

New York Court of Appeals: Prior to a Default, Indenture Trustees Owe No Fiduciary Duties to Bondholders but Owe a Duty to Perform Ministerial Functions with Due Care

On June 25, 2008, the New York Court of Appeals held that prior to a default, an indenture trustee owes no fiduciary duties to its bondholders, but does owe a duty to perform its ministerial functions with due care. A breach of this duty can give rise to tort liability.¹

Plaintiffs, a group of insurance companies, mutual funds and investment funds, who were holders of \$750 million in notes issued by Loewen,² sued State Street Bank & Trust Co (“State Street”), the indenture trustee, for numerous claims. Among the claims asserted were breach of fiduciary duty as an indenture trustee and as secured party representative as well as a claim of negligence. Plaintiffs alleged that State Street’s failure to deliver a required document to Bankers Trust, the collateral trustee, caused them to settle their claims in Loewen’s bankruptcy at a large discount.

The Appellate Division³ granted summary judgment on the breach of fiduciary duty as an indenture trustee and negligence claims, holding plaintiffs had not alleged the breach of an extra contractual duty redressable in tort but rather these claims were duplicative of breach of contract claims which had been barred by a release agreed to by plaintiffs. Plaintiffs appealed and the New York Court of Appeals dismissed all the claims except the negligence claim which was remanded for findings of fact.

I. Discussion

In 1996, Loewen and Bankers Trust entered into a collateral trust agreement (“CTA”). The CTA permitted holders of future Loewen debt offerings to acquire secured creditor status with regard to a common pool of collateral. The CTA provided that: “To become a Secured Party Representative hereunder each such representative or Holder must deliver to the Trustee . . . an Additional Secured Indebtedness Registration Statement.”

In 1997 and 1998, Loewen, owner and operator of funeral homes around the country, issued a series of debt securities including Pass-Through Asset Trust Securities (“PATS”) and Series 6 and 7 Notes (“Notes”). Loewen engaged State Street to serve as the indenture trustee. For each transaction, Loewen and State Street executed an Additional Secured Indebtedness Registration Statement (“ASIRS) as contemplated by the CTA. However, no ASIRS for the PATS or Notes was ever delivered or received by the Bankers Trust as required. In 1999, Loewen filed for chapter 11 bankruptcy protection. Because no ASIRS had been delivered, uncertainty arose as to whether the holders of the PATS and the Notes had secured creditor status. In light of this, plaintiffs voted in favor of the plan of reorganization and settled their claims against Loewen by accepting a discounted value for the PATS and the Notes. Plaintiffs also agreed to release State Street from any “claims . . . that if enforced against State Street, entitle State Street to a claim of indemnification from [Loewen]”. The indenture specified that Loewen indemnify State Street against all claims except those incurred by State Street through its negligence, bad faith or willful misconduct.

¹ *AG Capital Funding Partners, L.P. v. State St. Bank & Trust Co.*, 2008 N.Y. Slip Op. 05766 (N.Y. Jun. 25, 2008).

² Loewen Group International, Inc. and the Loewen Group, Inc.

³ *AG Capital Funding Partners, L.P. v. State St. Bank & Trust Co.*, 40 A.D.3d 392 (1st Dept. 2007).

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In 2002, plaintiffs sued State Street, bringing six causes of action alleging that State Street's failure to deliver the ASIRS to Bankers Trust for registration as required under the CTA caused plaintiffs to settle their claims in Loewen's bankruptcy at a large discount. The trial court dismissed the breach of contract claims as well as a claim for a violation of the Trust Indenture Act of 1939 ("TIA") on the basis of the release previously provided by the plaintiffs.⁴ Summary judgment was awarded to the plaintiffs for claims of a breach of fiduciary duty as an indenture trustee as well as a claim for negligence and denied regarding a claim of breach of fiduciary duty as a secured party representative. On appeal, the Appellate Division affirmed the summary judgment regarding the breach of contract claims and dismissal of the claim regarding violation of the TIA, but concluded that the fiduciary duty and negligence claims should have also been dismissed "since they are essentially duplicative of the claims for breach of contract."⁵ The New York Court of Appeals granted leave to appeal.

The Court of Appeals first reaffirmed the dismissal of the contract claims on the basis of the release since they did not involve negligence, bad faith or willful misconduct. The Court then discussed the claim for breach of the TIA and the breaches of fiduciary duty. Plaintiffs argued that State Street should not be excused from fulfilling its most basic and fundamental obligations as an indenture trustee. Plaintiffs asserted that prior to default, State Street owed plaintiffs an extra-contractual duty to perform basic, non-discretionary ministerial tasks (e.g., delivery of the ASIRS) and the breach of that duty supports a tort claim against State Street. The Court stated the TIA was enacted because "previous abuses by indenture trustees had adversely affected the national public interest and the interests of investors . . . and Congress sought to address this national problem in a uniform way."⁶ The Court noted that Section 315 (a)(1) of the TIA states that an indenture trustee is "not liable except for the performance of such duties as are specifically set out in the such indenture."⁷ The Court found that New York state and federal case law are consistent with this section of the TIA.⁸ The Court further noted that a number of courts have held that prior to default, indenture trustees owe note holders an extra-contractual duty to perform basic, non-discretionary, ministerial functions redressable in tort if such duty is breached.⁹ These decisions are consistent with Section 315(a)(1). The Court of Appeals concluded that an indenture trustee owes a duty to perform its ministerial functions with due care and a breach of this duty will be subject to tort liability. However, the breach of such duty does not give rise to fiduciary duty claims and thus did not support the plaintiffs' fiduciary duty claims in the case. The Court explained that "A fiduciary relationship 'exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation.'"¹⁰ Therefore, the breach of fiduciary duty as an "indenture trustee" claim was dismissed since there was no provision in the indenture placing fiduciary obligations on State Street prior to an event of default and no general fiduciary

⁴ *AG Capital Funding Partners, L.P. v. State Street Bank & Trust Co.*, 2005 N.Y. Slip Op. 30154 (N.Y. Sup. Jul. 19, 2005).

⁵ 40 A.D.3d at 394.

⁶ S. Rep. No. 248, 76th Cong., 1st Sess. 3 (1939).

⁷ Trust Indenture Act of 1939 § 315 (a)(1), 15 U.S.C. 77000 (1939).

⁸ See *Hazzard v. Chase Natl. Bank of City of New York*, 159 Misc. 57, 83,84 (1936), *affd no opn* 257 App. Div. 950 (1st Dept 1939), *aff no opn* 282 NY 652 (1940) ("[t]he corporate trustee has very little in common with the ordinary trustee The trustee under a corporate indenture . . . has his [or her] duties defined, not by the fiduciary relationship, but exclusively by the terms of the agreement. His [or her] status is more than one of a trustee"); *Elliot Assoc. v J. Henry Schroder Bank & Trust Co.*, 83 F.2d 66, 71 (2d Cir. 1988); *Meckel v. Continental Resources Co.*, 758 F.2d 811, 816 (2d Cir. 1985).

⁹ See *LNC Inv. v. First Fid. Bank, N.A.*, 935 F. Supp 1333, 1347 (SDNY 1996); *Philip v. L.F. Rothschild & Co.*, 1999 WL 771354, at 1 (SDNY 1999).

¹⁰ *State Street*, 2008 N.Y. Slip Op. 05766 at 13 (quoting *EBC I, Inc. v. Goldman, Sachs & Co.*, 5 NY3d 11, 19 (2005)).

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relationship was found to have existed.¹¹ Similarly, the claim for breach of fiduciary duty as a “secured party representative” was dismissed. Here, State Street never become a Secured Party Representative and accordingly never undertook “a duty to act for or give advice for the benefit of another” in that capacity.

Finally, the Court concluded that the Appellate Division erred in dismissing plaintiffs’ negligence claims as duplicative of the contract claims. The court reiterated that the release agreed to by plaintiffs did not apply to negligence claims. It was also undisputed that State Street and Loewen executed the ASIRS, that the ASIRS called for State Street to deliver the ASIRS and State Street failed to deliver it. Accordingly, the Court held there are issues of fact as to whether State Street undertook and breached a duty of care “connected with and dependent upon the ASIRS” requiring them to act in accordance with the ASIRS and CTA registration requirements to protect plaintiffs’ security rights in the CTA collateral and whether plaintiffs sustained losses as a result of this breach. Accordingly, the Court modified the order of the Appellate Division, remanding the case to the Supreme Court for further proceedings.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

¹¹ The Court of Appeals noted that the Trust Indenture Act distinguishes between an indenture trustee’s pre- and post-default duties. Post-default the trustee “shall exercise . . . such of the rights and powers vested in it by such indenture, and [use] the same degree of care and skill in their exercise, as a prudent [person] would exercise or use under the circumstances in the conduct of his [or her] own affairs.” *State Street*, 2008 N.Y. Slip Op. 05766 at 13 n.7 (quoting 15 U.S.C. 7700o(c)). Note that an issuer could impose a pre-default fiduciary duty on an indenture trustee by way of an express contractual provision in an indenture if it so chose, and if the trustee agreed to such a provision.