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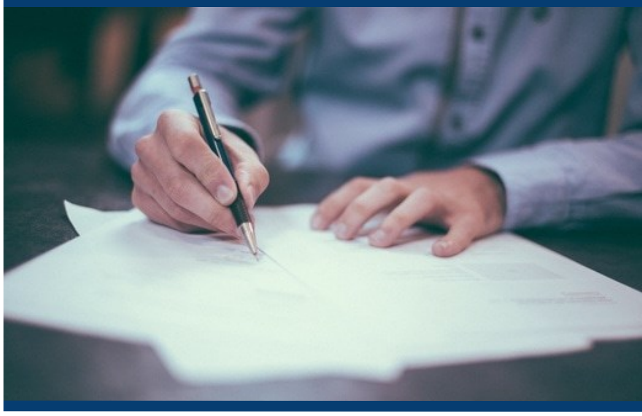

Trustee Duty To Avoid Conflicts With Security Holders

By: Alan Kolod & Kent C. Kolbig

The Appellate Division, First Department, recently issued two nearly identical decisions of importance concerning the pre-default duties of a corporate trustee to security holders. These decisions upheld a cause of action asserting that an indenture trustee ("trustee") may breach the indenture by buying trust assets for its own account, even if permitted to do so by the terms of the indenture, if the purchase price is less than the value of the trust assets. While the decisions found that the trustee had no fiduciary duty to the security holders and, instead, rested on an analysis of the terms of the indentures, the fact that the trustee's construction of such terms would put the trustee in conflict with the security holders caused the Court to reject the trustee's interpretation in favor of one that eliminated the potential conflict. *NMC Residual Ownership L.L.C. v. U.S. Bank N.A.*, __ N.Y.S.3d __, 2017 WL 3253445 [1st Dept 2017] (a copy of the decision is accessible *here*) and *Cece & Co. Ltd. v. U.S. Bank N.A.*, __ N.Y.S.3d __, 2017 WL 3253370 [1st Dept 2017] (a copy of the decision is accessible *here*).

The two unanimous decisions were written by Justice Gische, but the two appellate panels shared only one other justice (Manzanet-Daniels, J). Six different justices made up the remainder of the panels. Thus, the reasoning of the decisions garnered the support of 8 of the 19 justices sitting in the First Department.

The cases involved appeals from decisions dismissing two very similar complaints. In each case, U.S. Bank had served as trustee with respect to a real estate mortgage investment ("REMIC") trust. The REMIC trusts had two classes of security holders, the regular security holders and the residual security holders. The regular security holders were entitled to receive regular payments on distribution dates. The residual security holders, serving essentially as equity, would receive payments only from the disposition of assets remaining after the regular security holders had been paid in full.

In each case, it was alleged that the trustee had exercised a contractual right to terminate the trusts when the outstanding balance due on the regular securities had reached a minimal threshold. The indentures permitted the trusts to be terminated by the trustee's election to either sell the assets to a third-party or purchase the assets itself and to deposit the amount required to repay the regular security holders into an account for that purpose. In each case, the trustee had elected to exercise its contractual right to purchase the trust assets itself. In both cases, the trustee purchased the assets for the remaining amount due on the regular securities. It was alleged that the trustee then resold the assets in the *Cece* case for a $10 million profit and, in the *NMC* case, for a $3 million profit, demonstrating that the trustee had paid less than market value for the assets.

The trustee's defense to each complaint was that it had no fiduciary duties to the security holders, and its rights and duties were governed by the terms of the indenture. The trustee asserted that the indentures permitted the trustee to terminate the trusts (and its duties to the beneficiaries) by electing to purchase the assets for the amount then due on the regular securities, to pay that amount to the holders of the regular securities and to retain any excess market value obtained in a subsequent fair market sale, without any obligation to account to the holders of the residual securities.

In each case, the Court firmly and unanimously rejected the trustee's interpretation of the indentures and reversed dismissal of the breach of contract causes of action in the complaints, but affirmed dismissal of various related causes of action.

The Court found it to be undisputed that the trustee had the contractual right to terminate the trusts and retire the related securities, because the amount outstanding on the class of regular securities in each case had fallen below 1% of the original principal balance. The Court further found it to be undisputed that the trustee had the right to terminate each trust and retire the securities by purchasing, or causing the sale to third-parties, of all remaining trust assets and depositing into the "depository account" the aggregate remaining balance due on the regular securities plus 30 days of accrued interest (the "Termination Price"). Although the indentures required any proceeds in excess of the Termination Price to be deposited into a separate account and distributed to the residual security holders, there were no such proceeds at the time the trustee bought the assets and the trusts were terminated.

Finally, in each case the Court noted that the trustee conceded that it had purchased the trust assets for less than market value and had resold the assets for a profit, which it retained.

Analyzing the allegations of the complaints as to these facts, the Court found that, although the trustee's rights and duties are defined exclusively by the terms of the indentures, it nevertheless has a duty to perform its ministerial functions with due care and it has a duty to avoid conflicts of interest. In that regard, the indentures prohibited the trustee from asserting a claim against the trust assets in any capacity except as otherwise permitted by the indenture, because those assets are held for the exclusive benefit of all investors.

The Court then rejected the trustee's contention that the indentures expressly permitted the trustee to purchase the trust assets for less than market value. Absent such an express permission, the trustee's purchase of the assets for less than market value and subsequent resale and retention of the profit would create a prohibited conflict of interest with the residual security holders. The Court found no express provision permitting the trustee to purchase the assets for less than market value. Specifically, it rejected the trustee's assertion that the indentures gave the trustee the express right to purchase the trust assets for the Termination Price, the amount due with respect to the regular securities plus 30 days of accrued interest. According to the Court, the indentures did not specify any permissible purchase price. What the indentures did was permit termination of the trust by a sale and deposit of the Termination Price in the depository account with respect to the regular securities. According to the Court, the obligation of the trustee to deposit the Termination Price into the account used solely to repay the regular securities did not grant the trustee the right to purchase the trust assets at such price if it was below the market value of the trust assets.

In order to reach its conclusions, the Court also had to consider two provisions of the indentures that arguably supported the trustee's position. First, it considered a provision that one of the conditions for termination of the trust was the sale of assets "at a price equal to the Termination Price." The Court dealt with this provision by finding that it did not clearly enough provide that the trustee could purchase the assets at the Termination Price regardless of their value; rather this provision merely set the minimum price at which the assets had to be sold in order to terminate the trust. The Court also ruled that the provision of the indentures stating that termination of the trust terminated the trustee's obligations did not negate the obligation of the trustee to make payments to the holders of residual securities that would have been required had the assets been sold at market value.

The Court rejected the trustee's interpretation of the indentures as untenable because, as a practical matter, it created a conflict of interest between the trustee and residual security holders and would deprive the holders of any practical right to a recovery whenever a residual value existed. While the Court appeared to contemplate the possibility that an indenture might be drafted clearly enough to provide a trustee with the right to capture the residual value, as claimed in these cases, the underlying duty to avoid conflicts of interest prevented such an interpretation so long as any other interpretation was feasible.

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