

## Trustee Implied 'Ministerial' Duties Must Never Include Obligor Duties

By: Steve Wagner

When an obligor on a bond issue defaults and can't make payments to its bondholders, the bondholders naturally turn to their bargained-for collateral, hoping their prospects for recovery will fare better from the proceeds of that collateral than from the obligor's business fortunes. Not surprisingly, after an event of default has occurred, protection of and realization on collateral conveyed to the indenture trustee is among the trustee's most important functions, which is consistent with prudent person standards applicable under the Trust Indenture Act of 1939 (as amended, the TIA) and terms of typical indentures that reflect applicable common law principles.

When bonds are issued, the purchase contracts between the obligor and the initial bond purchasers specify the filings and transfers of property that must be made to render the liens effective as a condition to their issuance and obligation to purchase them. Evidence of filings from the appropriate governmental authorities, legal opinions and obligor officers' certificates are typically delivered at closing. Collateral is generally conveyed at the original issuance of the bonds by the obligor to the trustee for the benefit of the bondholders, consistent with the terms upon which the obligor markets the bonds to the bondholders. Obligor typically make covenants to the trustee in the indenture to properly convey the collateral to the trustee as required by applicable law when the bonds are issued, and to maintain legal effectiveness of the collateral throughout the life of the indenture while the bonds remain outstanding. In addition, due to the importance of collateral to the bondholders, the TIA and indenture terms generally require that the obligor provide the trustee with evidence that the collateral granted to the trustee is effective. Evidence we typically see includes opinions of counsel and officers' certificates that the requisite steps (*e.g.*, recording, filing, possession, control, etc.) have been taken to render the trustee's intended lien legally effective, both when the bonds are issued and the indenture is signed, and annually thereafter while the bonds remain outstanding. Trustees are expected to have no role in that process and have traditionally disclaimed any responsibility for the condition of the collateral or its effectiveness.

Until now, it has not been suggested that pre-default, ministerial responsibilities implied against the trustee of a TIA-qualified indenture could extend to responsibility for the legal effectiveness of collateral granted by the obligor to the trustee *when the bonds are*

*issued and the indenture is signed.* The New York Court of Appeals in *AG Capital Funding Partners, L.P., et al. v. State Street Bank and Trust Company*, 2008 WL 2510628 (N.Y.) (June 25, 2008), the most recent in a series of decisions arising from the Loewen Group, Inc. (Loewen) bankruptcy testing the outer limits of trustee pre-default duties, reinstated negligence claims by bondholders against the trustee concerning collateral defects – claims that had previously been dismissed. The Court of Appeals, New York’s highest state court, stated that “an issue of fact” exists for the trial court as to whether the trustee owed and breached a duty to the bondholders that was “separate and apart” from its pre-default contractual undertakings “connected with and dependent upon” the collateral. The court discussed several provisions of the TIA and New York case law in its decision defining trustee pre-default duties, focusing on several cases that held these duties include certain “extra-contractual” duties to perform “basic, non-discretionary, ministerial functions” that are in addition to those found in the express terms of the trust indentures. If you share our concern that those “separate and apart” or “extra-contractual” duties are really other ways of saying the trustee has implied pre-default duties with respect to collateral that Congress, through the TIA, specifically said trustees shall not have, please read on.

---

## The Case

Loewen issued bonds called Pass Through Asset Trust Securities in May 1998, pursuant to a TIA qualified indenture. Collateral consisted of the trustee’s share in the collateral pledged by the obligor under a collateral trust agreement for which another bank acted as collateral trustee. At the bond closing, the trustee signed a one-page closing document titled Additional Secured Indebtedness Registration Statement (ASIRS). The ASIRS contained the trustee’s agreement to deliver the ASIRS to the collateral trustee. The collateral trust agreement contained a clause that required creditors (or their representatives, such as the trustee) to deliver the ASIRS to the collateral trustee in order to be entitled to benefits of the collateral. Thus, the trustee’s agreement within the ASIRS to deliver the ASIRS to the collateral trustee was cited as evidence that it had expressly assumed the obligation under the collateral trust agreement. Unfortunately, the ASIRS sat on the closing table and was never delivered to the collateral trustee. Apparently, Loewen had no authority to independently designate the trustee a creditor representative on behalf of the bondholders, so the trustee’s agreement to deliver the ASIRS might have been necessary since it was not a collateral trust agreement party.

But what if the trustee had refused to sign the ASIRS? What if it had insisted that Loewen deliver the ASIRS? Why didn’t the collateral trust agreement simply provide that Loewen provide notice of the trustee’s interest on behalf of the bonds it was issuing to the collateral trustee? Evidence is conflicting and inconsistent over the meaning of the term “deliver” as applied to a trustee in the setting of a bond closing, and whether the trustee was actually expected to deliver the ASIRS to the collateral trustee or leave it with other closing documents, giving rise to separate but equally unfortunate litigation by the trustee against the counsel that conducted the bond closing. The trustee’s failure to appear as a secured party in the Secured Indebtedness Register permitted other creditors to claim the trustee and the bondholders were not secured in Loewen’s bankruptcy. Compromise of that claim resulted in significant losses for the bondholders. The bondholders claimed

the trustee's interest in the collateral would have been registered in the Secured Indebtedness Register (and therefore fully perfected) if the trustee had delivered the ASIRS to the collateral trustee at closing. Unfortunately, the trustee's agreement within the terms of the ASIRS (not the indenture) to deliver the ASIRS to the collateral trustee, and the resulting failure to comply with the collateral trust agreement provision noted above, left the trustee vulnerable to the bondholders' claim that their failure to appear on the collateral trustee's Secured Indebtedness Register and compromised collateral position was caused by the trustee's failure to deliver the ASIRS as it had expressly agreed. Previously, all claims against the trustee related to the ASIRS were released by court order in Loewen's bankruptcy proceeding. Unfortunately, that release was held to exclude claims for the trustee's negligence, and provided the opportunity to search for a duty that was breached other than the trustee's agreement within the terms of the ASIRS.

---

## Ministerial Duties, Collateral and the TIA

The TIA was enacted along with other securities laws following the Great Depression for remedial purposes, among them trustee independence and the presence of required indenture provisions. The full text of these provisions were once added to the specific terms of each qualified indenture, but have been imposed by law independent of indenture terms since the TIA was amended in 1990. Congress mandates that through the TIA that obligors like Loewen who avail themselves of the benefits of issuing public debt securities must comply with basic, minimum corporate governance requirements set forth in the TIA that are not subject to negotiation among the parties, no matter how convenient it may seem in a particular deal. Those requirements specifically include the condition of collateral, and require the obligor to deliver the trustee opinions of counsel pursuant to Section 314(b) that proper recording or filing has occurred to render the intended lien on collateral effective, both promptly after the execution and delivery of the indenture and annually thereafter. Section 314(c) requires the obligor to deliver to the trustee officers' certificates and an opinion of counsel that all conditions precedent to indenture trustee actions such as authentication of the original issue indenture securities have been complied with. Section 314(e) requires appropriate examination to occur that renders the basis of such certificates and opinions informed. If the obligor defaults in such obligations, Section 315(b) requires the trustee to give notice of such default to the indenture security holders, except notice of defaults not involving payment terms that the trustee withholds from the bondholders that it concludes is in the interest of the bondholders to withhold. Not surprisingly, Congress decided that a trustee independent of the obligor was required to issue such default notices and act in the interest of bondholders post default, and set forth independence standards in Section 310.

It is ironic that most actions required to render liens legally effective often involve execution of relatively clear, straightforward tasks. It is a credit to our legal system that activities of such importance can be accomplished with relative ease and usually at modest expense, which has helped enable commerce as well as the orderly flow of capital for investment. Consider how easily a real estate mortgage can be filed with the recorder of deeds in the county where the land is located, a Uniform Commercial Code financing statement can be filed with the secretary of state of the obligor's state of organization, or possession or control of personal property can be delivered to the secured party.

But does the ease and efficiency with which these highly material collateral perfection tasks can be accomplished render them “ministerial?” If so, is the indenture trustee then responsible for the effectiveness of its collateral that can be perfected by “ministerial” means? Authority the court cites for imposing implied pre-default ministerial trustee duties involved a case where bonds held by the trustee in a trust account created by a tax exempt revenue bond indenture were called for redemption, and the trustee was holder of the redeemed bonds. Regrettably, the trustee in that case could not deny receipt of the redemption notice, leaving no plausible reason for the loss of interest that resulted from the trustee’s failure to tender the bonds for redemption until it had not received an expected semi-annual interest payment six months following the redemption date. But how can a principle established to address securities custodial duties that arise during the life of a trusteeship, not within the express terms of an indenture but implied by the court as ministerial duties, be rationally extended to collateral adequacy at the time the bonds are originally issued? Even if the trustee expressly agrees to accept such a duty (*e.g.*, agree in writing to deliver the ASIRS to the collateral trustee), it simply does not follow that obligors can treat trustees in securities issuances in the same fashion as they might treat lenders in secured loans or secured parties in other commercial transactions. Obligor that benefit financially by issuing bonds must take responsibility as issuers of securities consistent with the TIA and other securities laws to convey collateral to the trustee on the terms it represents the collateral to the bondholders. An obligor that delegates that responsibility to the trustee, whether through express terms of the indenture or through clever means like the ASIRS in this case, would convert the trustee into simply another obligor, thus compromising the trustee’s independence and violating the obligor’s TIA obligations. The court, by characterizing collateral related duties the trustee has not agreed to in the indenture or anywhere else as ministerial as this case suggests, would accomplish the same unfortunate result by indirect means. If the trustee must act to protect collateral, the bondholders should know. It should do so only after proper notice of the obligor’s failure to comply with its collateral-related covenants has been given and the obligor’s default has not been timely cured.

---

## Conclusions

Noted jurist Learned Hand once stated, with respect to an indenture trustee, that “(t)he law ought not to make trusteeship so hazardous that responsible individuals and corporations will shy away from it.” Implying pre-default duties against indenture trustees, by conveniently characterizing obligor duties related to bondholder collateral as ministerial to facilitate tort claims against trustees that cannot be supported by the terms of indentures, might do just that. The law must carefully limit the extent to which pre-default indenture trustee conduct can be spun as torts via implied ministerial duties, especially when those duties involve highly material matters such as the condition of the collateral. The TIA, terms of indentures and well over one hundred years of case law give trustees good reason to believe their pre-default performance will be judged solely against their agreements within the terms of their indentures. Judge Hand’s objective will be advanced by clarification that those pre-default indenture trustee duties not within the express terms of the indenture (*i.e.*, those “extra-contractual” duties) that can be characterized in subsequent litigation as “ministerial” never include the indenture trustee’s implied assumption of express obligor duties and covenants, especially TIA obligations. The TIA

provides the trustee reasonable expectations that pre-default duties can be limited to its expressed agreements. The trustee in this case paid dearly for its agreement within the terms of the ASIRS. If this case stands for anything, it should be strictly limited to performance only of such express agreements. Implying pre-default ministerial duties against trustees over collateral, especially where they have expressly disclaimed responsibility for it, would conflict with the TIA and offend common sense. As the record of this case shows, implying pre-default duties against trustees will only generate concern as trustees speculate about the extent of their implied duties. If implied duties against the trustee are extended to responsibility for the obligor's failure to properly convey collateral at the bond closing as occurred in this case, those duties might expose trustees to precisely the kind of disproportionate liability that would cause any responsible person to, as the great jurist speculated, "shy away from."

## Corporate Restructuring Practice Group

For more information on the matters discussed in this Alert, please contact one of our Corporate & Securities lawyers listed below or your regular contact at Drinker Biddle.

 <p><b>Kristin K. Going</b> <i>Partner</i></p> <p>Washington, D.C. (202) 230-5177 Kristin.Going@dbr.com</p>	 <p><b>Daniel D. Northrop</b> <i>Paralegal and Research Assistant</i></p> <p>Chicago (312) 569-1510 Daniel.Northrop@dbr.com</p>	 <p><b>Steven M. Wagner</b> <i>Counsel</i></p> <p>Chicago (312) 569-1216 Steven.Wagner@dbr.com</p>	 <p><b>M. Stephanie Wickowski</b> <i>Partner</i></p> <p>New York (212) 248-3170 Stephanie.Wickowski@dbr.com</p>
---	---	---	---

### Other Publications



[www.drinkerbiddle.com/publications](http://www.drinkerbiddle.com/publications)

### Sign Up



[www.drinkerbiddle.com/publications/signup](http://www.drinkerbiddle.com/publications/signup)