IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

ALLAN LANGE, OTA LTD., TRIAGE)
CAPITAL MANAGEMENT, LEON)
FRANKEL IRA BRICKELL PARTNERS,)
CRANDON CAPITAL PARTNERS,)
HARBOR FINANCE PARTNERS LTD.,)
STEVEN M. MIZEL ROTH IRA, and)
STEVEN MIZEL,)
)
Plaintiffs,)
v.) C.A. No. 19245NC
)
CITIBANK, N.A., CITICORP NORTH)
AMERICA, INC., CITICORP CAPITAL)
INVESTORS LIMITED, COURT SQUARE)
CAPITAL LTD., FAIRWOOD)
CORPORATION, CONSOLIDATED)
FURNITURE CORPORATION, JOHN B.)
SGANGA, and M. SALEEM)
M-UQADDAM,)
)
Defendants.)

MEMORANDUM OPINION

Date Submitted: June 14, 2002
Date Decided: August 13, 2002

Samuel A. Nolen, Esquire, Raymond J. DiCamillo, Esquire, RICHARDS, LAYTON & FINGER, One Rodney Square, P.O. Box 55 1, Wilmington, DE 19801, Steven B. Feirson, Esquire, Arthur S. Gabinet, Esquire, DECHERT, PRICE & RHOADS, 4000 Bell Atlantic Tower, 1717 Arch Street, Philadelphia, PA 19 102; Attorneys for Defendants.

Brian P. Glancy, Esquire, HUGHES, SISK & GLANCY, P.A., 522 Greenhill Avenue, Wilmington, DE 19805, Thomas J. Fleming, Esquire, Jack M. Kint, Jr., Esquire, OLSHAN, GRUNDMAN, FROME, ROSENZWEIG & WOLOSKY LLP, 505 Park Avenue, New York, NY 10022; Attorneys for Plaintiffs.

STRINE, VICE CHANCELLOR

This case involves a suit by holders of "Debentures" of Fairwood Corporation against Fairwood's directors; one of its subsidiaries, Consolidated Furniture Corporation; and against certain affiliates of Citibank, N.A., which allegedly controls Fairwood and Consolidated through various other corporate entities it owns and controls. In their complaint, the "Debentureholders" claim that all of Consolidated's subsidiaries were sold at an unfair value to pay off debt owed to Citicorp affiliates that was incurred in connection with the leveraged buy-out of Consolidated in which the Debentures were issued. The leveraged buy-out ("LBO") involved a two-step transaction in which 93 percent of Consolidated's shares were purchased for $36.50 a share in cash on a prorated basis, with the remainder of the consideration being paid in the form of the Debentures. After the subsidiaries were all sold within the decade following the LBO, no money was left over to pay the Debentureholders.

The Debentureholders allege that the subsidiary sales were fraudulent conveyances and resulted from breaches of fiduciary duties. For various reasons, the defendants claim that the Debentureholders' complaint must be dismissed. In this opinion, I need address only one of those reasons.

In the Trust Indenture governing the Debentures, the Debentureholders were barred from filing claims with respect to the Debentures without complying with certain prerequisites, including making demand on the trustee. The Debentureholder plaintiffs admit that they failed to comply with this contractual obligation. Under the prior authority of ***Feldbaum*** v. ***McCrory*** *Corp.*' and other cases, therefore, the Debentureholders' complaint must be dismissed because they did not follow the contractually mandated procedures that must precede a suit of this kind.

I. Factual Background

In May 1988, Citicorp Venture Capital Limited ("CVC") struck a deal to acquire Mohasco Corporation, which later became Consolidated Furniture Corporation. Hereinafter, I refer to that company solely as Consolidated. As of 1988, Consolidated was a major manufacturer and retailer of furniture and carpets. It conducted its businesses through several operating subsidiaries.

To accomplish an acquisition of Consolidated, CVC formed Fairwood. Through another acquisition vehicle, Fair-wood entered into a merger agreement with Consolidated. The agreement contemplated a two-step transaction. In the first step, Fair-wood would purchase 93.15 percent of

[1] 1992 WL 119095 (Del. Ch. June 2, 1992).

Consolidated's common stock for $36.50 a share in cash. In the second step, which was to occur after Fairwood obtained permanent acquisition funding, Fairwood's acquisition vehicle would be merged into Consolidated, with the remaining Consolidated shares exchanged for subordinated pay-in-kind ("PIK") Debentures having a putative value of $36.50 per share. The second step of the transaction gave rise to appraisal rights on the part of Consolidated shareholders, who could therefore either accept the Debentures or seek a fair value award.

According to the complaint, Fairwood struggled to finance the acquisition almost immediately. After consummating the first step of the transaction in June 1988, Fairwood owed over $450 million to various lenders affiliated with Citicorp, including Citicorp North America, Inc. and Citicorp Capital Investors Ltd. The plaintiffs allege that the debt markets doubted that Consolidated's performance would enable Fairwood to pay off this debt (the "Acquisition Debt"), and therefore Fairwood was unable to obtain permanent financing from entities unaffiliated with Citicorp.

Even before the second step of the acquisition was consummated, two of Consolidated's operating subsidiaries were sold to generate cash. The first sale was of Cort Furniture Rental, which was sold to indirect subsidiaries of Court Square, a Citicorp affiliate. These subsidiaries were

formed solely to purchase Cort, and Fairwood received a $147 million promissory note in exchange. The purchasing entities later pre-paid this note. The proceeds were used to reduce the Acquisition Debt.

The second subsidiary sold was Mohawk Carpet, which was purchased for $69 million by another indirect subsidiary of Court Square. The proceeds were used to reduce the Acquisition Debt. Seven years later, Mohawk went public at a market capitalization that "far exceeded" $69 million.*

As intimated above, as of the consummation of the second-step merger in September 1989, Fairwood had been unable to secure financing from non-Citicorp affiliates. As a result, the Acquisition Debt was permanently refinanced by affiliates of Citicorp, and remained in the vicinity of $450 million. The Acquisition Debt was secured by the assets of Consolidated and Fairwood. Fairwood, however, had only one asset: its 100 percent interest in Consolidated, which held the operating companies.[3]

The Debentures issued in the second-step merger were governed by an August 15, 1989 "Indenture," and were due in 2004. Interest on the Debentures was payable annually at 16 7/8 percent, but could be paid in

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[2] Am. Compl. ¶ 36.

[3] How the Acquisition Debt was allocated between the two companies is not clear, nor pertinent.

additional Debentures until April 1, 1995. After that date, the interest on the Debentures was due in cash.

The Debentures were not issued by Consolidated, but by Fairwood. But because Fairwood had no operations of its own, the only source of payment for the Debentures was dividends up-streamed from Consolidated. In turn, Consolidated's source of revenues came from its operating subsidiaries, or any proceeds generated from the sale of those subsidiaries.

The Indenture expressly provides that the Debentures were subordinate to the Acquisition Debt owed by Consolidated. To wit, § 10.1 of the Indenture states that "each Securityholder by accepting a Security agrees, that the Security is subordinate in right of payment . . . to the prior payment in full of all Senior Indebtedness [i.e., the Acquisition Debt] . . . ." The Indenture also provides that Fairwood cannot make any payments on the Debentures in the event that the Acquisition Debt is in default, and that the Debentureholders and the Indenture Trustee cannot demand any payments in that circumstance.[4]

In the years following the merger, Consolidated continued to struggle under a debt load that its revenues could not support. Therefore, on April 23, 1992, Consolidated sold two more of its operating subsidiaries,

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[4] Indenture §§ 10.02, 10.04(b).

Chromcraft and Peters-Revington, to an acquisition entity created by CVC. Concurrently with the sale, the new company, Chromcraft Revington, made an initial public offering ("IPO") of 5 1 percent of its stock. The IPO resulted in an increased valuation of Chromcraft Revington, which allegedly inured to the benefit of CVC's acquisition vehicle. The proceeds Consolidated received from the sale were used to pay down the Acquisition Debt.

By this time, the Debentureholders assert, Consolidated and Fairwood were insolvent, in their words, as a "combined entity."[5] By this unusual locution, I assume that the plaintiffs mean that it was clear as of 1992 that the cash-generating potential of Consolidated was insufficient to produce revenues that would permit repayment of the Acquisition Debt and payment of the Debenture obligations.

In July 1994, Consolidated sold another of its subsidiaries, Super Sagless, Inc., to a third party for $40 million. The proceeds were again used to pay down the Acquisition Debt.

On April 1, 1995, Fairwood's obligation to begin paying cash interest on the Debentures came due. Before that time, it had publicly announced that:

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[5] Mem. in Opp. to Defs.' Mot. on the Pleadings at 6.

> The Company's cash flow from operations cannot be expected to be sufficient to permit the Company to make cash interest payments on these debt securities and the Company's senior debt obligations [i.e., the Acquisition Debt]. In addition, the Company's credit facilities do not permit the Company to borrow funds to make cash interest payments. Accordingly, the Company will most likely default on its obligations to make cash interest payments on its senior subordinated pay-in-kind debentures and merger debentures![6]

After Fairwood defaulted, several Debentureholders attempted to negotiate a settlement with Fairwood. To facilitate a voluntary resolution, Fairwood, Consolidated, CVC, and Court Square signed an agreement tolling the statute of limitations as to any claims that the Debentureholders possessed against them.

The negotiations ended without an agreement. The plaintiffs in this action were among the Debentureholders who then filed an involuntary bankruptcy petition against Fairwood in January 1996. The Indenture Trustee joined the suit soon thereafter. Fairwood eventually consented to the bankruptcy and its procession under Chapter 11 of the Bankruptcy Code.

The plaintiffs sought the appointment of a Trustee for Fairwood that would use its power to place Consolidated into bankruptcy. Their claims all centered on the sale of Consolidated's subsidiaries for less than fair market value. The dilemma they sought to overcome was that the Debentureholders were creditors of Fairview, not Consolidated. As a result, the plaintiffs were

[6] Fairwood 10-Q August 15, 1994 (Sganga Aff. Ex. B at 8).

concerned that they had no direct standing to press fraudulent conveyance claims against Consolidated. Nor, plaintiffs feared, did they have the right to file a derivative suit on behalf of Consolidated against the Consolidated directors for selling the company's operating subsidiaries at an unfair price.

The Bankruptcy Court permitted a period of discovery, after which in autumn 1998, the plaintiffs articulated the claims that they hoped to have a Trustee cause to be brought by Consolidated and its subsidiaries. Summarized, the claims sought to rescind the economic effects of the various subsidiary sales, through the entry of judgments of liability against the entities and individuals that allegedly caused the sales to occur. In addition, the claims sought to "equitably subordinate" the Acquisition Debt, by converting it into equity of Consolidated. By subordinating the Acquisition Debt into equity, the cash reinfused into Consolidated by the rescissionary relief could be upstreamed to Fair-wood to pay the Debentureholders. To effect this relief, the Debentureholders sought to have a trustee appointed for Fair-wood, who, in turn, would seek to place Consolidated in bankruptcy for the purpose of pressing certain of the claims, in particular the claim that Consolidated engaged in fraudulent conveyances. But Fair-wood's position in the proceeding was that it would not pursue

claims against any of the Citicorp affiliates connected with the sale of the Consolidated subsidiaries.

For intricate reasons that did not turn on the merits of the underlying claims, the Bankruptcy Court eventually dismissed the adversary proceeding in which these various issues were raised. The essential holding of the Bankruptcy Court was that there was not a sufficient basis to disturb Fairwood's decision not to seek to place Consolidated in bankruptcy in order to press claims that involved direct harm to Consolidated, and only indirect harm to Fairwood and, then, to the Debentureholders.[7] This dismissal was affirmed by the United States District Court for the Southern District of New York[8] and the United States Court of Appeals for the Second Circuit.[9] In the course of affirming, however, these courts made clear that the bondholders might be able to press claims against Citicorp and its affiliates outside of bankruptcy."

[7] ***In re Fair-wood Corp.,*** Ch. 11 Case No. 96 B 40016, Garrity, J. (Bankr. S.D.N.Y. Feb. 22, 1999).

[8] ***In re Fairwood Corp., Debtor, 2000*** WL 264319 (S.D.N.Y. Mar. 9, 2000).

[9] ***In re Fairwood Corp.,*** 2001 WL 11045 (2d Cir. 2001).

[10] ***See, e.g., In re Fair-wood Corp., Debtor, 2000*** WL ***2643*** 19, at *4 (S.D.N.Y. Mar. 9, 2000) ("[O]ther remedies were or are available to these creditors and constituted the appropriate path to trod, rather than the sought[-]for extraordinary remedy of conversion or the appointment of a trustee.").

II. The Amended Complaint In This Action

After the Bankruptcy Court dismissed their claims, a group of the Debentureholders who hold 47 percent of the outstanding Debentures and who had played a leading role in the federal proceedings initiated the present action. In their complaint, the Debentureholders purport to state several "claims for relief," all of which can be summarized thusly: they allege that Consolidated's subsidiaries were sold for less than fair-value, and that the proceeds of those sales was used solely to pay off the Acquisition Debt owed to Citicorp affiliates. The Debentureholders never allege that the value of the subsidiaries was in excess of the Acquisition Debt, to which the Debentures were subordinated. That is, the Debentureholders nowhere allege that if the subsidiaries had been sold at a fair price, there would have sufficient proceeds to pay off all the Acquisition Debt, and provide some return to the Debentureholders. Instead, they simply allege that the subsidiaries were not sold for adequate consideration."

[11] Although I do not reach this issue, the Debentureholders' challenge to the validity of the Acquisition Debt is, to say the least, unusual. There was litigation regarding the fairness of the transaction in which Consolidated's former shareholders received the Debentures, as well as an appraisal proceeding. *See Friedman v. Mohasco Corp.*, 929 F.2d 77 (2d Cir. 1991); *In re Application of Mohasco* Corp., 591 N.Y.S.2d 399 (N.Y. App. Div. 1992). Those litigations did not result in any judgment that the two-step acquisition transaction was tainted. Therefore, the Debentureholders are forced to argue that the valid Acquisition Debt must be subordinated to their inferior interest because of wrongdoing allegedly committed by the defendants years after the Trust Indenture became effective.

The sale of the subsidiaries for an unfairly low price is said to constitute a breach of fiduciary duty by the directors of Fair-wood and Consolidated, and by Citicorp (and one or more of its defendant-affiliates) as a controlling stockholder. The complaint is vague on the ownership chain, and on the involvement of Fair-wood and its directors in actions taken at the Consolidated level. As noted, the Debentureholders do allege that Fair-wood and Consolidated, when considered somehow as a "combined entity," were at all times insolvent or on the brink of that status. Therefore, the Debentureholders argue that the Fairwood and Consolidated directors owed them fiduciary duties.[12]

The sales of the Consolidated subsidiaries for too low a price are also alleged to be fraudulent conveyances, especially because many of the sales were from Consolidated to other affiliates of Citicorp and because the proceeds were used to pay down the Acquisition Debt owed to Court Square, another Citicorp affiliate. The complaint names various Citicorp affiliates as liable for these conveyances, with very little effort to distinguish among them and to specify their particular role.

[12] ***See, e.g., Geyer v. Ingersoll Publications Co.,*** 621 A.2d 784, 787 (Del. Ch. 1992) (When insolvency arises, "it creates fiduciary duties for directors for the benefit of creditors.").

As would be expected, the complaint also charges various of the defendants with aiding and abetting the breach of fiduciary duty counts. But more innovatively, the complaint also accuses several of the defendants of aiding and abetting fraudulent conveyances.

The complaint seeks aggressive relief. Namely, as a remedy for these breaches, the Debentureholders argue that the Acquisition Debt should be treated as a mere equity investment in Fair-wood and Consolidated. Rather than being superior to the Debentures, as the clear terms of the Indenture provide, the Acquisition Debt is instead to be subordinated to the Debentures. The subsidiary sales are to be rescinded, or their proceeds disgorged, and the resulting economic gains are to be devoted to the Debentureholders. Under this scenario, funds from the sales of the subsidiaries would go to pay down the Acquisition Debt only if the proceeds were first sufficient to pay off the Debentureholders in total.

III. Legal Analysis

Confronted with the Debentureholders' claims, the various defendants filed this motion for judgment on the pleadings, or in the alternative, for summary judgment. The motion is grounded in a plethora of arguments, many of which are quite complex.

In this opinion, however, I find it necessary only to address one of the defendants' arguments, as it disposes of the motion most efficiently. That argument in favor of dismissal is based on § 6.06 of the Indenture, which provides as follows:

> Section 6.06 Limitation on Suits.
>
> A Securityholder may not pursue a remedy with respect to this Indenture or the Securities unless:
>
> (i) the Holder gives to the Trustee written notice of a continuing Event of Default;
>
> (ii) the Holders of at least 25 percent in principal amount of the Securities then outstanding make a written request to the Trustee to pursue the remedy;
>
> (iii) such Holder or Holders offer to the Trustee indemnity satisfactory to the Trustee against any loss, liability, cost or expense;
>
> (iv) the Trustee does not comply with the request within 60 days after receipt of the request and the offer of indemnity; and
>
> (v) during such 60-day period the Holders of at least a majority in principal amount of the Securities then outstanding do not give the Trustee a direction inconsistent with the request.
>
> A Securityholder may not use this Indenture to prejudice the rights of another Securityholder or to obtain a preference or priority over another Securityholder. [13]

[13] Indenture § 6.06.

The defendants point out that the Debentureholder plaintiffs have failed to comply with the requirements of § 6.06, and that their claims must therefore be dismissed. For their part, the Debentureholders admit that they did not comply with § 6.06, but argue that the section somehow does not apply to their claims, because the amended complaint attempts to state fraudulent conveyance claims and because the complaint alleges that Fairwood and Consolidated were either insolvent or on the brink of insolvency at all relevant times.

Neither of the Debentureholders' arguments helps them escape the clear import of § *6.06.* In *Feldbaum* v. *McCrory Corp.*,[14] former Chancellor Allen lucidly and comprehensively outlined the legal principles governing the enforcement of so-called "no-action clauses." Notably, the no-action clause in *Feldbaum* was almost identical to § 6.06 in the Fairwood Trust Indenture, insofar as it governed all actions "with respect to" the indenture or the securities. As here," the indenture *in Feldbaum* was by its own terms expressly governed by New York contract law, and therefore Chancellor Allen relied heavily upon case law from that state in reaching his decision.

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[14] 1992 WL 119095 (Del. Ch. June 2, 1992).

[15] Indenture § 12.09 ("This Indenture and the Securities shall be governed by the laws of the State of New York applicable to contracts to be performed wholly in the State of New York, without regard to the conflicts of laws thereof.").

He summarized the relevant principle of law this way: "[a]bsent an allegation of fraud in the inducement of the purchase [of the debentures], clauses of this sort are generally applied to foreclose bondholder suits under the indenture, where the plaintiff has not complied."[16]

Of particular pertinence here is Chancellor Allen's rejection of the argument that a no-action clause did not apply to a fraudulent conveyance asserted on behalf of bondholders:

> [N]o matter what legal theory a plaintiff advances, if the trustee is capable of satisfying its obligations, then any claim that can be enforced by the trustee on behalf of all bonds, other than a claim for the recovery of past due interest or principle, is subject to the terms of a no-action clause of this type . . . .
>
> Plaintiffs assert that the fraudulent conveyance action is a statutory action that does not arise under the 'Indenture or the Securities.' Thus, they say it is not covered by the no-action clause. I cannot agree. The clause in question bars all action 'with respect to' the indenture or the securities . . . .
>
> The fraudulent conveyance claims brought here . . . plainly do fall within the scope of the no-action clauses. The claims allegedly arise from transactions by issuers of their bonds and assert injuries arising from the bondholder status of the plaintiffs. If plaintiffs have been legally injured by the transactions complained of, they are hurt derivatively. They can allege no harm different from that suffered by their fellow bondholders and thus should share any remedy they receive on ***aparipassu*** basis with other bondholders.
>
> Given the derivative character of these claims, it is clear that they can be prosecuted by the trustees representing the bondholders as a group,

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[16] 1992 WL 119095, at *5.

provided the trustees are in a position in which they can represent plaintiffs fairly. [17]

The reasoning of ***Feldbaum*** is sound and applies to bar plaintiffs' claims in this case.[18] Each of the claims that the plaintiffs have asserted are brought on behalf of the Debentureholders as a class and may be asserted by the Indenture Trustee. By accepting the Debentures, the plaintiffs agreed that all claims of this type would be subject to the provisions of § 6.06. Per ***Feldbaum,*** the particular nature of a claim that is asserted on behalf of the Debentureholders as a class is not determinative of the applicability of §6.06; what is determinative is whether the claim is one with respect to the Indenture or the Debentures themselves. Each of the claims pled in the amended complaint clearly satisfies that test, as the Debentureholders' ability to press those claims depends entirely on their ownership of the Debentures and the adverse effect that certain actions have allegedly had on each Debentureholder, ***pro rata*** to her ownership of those securities.

"*Id.* at *6-*8.

[18] ***Feldbaum***'s conclusion that a no-action clause may serve as a bar to fraudulent conveyance claims finds support in other case law. *See, e.g.,* ***McMahan & Co. v. Wherehouse*** *Entertainment,* *859* F. Supp. 743, 748-49 (S.D.N.Y. 1994), ***aff'd in part*** *and rev'd* ***in part,*** *65* F.3d 1044 (2d Cir. 1995) (no-action clause barred state fraudulent conveyance and breach of implied duty of good faith claims); *Victor v.* ***Riklis,*** 1992 WL 122911, at *6 (S.D.N.Y. May 15, 1992) (parallel case to *Feldbaum* brought in federal district court, holding that fraudulent conveyance claims were barred by the no-action clause); *Ernst v. Film Prod. Co.,* 264 N.Y.S. 227,228 (N.Y. Supr. 1933) (a failure to make demand of a trustee, where the indenture required that no action could be brought unless a prior ineffective demand had been made upon the trustee by the holders of 25 percent of the outstanding bonds, barred plaintiffs fraudulent conveyance claim).

Likewise, for all the reasons so persuasively articulated in ***Feldbaum,*** the mere fact that the plaintiffs have attempted to state claims for breach of fiduciary duty does not vitiate the force of § 6.06. The complaint's allegation that Consolidated's sale of subsidiaries and use of the proceeds to pay down the Acquisition debt resulted from fiduciarily improper conduct by the defendants is one that seeks redress for harm suffered by all the Debentureholders, on a *pro rata* basis. It may be pursued by the Indenture Trustee on their behalf. Therefore, the rationale of ***Feldbaum*** applies to these claims as well. Indeed, ***Feldbaum*** itself cited to venerable authority from New York, which held that bondholders could not sue an issuer's directors for breach of fiduciary duty "unless there has been compliance with the [no-action provisions] of the indenture."[19]

Moreover, the amended complaint's allegation that Fairwood and Consolidated -- considered as a combined entity -- were on the brink of insolvency or actually insolvent at all relevant times does not aid the plaintiffs. The circumstance of insolvency is a factor that is legally necessary for the Debentureholders to state a claim for fiduciary duty against

[19] *Levy v. Paramount Publix Corp.,* 266 N.Y.S. 271,275 (N.Y.Supr. 1933), *aff'd,* 269 N.Y.S.2d 997 (N.Y. App. Div. 1934) (dismissing for failure to comply with no-action clause breach of fiduciary duty claims against issuer's directors in connection with issuer's alleged fraudulent conveyance).

the Fairwood directors,[20] but it is not one that helps them escape the reach of § 6.06.[21] To the extent that Fair-wood was insolvent, its directors may have owed fiduciary duties to the Debentureholders as a class, and such duties may be enforced in an action by the Indenture Trustee.

IV. Conclusion

For the foregoing reasons, the defendants' motion for judgment on the pleadings is granted. The parties shall submit a conforming order within ten days.

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[20] ***Geyer v. Ingersoll Publications Co.,*** 621 A.2d 784, 787 (Del. Ch. 1992).

[21] Admittedly, certain pre-*Feldbaum* cases can be read as supporting the plaintiffs' position. See, ***e.g., Continental Illinois Nat 'l Bank & Trust Co.*** *of* ***Chicago v. Hunt Int 'l Resources Corp., 1987*** WL 55826, at *5-*6 (Del. Ch. Feb. 27, 1987) (common law fraud claim not within scope of no-action clause). Most of this confusion seems to arise out of an earlier case involving indenture provisions containing both a "no-recourse clause" purporting to limit the types of remedies bondholders could assert, and a no-action clause detailing the manner in which bondholders could assert claims. ***Harff v. Kerkorian, 324*** A.2d 215 (Del. Ch. 1974), ***aff'd in part and rev'd in part, 347*** A.2d 133 (Del. 1975). To wit, did ***the Harff*** case hold that a no-action clause could not bar a bondholder suit alleging fraud or that the issuer was insolvent? The answer to that question is no. In ***Harff***, the Court of Chancery expressly avoided any ruling on the scope of applicability of the no-action clause, and the Supreme Court never addressed it any discernible, articulated way.