

## New York Court of Appeals Decision Recognizes Pre-Default Negligence Claim Against Indenture Trustees

The New York Court of Appeals late last month issued an important and precedent-setting opinion concerning the pre-default duties of indenture trustees under New York law. *A.G. Capital Funding Partners, L.P. v. State Street Bank and Trust Company*, No. 114, 2008 WL 2510628, 2008 N.Y. Slip Op. 05766 (N.Y. June 25, 2008) (the “Opinion”). In a departure from prior law, the Court held that “an indenture trustee owes a duty to perform its ministerial functions with due care, and if this duty is breached the trustee will be subjected to tort liability.” (Opinion at 12). Thus, under the Court of Appeals’ decision, a holder of debt securities, who alleges that its indenture trustee has breached pre-default contractual duties, may now potentially have a claim against the trustee under both contract and tort law.

### BACKGROUND

State Street was sued in New York state court by forty-four plaintiffs for alleged breaches of contract and tort duties and violations of the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa, *et seq.* Plaintiffs consist primarily of investment and distressed debt funds which purchased notes of Loewen Group International, Inc. (“Loewen”). State Street was the indenture trustee for \$750 million principal amount of notes issued in 1997 and 1998 by Loewen. The plaintiffs claim that State Street, as indenture trustee, had an obligation to ensure the secured status of the notes, and that it had allegedly failed to take certain steps in that regard, namely delivering a document called an Additional Secured Indebtedness Registration Statement (“ASIRS”) to the collateral trustee, Bankers Trust Company. According to plaintiffs, State Street’s alleged delivery obligation arose from the two indentures at issue and the terms of the ASIRS document itself.

Plaintiffs assert that State Street’s alleged failure to deliver the ASIRS document to Bankers Trust purportedly caused uncertainty in the secured status of the notes in the subsequent bankruptcy case of Loewen and that as a result, plaintiffs received tens of millions of dollars less in bankruptcy distributions than they would have received had there been no issue regarding the secured status of the notes.

### LOWER COURT DECISIONS

After substantial discovery, motion and appellate practice, the plaintiff note holders and State Street both moved for summary judgment before the trial court. The trial court dismissed plaintiffs’ claims against State Street for breach of contract and breach of the Trust Indenture Act, based on the operation of a release of State Street included in the Loewen bankruptcy plan of reorganization. Specifically, under the terms of the Loewen reorganization plan, State Street was released from all loss or liability for which it would have been entitled to indemnification from Loewen under the terms of its indentures; namely, loss or liability except “to the extent incurred by the Trustee through its negligence, bad faith or willful misconduct.” The trial court, however, denied summary judgment on plaintiffs’ negligence and breach of fiduciary duty claims, finding that questions of fact existed as to whether State Street had a duty to plaintiffs and whether State Street breached any such duty.

On appeal, the Appellate Division, First Department, New York’s intermediate appellate court, dismissed plaintiffs’ complaint in its entirety, affirming judgment in State Street’s favor on the breach of contract and statutory claims, based upon the Loewen bankruptcy release, but reversing the denial of judgment to State

Street on the negligence and breach of fiduciary duty claims. The Appellate Division dismissed plaintiffs' negligence and breach of fiduciary duty claims on the grounds that they were duplicative of the breach of contract claims.

**THE COURT OF APPEALS' DECISION**

Plaintiffs were granted permission to appeal the Appellate Division's decision to the Court of Appeals. In its Opinion, the Court of Appeals affirmed the dismissal of plaintiffs' claims against State Street for breach of the indentures, breach of the ASIRS and breach of the Trust Indenture Act, based on the Loewen bankruptcy release. The Court of Appeals also affirmed dismissal of plaintiffs' claims for breach of fiduciary duty as indenture trustee and breach of fiduciary duty as "Secured Party Representative,"<sup>1</sup> rejecting plaintiffs' argument that an indenture trustee has pre-default fiduciary duties to holders. The Court of Appeals, however, ruled that it was error for the Appellate Division to have dismissed plaintiffs' negligence claim as duplicative of plaintiffs' breach of contract claims.

In reaching its conclusion on plaintiffs' negligence claim, the Court began its discussion by emphasizing the Trust Indenture Act's stated policy of protecting investors. The Court recognized that both federal and New York law provide that prior to an event of default, an indenture trustee's duties are limited to those specifically set out in the indenture. (Opinion at 11-12) (citations omitted). However, the Court noted that certain lower court decisions have stated 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." (Opinion at 12) (citations omitted). The Court of Appeals then went on to state: "we hold that an indenture trustee owes a duty to perform its ministerial functions with due care, and if this duty is breached the trustee will be subjected to tort liability." (*Id.*) The Court reversed the dismissal of plaintiffs' negligence claim against State Street and determined that "there are issues of fact as to whether State Street, separate and apart from its contractual duty under the ASIRS, undertook and breached a duty of care, 'connected with and dependent on the [ASIRS]' ..., to act in accordance with the ASIRS and the CTA registration requirements to protect plaintiffs' security rights in the CTA collateral and whether plaintiffs sustained significant losses as a result of this alleged breach." (Opinion at 14-15).<sup>2</sup>

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<sup>1</sup> "Secured Party Representative" is a designation derived from the transaction documents particular to the transactions at issue in this case.

<sup>2</sup> The Court found that the release of State Street included in the Loewen bankruptcy plan of reorganization did not release Plaintiffs' negligence claim because the plan had not released State Street from any loss or liability incurred by the Trustee through its own negligence.