delivered the Notes to the Trustee for cancellation.

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a stipulated price" (quoting Webster's *New International Dictionary* 2085 (2d ed. 1934)) (emphasis added).

Appeal Br. at 23-28. But, as the Court of Chancery properly found, Section 2.09 is an administrative provision that addresses cancellation; it does not purport to retroactively convert voluntary purchases into redemptions. Trial Op. at 30.

Section 2.09 provides that:

> All securities surrendered for *payment, redemption, registration of transfer or exchange* . . . shall be delivered to the Trustee for cancellation . . . . If the Issuer shall acquire any of the Securities, such acquisition shall not operate as a *redemption or satisfaction of the indebtedness* represented by such Securities unless and until the same are delivered to the Trustee for cancellation.

A746 (emphasis added). Section 2.09 expressly contemplates that the Issuer (Athilon) may acquire its own securities either through "payment" *or* "redemption." *Id.* Section 2.09 further states that an acquisition does not operate as either a "redemption" *or* a "satisfaction of the indebtedness" until the securities are delivered to the Trustee for cancellation. *Id.* The act of delivering the securities to the Trustee after purchase cancels the securities; it does not convert the purchase into a redemption. Quadrant's argument to the contrary rests on the logical fallacy of "affirming the consequent," sometimes called "converse error" ("1. If A, then B. 2. B 3. Therefore, A."). It is true that if a note is redeemed then it has been cancelled. But that does not mean that the converse is true—"if a note is cancelled then it has been redeemed."

3. *The Trial Record Demonstrates That the January Purchase Did Not Breach the Indenture*

The evidence presented at trial confirms the plain-language reading that the January Purchase did not breach Article IV of the Indenture. For example, Quadrant bought subordinated notes from a CDPC called Primus. Quadrant's CEO, Martin Nance, admitted that Quadrant later sold those notes back to Primus in a voluntary transaction "at a discount" to par, B298 (Tr. 881:16-882:2)—and that Primus's buyback "wasn't a redemption." B299 (Tr. 887:14-20). Both Sections 4.04 and 2.09 of the Primus indenture are *identical* to Athilon's Indenture, and both indentures were drafted by the same counsel, Davis Polk. B109 (Tr. 130:16-131:3); *compare* B1563, B1580, *with* A746, A764. If Primus's repurchase transactions were not redemptions, then neither were Athilon's.

Furthermore, as the Court of Chancery found, Trial Op. at 29, the Indenture Trustee, when presented with the same arguments Quadrant presented to the Court of Chancery, concluded that the January Purchase was not a redemption. B1736. Likewise, Quadrant's fact and expert witnesses admitted that redemptions occur only at "stated value" or "repayment in full." B70 (Tr. 163:3-18; 164:5-8); B201 (Tr. 496:9-20).[2] Quadrant's claim was properly dismissed.

[2] Neither rating agency determined the January Purchase was in breach of the Senior Indenture. B76 (Tr. 64:22-65:4); B73 (Tr. 43:4-44:10).

II. THE COURT OF CHANCERY CORRECTLY HELD THAT THE INDENTURE DOES NOT CONTAIN AN IMPLIED COVENANT BARRING THE CHALLENGED TRANSACTIONS

A. Questions Presented

Was the January Purchase, which was permitted by the express terms of the Indenture, also permitted by the implied covenant of good faith and fair dealing?

B. Scope of Review

Issues of contract interpretation are reviewed de novo. *Gatz Props.*, 59 A.3d at 1212.

C. Merits of Argument

As the Court of Chancery held, the Indenture does not contain an implied covenant that Athilon "not return capital only to its insiders." Trial Op. at 31.[3] Quadrant's purported covenant runs afoul of three settled rules of New York law.

First, because, as explained above, the Indenture expressly authorized Athilon to "purchase," "repay," and "repurchase" its Notes—which is what Athilon did in the January Purchase—the Indenture cannot be read to prohibit this. New York law does not permit a Court to imply a duty that "would be inconsistent with other terms of the contractual relationship." *Murphy v. Am. Home Prods. Corp.*, 58 N.Y.2d 293, 304 (1983); *see also Hartford Fire Ins. Co. v. Federated Dept. Stores, Inc.*, 723 F.

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[3] Quadrant does not identify any provision in the Indenture that was breached by the Merced Funds' contribution of Notes at no cost to Athilon.

Supp. 976, 991 (S.D.N.Y. 1989) ("cannot imply a covenant inconsistent with terms expressly set forth in the contract.").

Second, both Quadrant's express breach and implied covenant claims challenge the same transaction—the January Purchase. "New York law . . . does not recognize a separate cause of action for breach of the implied covenant of good faith and fair dealing when a breach of contract claim, based upon the same facts, is also pled." *Harris v. Provident Life & Accident Co.*, 310 F.3d 73, 81 (2d Cir. 2002). Quadrant's implied covenant claim must therefore be dismissed as duplicative. *L-7 Designs, Inc. v. Old Navy, LLC*, 647 F.3d 434 n.17 (2d Cir. 2011).

Third, under New York law an implied covenant cannot "add to the contract a substantive provision not included by the parties." *Broder v. Cablevision Sys. Corp.*, 418 F.3d 187, 198-99 (2d Cir. 2005). As then-Vice Chancellor Strine held in interpreting an indenture governed by New York law, "[t]he implied covenant in a bond indenture is not a license for judges to invent market terms that should act as a default rule simply because plaintiffs or the judge think they would be a good thing." *In re Loral Space & Commc'ns, Inc.*, 2008 WL 4293781, at *3 (Del. Ch. Sept. 19, 2008); *see also Hildene Capital Mgmt., LLC v. Friedman, Billings, Ramsey Grp., Inc.*, 2012 WL 3542196 at * 7 (S.D.N.Y. Aug. 15, 2012) ("[A] court cannot employ an implied covenant to supply additional terms for which the parties did not bargain."); *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1520

(S.D.N.Y. 1989) ("The sort of unbounded and one-sided elasticity urged by plaintiffs would interfere with and destabilize the market;" "a court will not, *sua sponte*, add new substantive terms to the indenture as it sees fit.").

Further, the Indenture contains express provisions barring certain transactions with affiliates—none of which forbids the January Purchase. *See* A749 (§ 3.03(d)(iii)) (prohibiting Athilon from making payments to affiliates specifically while Athilon is deferring interest on the Senior Notes); A755 (§ 3.06(i)) (prohibiting affiliates from submitting certain orders in auctions). These provisions show that the parties to the Indenture made decisions regarding which affiliate transactions should be barred. The absence of an express provision that would bar the January Purchase conclusively demonstrates that the parties to the Indenture "intended the omission." *Vertin*, 23 N.Y.3d at 560; *Bank of N.Y. Mellon Trust Co., N.A. v. Morgan Stanley Mortg. Capital, Inc.*, 821 F.3d at 306.

Finally, Quadrant's implied covenant would yield results that are commercially absurd. *See Macy's, Inc. v. Martha Stewart Living Omnimedia*, *Inc.*, 127 A.D.3d 48, 54 (N.Y. 1st Dep't 2015). According to Quadrant, the Indenture "should be interpreted to include an implied covenant precluding Athilon from partially liquidating its assets to fund preferential debt prepayments for insiders." Appeal Br. at 31. But Quadrant admits that the January Purchase was entirely permissible up until the moment Athilon canceled the Notes. Appeal Br. at 23.

Thus, in Quadrant's view, Athilon could have executed the same purchase of the Notes from Merced at 92 cents, and held them (instead of canceling them), without breaching any implied or express term of the Indenture. In other words, Quadrant admits the indenture permits so-called "preferential debt prepayments for insiders," and contends that it merely stops Athilon from canceling the Notes. But the cancellation of affiliate Notes *benefits* unaffiliated creditors because, after cancellation, Athilon no longer has an indenture-based claim to its own assets that entitles it to payments *pari-passu* with its unaffiliated noteholders (including Quadrant). Quadrant's construction leads to an absurd result.

III. THE COURT OF CHANCERY CORRECTLY FOUND, FOLLOWING TRIAL, THAT DEFENDANTS DID NOT ACT WITH FRAUDULENT INTENT

A. Question Presented

Does the trial record contain sufficient evidence to affirm the factual finding that the Defendants did not act with fraudulent intent?

B. Scope of Review

"Factual findings bearing on the application of the statute are reviewed for clear error." *SmithKline Beecham Pharm. Co. v. Merck & Co.*, 766 A.2d 442, 450 (Del. 2000). "To the extent those findings turn on determinations of the credibility of live witness testimony and the acceptance or rejection of particular items of testimony, those findings will be upheld. To the extent the challenged factual findings do not turn on the credibility of live witnesses, this Court will accept those findings if they are supported by the evidence and are the product of an orderly and logical reasoning process." *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 50 (Del. 2006).

C. Merits of Argument

1. *Quadrant Disregards the Deferential Standard of Review*

Under 6 *Del. C.* § 1304(a)(1), a transfer is fraudulent only if made "with actual intent to hinder, delay or defraud any creditor or debtor." Intent is a question of fact. 37 C.J.S. *Fraudulent Conveyances* § 76.

After hearing live testimony, the Court of Chancery found as a matter of fact that Defendants lacked the requisite intent. Trial Op. at 42. The Court of Chancery found that the January Purchase "was not a fraudulent transfer under the 'actual intent' standard" because "Athilon expected that it would be able to generate returns from its capital basis sufficient to make interest payments on the Notes over time and pay off the Notes when they came due, decades in the future, [and that] Athilon intended to comply with its obligations to its creditors, which were minimal." *Id.*

Quadrant suggests that the Court of Chancery failed to properly consider the badges of fraud, and failed to apply the presumption applicable to insider transfers. Appeal Br. at 37-38, 40. But the Court of Chancery *did* consider each of the eleven badges of fraud, Trial Op. at 41; *id.* at 42 ("The evidence at trial established that only two of the [badges] were present in this case."), and applied the presumption, *id.* at 41. Quadrant is merely unhappy with the result.[4]

2. *The Trial Record Supports The Court of Chancery's Finding that the January Purchase Provided Reasonably Equivalent Value*

Quadrant contends that Court of Chancery erred by failing to consider the January Purchase's purportedly "unfair[]" price a badge of fraud. Appeal Br. at 37.

[4] Quadrant's reliance on *Homestore, Inc. v. Tafeen*, 886 A.2d 502, 506 (Del. 2005), is misplaced because here the Court of Chancery considered all relevant factors before reaching its determination. But even if it had not, it was "not required to consider" all of the badges of fraud. *Cardrew LLC v. Jones*, 2010 WL 4060339, at *6 (N.M. Ct. App. Mar. 29, 2010); *see* 6 *Del. C.* § 1304(b) (court "may" consider badges).

To the contrary, the Court of Chancery found that the January Purchase "strengthened Athilon's balance sheet," Trial Op. at 40, thereby increasing the likelihood that Athilon's creditors will be repaid.

The Court of Chancery's finding is well supported by the record. The January Purchase increased Athilon's asset to liability coverage, reduced its interest payments, and generated substantial tax savings. B1724; B1735 (comparing outstanding debt before and after the January Transaction); B138-39 (Tr. 247:24-250:3, 251:21-252:10). It was executed at a price that was fair both to Athilon and to Merced Partners III, L.P., which was not an Athilon equity owner. B1139 (Tr. 1139:6-18) ("Merced 3 is not an equity owner, and that's at the heart of this, in my mind. Merced 3 is essentially a third party. Because if Merced 3 sold at those prices and the company liquidated, Merced 3 sold at a price way too low, and the company bought at a great price."). Considering the approximately $12 million of tax benefits from the affiliate repurchase and the additional tax burden that Athilon would have incurred by purchasing the same Notes from an unrelated party, the effective price of the January Purchase was equivalent to a sales price to an unrelated party of approximately 78 cents, fully consistent with the odd-lot offer of "70-something" for an unspecified class of Notes that Athilon received immediately prior to the

January Purchase.[5] B138-139 (Tr. 247:24-251:10); A1252; B1749. The January Purchase price was also consistent with *Quadrant's* own valuation of its Athilon Senior Notes. B296-97 (Tr. 876:11-877:18) (testifying that Quadrant would not sell its Senior Notes for $82.75 based on its belief that the Senior Notes were worth more).[6]

[5] Quadrant argues that a 52 percent of face price indication from Morgan Stanley demonstrates that the January Purchase did not provide Athilon with reasonably equivalent value. A1257. But Quadrant admitted this indication does not reflect a fair price. B296 (Tr. 875:16-23) ("[M]arket quotes . . . . don't reflect what Quadrant believes is the actual or intrinsic value of the Notes.").

[6] Quadrant argues that the January Transaction shifted risk from affiliates to outside creditors. Appeal Br. at 38-39. But Quadrant fails to acknowledge that the affiliates—*i.e.,* the Merced Funds, which own one hundred percent of Athilon's equity—would be the first to suffer losses if Athilon's business model results in losses for the Company. Also, Quadrant has never assessed the probability that Athilon would not be able to repay its debt obligations, B287 (Tr. 839:6-17) (Nance), and thus could not determine whether or how much the January Purchase would impact Athilon's ability to make future payments.

IV. THE COURT OF CHANCERY CORRECTLY HELD THAT QUADRANT LACKED STANDING TO PURSUE ITS DERIVATIVE JANUARY PURCHASE AND XXX CLAIMS.

A. Question Presented

Did Quadrant lack standing to file derivative claims for breach of fiduciary duty as to the January Purchase and XXX transactions because Athilon was undisputedly solvent at the time those claims were filed and the claims related to new transactions not addressed by the Complaint or FAC?

B. Scope of Review

A plaintiff's standing to bring a derivative claim is a question of law that is reviewed *de novo*. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 48.

C. Merits of Argument

Quadrant argues that in April 2015, when it filed its SAC, it had standing to bring claims for breach of fiduciary duty based on the January Purchase and XXX Securities transactions, (i) because they purportedly relate back to the Complaint, or (ii) alternatively, as a matter of "equitable" standing. Appeal Br. at 41-49. But as the Court of Chancery concluded, Quadrant is wrong.

1. *Quadrant's January Purchase And XXX Securities Claims Do Not Relate Back To the Filing of the Original Complaint*

Under Chancery Court Rule 15(c)(2), "[a]n amendment of a pleading relates back to the date of the original pleading when . . . the claim or defense asserted in the amended pleading arose out of the conduct, transaction or occurrence set forth

or attempted to be set forth in the original pleading." "[I]f a plaintiff attempts to allege an entirely different transaction by amendment, Rule 15(c) will not authorize relation back." Trial Op. at 44 (quoting *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC*, 2012 WL 3201139, at *17 (Del. Ch. Aug. 7, 2012)).

In *Central Mortgage*, plaintiff's original complaint against Morgan Stanley sought relief both for a specific list of loans that breached representations and warranties, and also purported to seek relief for similar harm plaintiff expected to suffer in connection with additional, unspecified loans in the loan pool. *Cent. Mortg. Co.*, Complaint, No. 5140-VCS, 2010 WL 6001603, ¶¶ 7, 100, 109 (Del. Ch. Jan. 29, 2010). Plaintiff later sought to amend its complaint to add allegations that many specific loans beyond those listed in the original complaint breached the same contractual representations and warranties. *Cent. Mortg. Co.*, 2012 WL 3201139, at *3. Plaintiff argued that its claims as to additional loans related back because the complaint gave express notice that it would seek to recover for harm as to additional loans—and that the claims arose out of the same set of facts that supported the original complaint, including (a) the same representations by Morgan Stanley concerning the truthfulness of all mortgage loan information; (b) the same representations by Morgan Stanley concerning competent due diligence; (c) Morgan Stanley's admission that it failed to conduct due diligence; and (d) Morgan Stanley's

subsequent refusal to cure. *Central Mortg. Co.*, Plaintiff's Answering Brief, No. 5140-CS, at 14 (Del. Ch. Feb. 28, 2012).

The Court of Chancery rejected plaintiff's argument. 2012 WL 3201139, at *3. The court explained that a claim does not relate back merely because the plaintiff "alleges that it expects further claims of a similar nature may be discovered in the future," and that "a separate independent violation of the same contract provision does not 'arise' out of the same conduct, transaction or occurrence as did the first, unrelated violation." *Id.* at *3, *18.

Unlike in *Central Mortgage*, Quadrant's initial Complaint did not include allegations threatening future claims against the January Purchase and the XXX transactions, which had not even occurred when the Complaint was filed. Trial Op. at 44-45. If the claims in *Central Mortgage* did not relate back, then, *a fortiori*, neither do Quadrant's.

Quadrant argues that the XXX transactions and the January Purchase were both part of the "risk-on" strategy alleged in the Complaint. Appeal Br. at 45. But, as the Court of Chancery recognized, "a general principle is not the same as a legal claim." Trial Op. at 45. At bottom, Quadrant's argument would allow any derivative plaintiff that obtains standing to bring a claim for breach of fiduciary duty to challenge *all subsequent corporate action*—regardless of whether the plaintiff retains standing—by making broad, generalized challenges to "risky" or "self-

dealing" transactions in its initial Complaint, and arguing that any subsequent corporate action was consistent with that theory. That is clearly not the law. Quadrant's attempt to challenge "entirely different transaction[s] by amendment" should be rejected. Trial Op. at 44.

Quadrant also argues that Athilon "understood" from the original Complaint that Quadrant would seek to challenge the future January Repurchase and XXX transactions. Appeal Br. at 46. Put charitably, Quadrant's cites to the record do not support the assertion. For example, Quadrant's lead citation is to "Ex. A at 33-34." But the cited pages are from the Court of Chancery's decision on the motion to dismiss, and refer to Athilon's decision to not to defer interest on the Junior Notes—a transaction that is not at issue on this appeal. The cited pages do not refer to any XXX Securities or any repurchases of any Notes, much less indicate that Athilon "understood" from the original Complaint that Quadrant would in the future sue on the XXX or January Repurchase transactions.

In any event, the Court of Chancery rejected the argument that Athilon's investment in riskier investments could constitute a breach of fiduciary duty and held that such a decision was protected by the business judgment rule. MTD Op. at 49-50. Quadrant does not appeal this ruling. Because these claims were dismissed from the suit, even if these claims actually did "relate back" to the original Complaint,

they would also have been dismissed under the business judgment rule. MTD Op. at 50.

2. *Defendants Did Not "Manipulate" Athilon's Solvency—They Improved Athilon's Financial Position*

Alternatively, Quadrant contends that it should be equitably permitted to challenge the January Purchase and XXX transactions because, according to Quadrant, Defendants "manipulated" Athilon's solvency. Appeal Br. at 47-50. But as the Court of Chancery found, Defendants did not "manipulate" Athilon's solvency; at the time the SAC was filed, Athilon *was* solvent. Trial Op. at 34. Thus, the January Purchase was not an example of "self-dealing by insiders"—it was a transaction between a parent and its wholly-owned solvent subsidiary that Athilon's Board was obligated to approve. *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988).

Between 2011 and 2015, Defendants engaged in transactions that benefitted Athilon on both the equity and the debt side of its balance sheet. On the asset side, Athilon purchased XXX Securities from the Merced Funds at or below market prices, as shown by third party market indications and spot trades with other counterparties, Trial Op. at 17-18; B1766-71.[7] These securities have since

[7] The Court of Chancery found that, "in all but two transactions, Athilon paid the same price or a lower price than what the insurance companies paid during the same period in arms' length transactions. For the two exceptions, Athilon paid only slightly more." Trial Op. at 18.

substantially increased in value, benefitting Athilon and its creditors. Trial Op. at 36.

On the liability side, the Merced Funds' contribution of $162.5 million face of Notes in exchange for preferred equity issued by Athilon's parent, and at no cost to Athilon, greatly improved Athilon's financial condition. These transactions reduced Athilon's interest payments, lowered its debt load, and generated tax benefits. B1724; B138 (Tr. 247:4-12). None of these facts are in dispute. Through those transactions, the Merced Funds subordinated their claims to Athilon's assets below all of Athilon's other creditors, including Quadrant. Under Delaware law, Athilon cannot pay dividends to its parent unless it is solvent. 8 *Del. C.* § 170. These transactions were not "manipulative," but rather were well-considered actual transactions that improved Athilon's long term value.

Once Athilon returned to solvency, it returned funds to its sole equity owner, as it was entitled to do. Defendants could just as easily have structured the January Purchase as a note cancellation and dividend. Athilon's assets exceeded its liabilities by $168 million before the January Purchase, and by $181 million afterwards. B1711; B1740. The transaction was structured as a repurchase primarily for tax reasons. B363 (Tr. 1142:1-23). Because Athilon was solvent both before and after the transaction, under *Anadarko* Athilon's transaction with its 100% equity owner does not trigger entire fairness review as Quadrant suggests. Appeal Br. at 49.

Quadrant's attempt to challenge Athilon's transactions derivatively was properly rejected.

Additionally, Quadrant's claims against independent-director Defendants Jundt and Wagoner should have been dismissed at the pleading stage for the independent reason that the Complaint merely alleged that Athilon engaged in an interested transaction, without alleging that these independent directors personally gained, or alleging any other facts supporting an inference of a breach of duty of loyalty. *In re Cornerstone Therapeutics, Inc. S'holder Litig.*, 115 A.3d 1173 (Del. 2015).

V. THE COURT SHOULD AFFIRM THE DISMISSAL OF QUADRANT'S DERIVATIVE CLAIMS ON TWO ALTERNATIVE GROUNDS THAT WERE INCORRECTLY REJECTED BY THE COURT OF CHANCERY

A. Questions Presented

Did Quadrant lack standing to pursue derivative claims on behalf of Athilon because (1) Athilon was not insolvent at any time after July 2014; and (2) Athilon has always paid its debts when they came due and, at the time Quadrant filed suit and at all times thereafter, Athilon always had a reasonable prospect of successfully continuing its business? Preserved at B56, B60, MSJ Op. at 2.

B. Scope of Review

This Court may affirm the Court of Chancery's final judgment "with any argument that is supported by the record." *Hercules Inc. v. AIU Ins. Co.*, 783 A.2d 1275, 1277 (Del. 2000). Questions of law are reviewed *de novo*. *B.F. Rich & Co. v. Gray*, 933 A.2d 1231, 1241 (Del. 2007). Factual findings concerning Athilon's solvency are entitled to substantial deference. *See supra* III.C.2.

C. Merits of the Argument

Agents who make decisions for the corporation should strive to maximize its value. *See Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 788, 791 (Del. Ch. 2004); *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 195 n.75, 205 (Del. 2006). Derivative standing to assert fiduciary claims is conferred on stakeholders as a tool to accomplish this value-maximization goal. While it may

be true—as the Court of Chancery noted in the present case—that "[c]reditors always have some interest in improving the financial condition of the [solvent] firm" to increase security from an equity cushion, MSJ Op. at 27—Delaware case law has long recognized that any such desire by a creditor for increased cushion is *non-cognizable*. *See Katz v. Oak Indus., Inc.*, 508 A.2d 873, 878-79 (Del. Ch. 1986) ("*no cognizable legal wrong*" when a solvent company benefits its "common stockholders at the expense of Holders of its debt"; changing this rule would require "either *legislative direction* to do so or the *negotiation of indenture provisions* designed to afford such protection") (emphasis added). Thus, Delaware precedent does not grant standing to creditors of a solvent company to allege fiduciary claims against corporate directors, and this is so regardless of whether or not the allegedly self-dealing wrongdoers own 100% of the equity. *See Prod. Res.*, 863 A.2d at 788, 791; *Trenwick.*, 906 A.2d at 195 & n.75.

This well-established precedent recognizes that, during solvency, the constituency whose incentives are aligned with the corporate pursuit of value maximization is equity, because equity participates substantially in both the upside gains and downside risks entailed by corporate decision-making. This precedent also recognizes that creditors have no extra-contractual, fiduciary claims to cash flows in excess of what is required to fulfill the company's contractual obligation to pay them according to the terms of their contract. *See Cont'l Ill. Nat. Bank & Trust*

Co. of Chicago v. Hunt Int'l Res. Corp., 1987 WL 55826 (Del. Ch. Feb. 27, 1987) ("The proposition . . . that the relationship between a [solvent] corporation and its directors and debenture holders is *contractual, not 'fiduciary,'* in nature, is well settled in this state.") (emphasis added).[8]

In the present case, the Court of Chancery erred in departing from these sound principles—and created a new rule that treats the creditor's non-cognizable desire for excess cushion as actionable—by holding that a creditor derivative plaintiff has standing to pursue fiduciary claims even when the company is proven solvent at the time of summary judgment or at the time of trial.

The Court of Chancery's new rule not only departs from legal principles recognizing the agency problems entailed by creditor standing during solvency, but also breaks from traditional injury and redressability principles under which standing is tested on the facts as they exist at each successive stage of the litigation (motion to dismiss, summary judgment, and trial), in order to determine whether there is any existing injury that the court currently can redress. *See Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561 (1992); *Dover Historical Soc'y*, 838 A.2d at 1109-10 (citing and quoting *Lujan*, 504 U.S. at 561).

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[8] *See also Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986); *eBay Domestic Holdings, Inc. v Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010); *TW Services, Inc. v. SWT Acquisition Corp.*, 1989 WL 20290, at *7 (Del. Ch. Mar. 2 1989); *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. Supr. 1919).

The Court of Chancery departed from sound agency and standing principles even though there was no "gap" in creditor-rights that needed to be filled. Creditors protect their rights through heavily negotiated indentures (*e.g.*, in *Credit Lyonnais* the creditor bargained for a contractual prohibition against the controlling stockholder interfering with management of the company);[9] the implied covenant of good faith; state fraudulent transfer laws; voidable transfers in bankruptcy; higher interest rates; and the price they pay for their Notes. *See Trenwick*, 906 A.2d at 195 n.75, 198-99 (citing Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. Bus. & Tech. L. 335 (2007)). Here, Quadrant did not bargain for any contractual right to require Athilon to maintain any amount of equity cushion above what is needed to repay Quadrant's Notes. The Court of Chancery erred by granting Quadrant such a right and declaring a new rule that conferred standing on Quadrant to pursue fiduciary claims nearly a year after Quadrant *conceded* that Athilon was undisputedly solvent, and in fact had assets that exceeded liabilities by at least $173 million when summary judgment was filed, B1711, and $181 million at the time of trial, B1740.

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[9] *See Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'n Corp.*, 1991 WL 277613, at *9-*11 (Del. Ch. Dec. 30, 1991); Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 Vand. L. Rev. 1485, 1523 (Nov. 1993).

1. *Quadrant Was Divested of Creditor-Derivative Standing by Athilon's Solvency, and Its Claim Was Therefore Moot*

Under the mootness doctrine, "although there may have been a justiciable controversy at the time the litigation was commenced, the action will be dismissed if that controversy ceases to exist." *Gen. Motors Corp. v. New Castle Cnty.*, 701 A.2d 819, 823 (Del. 1997). A proceeding becomes moot when the plaintiff has been divested of standing, *id.*, which requires an injury in fact, causation, and redressability. *In re Celera Corp. S'holder Litig.*, 59 A.3d 418, 429 (Del. 2012). "The primary purpose of standing is to ensure the plaintiff has suffered a redressable injury." *Schoon v. Smith*, 953 A.2d 196, 200 n.3 (Del. 2008) (quoting *In re Career Educ. Corp. Deriv. Litig.*, 2007 WL 2875203, at *9 (Del. Ch. Sept. 28, 2007)).

Because "[a] change in the parties' standing may . . . occur while the litigation is in progress," *Gen. Motors Corp.*, 701 A.2d at 824 & n.6, the facts alleged by the plaintiff to demonstrate standing "must be supported adequately by the evidence adduced at trial." *Dover Historical Soc'y v. City of Dover Planning Comm'n*, 838 A.2d 1103, 1110 (Del. 2003) (citation omitted). At trial, Quadrant failed to present facts supporting its assertion of standing—namely, that it had suffered an injury that the Court of Chancery currently could redress.

Insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 101 (Del. 2007). Thus,

"equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation." *Id.*; *see also Schoon*, 953 A.2d at 208 n.46 ("*Gheewalla* confers [derivative] standing upon creditors . . . where the corporation is insolvent . . . only because the shareholders of an insolvent corporation no longer have an economic interest in the corporate entity—only its creditors have that interest.").

But the creditor is entitled only to the terms of its debt, not more. *See Gheewalla*, 930 A.2d at 99 ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms." (quoting *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992))). Quadrant could have, but did not, bargain for the right to require Athilon to maintain an excess equity cushion above and beyond what is needed to pay the Notes. Nor did Quadrant bargain for a share of the upside through convertible debt securities or otherwise. *See* Bainbridge, *Much Ado About Little?*, *supra* at 357-58. In this situation, the meritorious derivative claim does not redress any cognizable injury, because the appreciation of the corporation's assets to the point of undisputed solvency itself secures payment of the debt in accordance with the parties' bargain (just as it does for a company that has never been insolvent). By the time of summary judgment and trial—when Athilon was undisputedly solvent—there was no injury to relieve because Quadrant never had a

protectable right to surplus cash flows in the first place, whereas the stockholders always did.

Here, even if Athilon were once insolvent, as the Court of Chancery found, it returned to solvency no later than July 2014, almost a year before trial. Trial Op. at 34. Had Quadrant secured a judgment on its derivative claims at trial, Athilon would have received funds from its directors and controllers, and its residual value would have appreciated to the benefit of the constituency that contributed funds to the company in exchange for the right to share in the upside—*i.e.*, the stockholders. Quadrant, which did not contribute funds to the company in exchange for the right to share in any such upside, would have derived no non-negligible benefit. Indeed, as Quadrant conceded, Athilon has "[n]ever missed any payments" on its Notes or any other debts. B287 (Tr. 838:22-839:1).

With no non-negligible stake in the outcome, Quadrant's incentives were fundamentally misaligned with the company's. Delaware law recognizes the importance of the derivative plaintiff adequately representing the economic interests of the corporation in a number of contexts. For example, the purpose of the judicially-created continued ownership rule—which requires a stockholder derivative plaintiff to maintain ownership in the corporation through the pendency of the derivative suit—is to "ensure that the plaintiff . . . has an economic interest aligned with that of the corporation and an incentive to maximize the corporation's

value." *Parfi Holding AB v. Mirror Image Internet, Inc.*, 954 A.2d 911, 939 (Del. Ch. 2008). Likewise, the Court of Chancery Rules require the Court of Chancery to evaluate the adequacy of a representative plaintiff, including "economic antagonisms between the representative and the class." *In re Fuqua Indus., Inc. S'holder Litig.*, 752 A.2d 126, 129-30 (Del. Ch. 1999); *see also In re Infinity Broad. Corp. S'holder Litig.*, 802 A.2d 285, 291 (Del. 2002) (citing *Fuqua* with approval). A requirement of continued insolvency to support creditor derivative standing similarly ensures proper alignment of the plaintiff's and corporation's interests.

This case starkly demonstrates the importance of ensuring such alignment. Athilon's interests were best served by continuing to execute its business plan, which has been a resounding success. *Compare* B1644 (stockholder deficit in September 2011 of approximately $660 million), *with* B1711 (stockholder equity in December 2014 of approximately $172 million). But, as it pleaded and as it conceded at trial, Quadrant brought suit to force Athilon to liquidate. Trial Op. at 2; *see also* B286 (Tr. 835:2-9) (Quadrant "expected" liquidation because of lawsuit); B1653-64; B15 (¶¶ 65-66); A275 (¶ 276). This liquidation would benefit Quadrant, a senior creditor, because it otherwise would not receive repayment of principal on its Athilon Notes for nearly thirty years. But liquidation would not serve Athilon's economic interests, or those of its owners and residual claimants.

The Court of Chancery's case management and policy justifications for declining to apply the continued insolvency rule are flawed. *First*, the Court of Chancery noted that "a troubled firm could move back and forth across the insolvency line," such that controllers of a truly insolvent company could evade review by seeking to trigger the solvency determination at a time when the company temporarily had obtained the appearance of solvency. MSJ Op. at 28. But as the Court of Chancery noted, the solvency determination "is not a bright-line inquiry." MSJ Op. at 26 (collecting authorities). It would be an undesirable development in Delaware corporate law to subject clearly solvent corporations to creditor derivative litigation to protect the availability of creditor derivative suits in borderline situations. Under the continued insolvency rule, standing is tested at the traditional points in a litigation; in keeping with *Lujan*,[10] the creditor derivative plaintiff is required to prove insolvency only once (at trial), before that the derivative plaintiff need only plead facts supporting insolvency (at the motion to dismiss stage) and present evidence sufficient to create a dispute of material fact of solvency (at the summary judgment stage). Where a corporation remains near the insolvency line,

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[10] "Since [the elements of standing] are not mere pleading requirements but rather an indispensable part of the plaintiff's case, each element must be supported in the same way as any other matter on which the plaintiff bears the burden of proof, *i.e.*, with the manner and degree of evidence required at the successive stages of the litigation." *Lujan*, 504 U.S. at 561.

the creditor derivative plaintiff will have no trouble presenting evidence sufficient to raise a reasonable dispute of material fact as to the corporation's solvency and proceed to trial.[11]

Second, the Court of Chancery noted practical difficulties associated with proving Athilon's solvency. MSJ Op. at 26-27. But regardless of whether the creditor derivative plaintiff must prove time-of-trial insolvency or time-of-complaint insolvency, the creditor derivative plaintiff must prove insolvency. A continued insolvency requirement does not inject complexity at trial, but rather focuses the insolvency inquiry on the points in time that have always been relevant under fundamental principles of standing law. *See Dover Historical Soc'y*, 838 A.2d at 1110-11 (at summary judgment "plaintiff can no longer rest on 'mere allegations' to establish standing" (citing *Lujan*, 504 U.S. at 561)).

Because Athilon was solvent at the time of trial, this Court should affirm the Court of Chancery's dismissal of each of Quadrant's derivative claims for breach of fiduciary duty on this alternative ground.

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[11] And if the corporation moves for summary judgment before the close of discovery, the creditor derivative plaintiff can make use of Court of Chancery Rule 56(f) to delay a ruling.

2. *Quadrant Failed To Plead Or Prove That Athilon Lacked a Reasonable Prospect of Successful Continued Operations*

Quadrant failed to plead or prove Athilon's insolvency at the time it filed suit—a condition of its standing to bring creditor derivative claims. Quadrant's Complaint did not (and could not) allege that Athilon had ever failed to pay a debt when due. Although Quadrant alleged that Athilon's liabilities exceeded its assets on a GAAP balance sheet basis, it failed to plead or prove the other essential element of balance sheet insolvency—namely, that there was "no reasonable prospect that the business can successfully be continued in the face [of a book equity deficit]." *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004) (quoting *Siple v. S & K Plumbing & Heating, Inc.*, 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982)); *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 2006 WL 2588971, at *10 (Del. Ch. Sept. 1, 2006), *aff'd* 930 A.2d 92 (Del. 2007).

To the contrary, Quadrant has conceded—and indeed affirmatively pled—facts that made clear that Athilon *did* have a reasonable prospect of successful continued operations at the time Quadrant brought suit in October 2011 and at all times thereafter. The original Complaint alleged that as of September 30, 2011, Athilon held $426 million in cash and investments against approximately $1.5 billion in liabilities. B14 (¶ 58). But this book deficit was highly misleading.

First, the Complaint alleged, and Quadrant conceded at trial, that Athilon was unlikely to ever pay out on the $813 million in negative mark-to-market losses

arising from its corporate CDS book. B15 (¶ 62) ("The risk in [Athilon's] remaining Credit Swaps portfolio is so low that [Athilon] is unlikely to have to pay a Credit Swaps claim."); B284 (Tr. 825:6-19) ("extremely unlikely" that Athilon would have to pay on swaps).

Second, Quadrant effectively conceded in its Complaint, and admitted at trial, that Athilon's $133 million non-current tax liability relating to its tax treatment of CDS was "very unlikely" to have to be repaid. B14 (¶ 58) ("the Company carries $600 million of outstanding debt," which does not include the contingent tax liability); B287 (Tr. 837:14-838:8) ("very unlikely" that Athilon would have to pay CDS taxes).

Third, Quadrant conceded, as it must, that Athilon's $600 million in long term debt, which constituted the vast majority of its remaining liabilities, was not due for over thirty years. *See* A980 (listing classes and maturity dates of Athilon debt). Moreover, all $50 million of the Junior Notes were held by the Merced Funds, Athilon's equity owner, and were subordinated to all debt held by unaffiliated noteholders. A438 (¶ 61). For the next thirty years, Athilon only had to generate enough income to cover the remaining debt's low interest rate of LIBOR plus 250 basis points, A980, and generate a few million dollars of additional income per year from its $426 million capital base to ensure all unaffiliated noteholders were repaid when their Notes came due in the 2040s.

Quadrant's sole basis for alleging that Athilon lacked a reasonable prospect of successfully continuing its business was that Athilon was prohibited from investing in higher-yielding assets by its Operating Guidelines and by Delaware fiduciary law. *See* B14-15 (¶ 61). But as the Court of Chancery correctly held, and Quadrant does not challenge on appeal, this was not true. MTD Op. at 38; MR Op. at 1, 7, 11. Because Athilon had a viable business strategy, had the ability to amend the Operating Guidelines, and had entirely manageable liabilities when Quadrant brought suit, Athilon always had a reasonable prospect of successful continued operations.

Further confirming this, as the Court of Chancery held, Athilon's GAAP balance sheet did show positive stockholder equity, and Athilon has been indisputably solvent, since at least July 2014. Trial Op. at 34. As of March 31, 2015—just three and a half years after Quadrant alleged it was hopelessly insolvent—Athilon had positive stockholder equity of $181 million. B1740.

The Court of Chancery erroneously declined to follow *Production Resources* and *Gheewalla* and to apply the "reasonable prospects" prong of the balance sheet test to assess Athilon's solvency. MSJ Op. at 36. Although this Court has never had occasion to consider this prong of the test in a creditor derivative suit, it was drawn from receivership cases, in which it has consistently been used to determine insolvency and not, as the Court of Chancery held, in deciding whether to exercise

the discretion to appoint a receiver.[12] In the creditor-derivative context, this test strikes the appropriate balance between incentivizing productive risk taking and protecting creditor rights. When a company has a reasonable prospect of success, equity holders have the incentive to police fiduciary misconduct, because a company that has a reasonable prospect of success is one in which equity holders can reasonably expect to benefit from the corporation's growth. Only when the company lacks a reasonable prospect of success do creditors become the proper enforcers of fiduciary breaches.

If a mere book imbalance were sufficient to confer standing, a company that found itself technically balance sheet insolvent for just one day could be hijacked by an unscrupulous derivative suit. The "reasonable prospects" test protects companies

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[12] For example, in *Production Resources*, the court first applied the reasonable prospects test and held that the creditor plaintiff had raised a reasonable inference that the defendant corporation was insolvent. *Prod. Res.*, 863 A.2d at 782-83. Only after addressing the corporation's solvency did the *Production Resources* court consider whether it was appropriate to exercise its discretion to appoint a receiver. *Id*. at 784-86; *see also Pope Invs. v. Benda Pharm.*, 2010 WL 5233015, *6-8 & n.13 (Del. Ch. Dec. 15, 2010); *Siple*, 1982 WL 8789, at *2 (declining to address whether to appoint receiver because defendant was not insolvent); *Freeman v. Hare & Chase*, 142 A. 793, 795 (Del. Ch. 1928) ("Insolvency under the statute may be of two kinds, viz. (a) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof, or (b) an inability to meet maturing obligations as they fall due in the usual course of business."); *Whitmer v. William Whitmer & Sons, Inc.*, 99 A. 428, 430 (Del. Ch. 1916) ("An excess of liabilities over assets may constitute insolvency, unless it appears that there is a reasonable prospect that the business could be successfully continued notwithstanding the deficiency of assets.").

from baseless suits which seek wrest control from the board under such circumstances, contrary to the interests of the company as a whole and all of its stakeholders—just as Quadrant sought to do here.

The Court of Chancery has rejected application of a strict book calculation of solvency in response to this exact concern. In *Francotyp-Postalia AG & Co. v. On Target Tech.*, 1998 WL 928382, at *5 (Del. Ch. Dec. 24, 1998), then-Vice Chancellor Steele refused to apply the strict balance sheet test in a request for a receiver because it "could lead to a flood of litigation arising from alleged insolvencies." As *Francotyp-Postalia* acknowledges, many companies with strong financial prospects, including start-ups, can continue to operate successfully even if they fail the mechanical balance sheet test. Including the reasonable prospects prong properly places more emphasis on the company's ability to continue its business and pay its debts than it does on a formalistic balance sheet analysis.[13]

The Court of Chancery concluded that the reasonable prospects prong was unnecessary because DUFTA contains a statutory definition of insolvency that does

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[13] In rejecting the reasoning of *Francotyp-Postalia*, the Court of Chancery suggested that because the balance sheet considers the "reasonable market value" of assets, it "takes into account the realities of the business world in which corporations incur significant debt in order to seize business opportunities." MSJ Op. at 39-40. But the rash of litigation that the reasonable prospect prong eliminates comes from the ability of plaintiffs to *plead*, not to *prove*, insolvency, and the Court of Chancery held that an excess of liabilities over assets was sufficient to plead insolvency *in this very case*. MTD Op. at 21.

not apply the reasonable prospects prong, and fraudulent transfer actions are likely to be asserted in connection with derivative claims. MSJ Op. at 42-43. But a breach of fiduciary duty claim is qualitatively different than a fraudulent transfer claim, because it exposes directors to personal liability for their actions, it exposes directors and controllers to grave reputational risks that are qualitatively different than constructively fraudulent transfer claims, and it can reach conduct that a fraudulent transfer action cannot. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 884 (1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (liability for breach of the fiduciary duty of care). These differences warrant a more stringent requirement to plead and prove insolvency for breach of fiduciary claims than for DUFTA claims, which remain available to ensure that creditor rights remain protected in broader circumstances.[14]

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[14] The Court of Chancery also suggested that *Gheewalla*'s clarification that direct breach of fiduciary duty claims are not available to creditors obviates concerns of excessive litigation. MSJ Op. at 42. But the Court of Chancery's pre-trial decisions in this case chipped away at corporate protections against creditor derivative suits, and seem likely to lead to substantial creditor derivative litigation in the future.

VI. THE COURT OF CHANCERY ERRED BY REWARDING QUADRANT WITH OVER $9 MILLION IN ATTORNEYS' FEES FOR ITS ATTEMPT TO FORCE ATHILON TO LIQUIDATE

A. Questions Presented

Did the Court of Chancery err in awarding attorney's fees when Quadrant brought non-meritorious claims with the express intent of forcing Athilon to liquidate against the interests of its equity holders and junior creditors? Preserved at B1861.

B. Scope of Review

This Court reviews the Court of Chancery's decision to grant or deny attorneys' fees for abuse of discretion. *Ala. Elec. Pension Fund v. Brown*, 988 A.2d 412, 417 (Del. 2007). However, it "review[s] *de novo* the legal principles applied in reaching that decision." *Id*.

C. Merits of the Argument

Delaware law recognizes the plaintiff's ability to satisfy the three prongs of the corporate benefit test is "necessary but not sufficient" to a grant of a fee award. *In re Orchard Enter., Inc. Stockholder Litig.*, 2014 WL 4181912, at *3 (Del. Ch. Aug. 22, 2014). Delaware courts have also considered "the potential for the

litigant's interest to diverge from those of the class" and "whether a fee award would . . . incentivize plaintiffs' counsel to police fiduciary wrongdoing." *Id.*[15]

Applying this principle here, Quadrant's fee award should be denied. Quadrant's interest was adverse to Athilon's because Quadrant sought to force Athilon to liquidate, rather than to maximize Athilon's enterprise value for the benefit of all stakeholders. As the Court of Chancery found, Quadrant brought suit seeking "to force Athilon to liquidate" when Athilon's corporate swap book expired so that "[c]reditors like . . . Quadrant who had purchased the Notes at discounted prices would reap healthy returns" while Athilon's equity owners received nothing. Trial Op. at 2; B284-87 (Tr. 835:2-9) (Quadrant expected "Athilon to liquidate" because of lawsuit); (Tr. 825:6-13) ("[P]remise of investment thesis . . . was that Athilon would never have to pay out on its swaps."); (Tr. 831:3-16) (Quadrant's

[15] For example, the Court of Chancery has declined to award fees to a derivative plaintiff who is both a stockholder and a bidder in a takeover attempt, because "bidders have economic interests that are inherently and structurally in conflict with the target company's stockholders interest in receiving maximum available value," and because bidders do not need fees as an economic incentive to bring litigation. *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 789 A.2d 1216, 1227 (Del Ch. 2001), *aff'd sub nom Mentor Graphics Corp. v. Shapiro*, 818 A.2d 959 (Del. 2003); *In re Dunkin' Donuts S'holder Litig.*, 1990 WL 189120, at *1 (Del. Ch. Nov. 27, 1990). Likewise, the Court of Chancery has declined to award fees to an appraisal plaintiff who does not seek to represent a class of stockholders for the same reasons. *Orchard Enter.*, 2014 WL 4181912, at *10.

"worst-case scenario . . . based on assumption that Athilon extends the debt to maturity"); B1653-54.

Quadrant's attempt to force Athilon to liquidate was not in the best interests of Athilon's stakeholders when Quadrant filed its Complaint. The Court of Chancery denied Defendants' motion to dismiss on the basis of Athilon's September 2011 financial statements. MTD Op. at 22. At the time, discarding liabilities that Quadrant conceded were illusory, Athilon had $600 million in long term debt in three series ($350 million in Senior Notes, $200 million in Subordinated Notes, and $50 million in Junior Notes). *See supra* IV.C.2. Against these liabilities, Athilon held $426 million in cash and available for sale investments—enough to pay the Senior Notes in full, but not enough to cover the Subordinated Notes or the Junior Notes. B1644. At the time it brought suit, Quadrant's attempt to force Athilon to liquidate was not in the best interests of the subordinated noteholders, who would receive only a portion of the principal value of their Notes, the junior noteholders, who would receive none of the principal value of their Notes, or the equity, who would receive nothing. Quadrant did not seek to maximize enterprise value for all stakeholders.

Quadrant's attempt to force Athilon to liquidate was also not in the best interests of Athilon's stakeholders as its suit progressed to trial. As explained above, Athilon returned to solvency long before trial, and the Merced Funds, its ultimate

beneficial owners, returned to residual claimant status. As the Court of Chancery recognized, "[g]enerating returns for equity holders is the opposite of a fiduciary wrong; it is the purpose of a for-profit entity." Trial Op. at 2. Quadrant's continued pursuit of this litigation to force Athilon to liquidate was an attempt to harm Athilon's equity owners, in direct opposition to Athilon's corporate purpose.

Nor did Quadrant need any added economic incentive to bring its claims. Quadrant held over $55 million face value in Athilon Notes, A446-48 (¶¶ 113, 115, 118, 120), B1649, and if it succeeded in forcing Athilon's liquidation, it anticipated a "230 percent" return on its investment "in five years." B285 (Tr. 830:10-831:6). This enormous return was plainly sufficient for Quadrant to pay lawyers to bring suit on its behalf, as demonstrated by the fact that Quadrant's attorneys represented Quadrant on a non-contingent basis. B1827 (¶ 13).

Last, Quadrant pursued Athilon's liquidation by means of non-meritorious claims. From the outset, Quadrant lacked standing to pursue its claims because Athilon always had a reasonable prospect of successful continued operation, *supra* V.C.2, and because Athilon returned to solvency well before trial. *Supra* V.C.1. Because Quadrant's claims were not meritorious, it was not entitled to attorney's fees, *Allied Artists Pictures Corp. v. Baron*, 413 A.2d 876, 879 (Del. 1980), particularly because when Quadrant filed the Complaint it knew of facts demonstrating solvency, but omitted those facts from the Complaint in order to

fabricate standing. *See* Trial Op. at 39-40 (Quadrant experienced valuing CDPCs due to Cournot ownership); B287 (Tr. 837:14-838:8) (CDS tax "very unlikely").

The Court of Chancery erred in awarding attorneys' fees based on a mechanical application of the corporate benefit test, in disregard of the principles set forth above. Fee Op. ¶¶ 2-3.

Conclusion

For the reasons set forth above, this Court should affirm the judgment of the Court of Chancery dismissing all of Quadrant's claims, and reverse the order of the Court of Chancery granting Quadrant's fee application.

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