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Danger for Buyers of Distressed Securities or a Gift to Bond Indenture Trustees

A thriving market exists for the transfer of troubled secured debt. Recently, the Ohio Supreme Court reminded distressed debt buyers that they need to carefully understand exactly what rights they are getting when they buy troubled secured debt, in this case a municipal bond. The situation is very common: the debt buyer purchased municipal bonds issued to fund a specific project; the bonds were not general obligation bonds; and the bond indenture appointed a bank as trustee to deal with the bondholders and the project. As it happened, the project's first occupant defaulted on payments owed on the bonds as did a replacement occupant. That second occupant then filed a bankruptcy case that was dismissed. Ultimately, the bank acting as trustee filed a foreclosure action against the project.

The distressed debt buyer first purchased bonds after the initial occupant's payment default. The Ohio Supreme Court described the distressed buyer's plan as follows:

This was a potentially risky investment strategy: identify distressed, nontaxable bonds and buy them at a discount with the hope that any problems that had caused the value of the bonds to decline would be remedied, resulting in an increase in value. In fact, the Cheatham IRA [debt buyer] continued to purchase the bonds after Benchmark [second occupant] filed for reorganization under the bankruptcy code, paying 32 cents on the dollar. However, out of an initial bond issue in the amount of \$6.59 million, bondholders received a total of \$339,452.05, or five cents on the dollar.

After this unhappy result, the debt buyer launched class action litigation against the bond trustee.^[1] The trial court refused to certify the requested class. An Ohio intermediate appellate court (the Sixth District Court of Appeals) reversed that decision. The trial and lower appellate courts disagreed on the meaning of UCC

Section 8-302. The Ohio Supreme Court described the dispute between the trial and appellate courts as follows:

Thus, the [trial] court held that the questions of law and fact common to the class members did not predominate over questions affecting each individual member, because each class member would allege a different time and purchase price as the basis for a breach and thus would have different potential damages.

On appeal, the Sixth District Court of Appeals reversed. That court noted that the Cheatham IRA had phrased the issue as “whether the purchaser of a bond acquires causes of action that arose, under the terms of a Trust Indenture, prior to the time that the bondholder acquired the bonds.”

The Ohio Supreme Court quoting the appellate court decision, *Paul Cheatham IRA v. Huntington National Bank*, 102 N.E.3d 597 (Lucas Cty. App. 2017) (reversing the trial court, the intermediate appellate court held that a contract claim against trustee for municipal bondholders was right in the security that automatically transferred to subsequent bond purchasers).

The statute at issue, UCC 8-302 or Ohio Revised Code Section 1308.16(A), is this:

(A) Except as otherwise provided in divisions (B) and (C) of this section, a purchaser of a certificated or uncertificated security **acquires all rights in the security that the transferor had or had power to transfer.** (emphasis added)

The trial court, appellate court and Ohio Supreme Court all agreed on the issue, in this case, is one of the first impressions in Ohio. Due to this, the trial and lower appellate court turned to *Consol. Edison, Inc. v. Northeast Util.*, 318 F.Supp. 2d 181 (S.D.N.Y. 2004), *reversed on other grounds* at 426 F.3d 524 (2nd Cir. 2005). Discussing the relevant UCC section and the *Consolidated Edison* cases, the Court of Appeals said:

NU argued, as appellant [Cheatham IRA] does here, that the stock-related contract claims against third parties were automatically assigned to subsequent purchasers of the stock

by virtue of New York's version of [U.C.C. § 8–302\(a\)](#), which is identical to [R.C. 1308.16\(A\)](#). The trial court rejected this argument, finding that the legislative history and structure of the U.C.C. “confirm that [§ 8–302\(a\)](#), rather than defining what rights are in the security, involves the mechanism for transferring rights and applies primarily to disputes over the quality of title and the competing ownership rights passed from transferor to transferee.” [Id. at 188](#). The [trial] court concluded that,

[Section 8–302](#) does not define “rights in a security” or codify a rule assigning to purchasers any claim accrued while possessing the security. The provision simply provides that whatever “rights in the security” are, they are automatically transferred to a purchaser unless (a) the transferor did not own or control them, (b) the purchase was for a limited interest, or (c) the purchaser is a prior holder with notice of an adverse claim taking from a protected purchaser. [Id. at 189–190](#).

Having concluded that [U.C.C. § 8–302](#) automatically conveys only the “rights in the security,” the trial court then determined that the “rights in the security” do not include the rights of “third-party beneficiaries arising out of agreements separate from the contract embodied in the security.”

The Ohio Appellate Court ultimately rejected this analysis from the trial court. *Paul Cheatham IRA v. Huntington National Bank*, 102 N.E.3d at paras. 17–19.

The Ohio Supreme Court accepted the bank's appeal. In its opinion, published at *Paul Cheatham IRA v. Huntington National Bank*, 157 Ohio St.3d 358 (2019), the Ohio Supreme Court held that neither the above-quoted statute nor the language of the trust indenture automatically transferred an accrued breach of trust indenture contract claim to the purchaser of a municipal bond. Moreover, nothing in that decision's rationale would limit the decision to municipal bond securities.

At first glance, the Ohio Supreme Court's decision seems at odds with Ohio Revised Code Section 1308.16(A), which states that a

“purchaser of a certificated or uncertificated security acquires all rights in the security that the transferor had or had power to transfer.” Hence, if a seller of municipal security had a claim against the bond indenture trustee, it would seem to follow that said claim was a right “in the security” that would transfer with the security (the municipal bond).

When it accepted jurisdiction over the case, the Ohio Supreme Court agreed to hear this specific issue: is it the law that “[a]bsent a valid assignment of claims, the mere sale of a municipal bond does not automatically vest in the buyer, by operation of [R.C. 1308.16](#) [[UCC 8-302](#)], all claims and causes of action of the seller relating to the bond that arose before the transaction.” 157 Ohio St.3d 358 at para. 13. In framing the issue, the bank or perhaps the Ohio Supreme Court transformed the operative statutory language of “rights in the security” into “relating to the bond.” I am not sure those two phrases have the same meaning.

The Ohio Supreme Court began its analysis referencing a concurring opinion issued by one of the Lucas County Court of Appeals judges. The Ohio Supreme Court said this:

A concurring judge stated her view that under [R.C. 1308.16\(A\)](#), a bondholder has standing to sue under a trust indenture but that the statute did not answer the ultimate question of whether a bondholder has standing to sue for prior breaches of that agreement. [2017-Ohio-9234, 102 N.E.3d 597, at ¶ 31](#) (Mayle, J., concurring). The concurring opinion stated that the answer could be found in whether an accrued cause of action could be asserted independently of continued ownership of the security. *Id.* at ¶ 38, citing [Natl. Res. Co. v. Metro. Trust Co., 17 Cal.2d 827, 833, 112 P.2d 598 \(1941\)](#). The concurring opinion examined the trust indenture to determine what rights could be transferred to a subsequent bondholder under [R.C. 1308.16\(A\)](#). The indenture defined a “bondholder” as the person in whose name a bond was registered. **In the concurring judge’s view, the actual ownership of a bond was a condition precedent to the maintenance of a cause of action**, so the breach-of-contract claims under the trust indenture transferred with the bond to a subsequent

bondholder because those claims could not be asserted apart from the contract out of which they arose and they were essential to the complete enforcement of the trust indenture. Id. at ¶ 42. (emphasis added).

157 Ohio St.3d 358 at para. 12.

After the above-quoted discussion of the concurring appellate opinion and a recitation of the common law differences between personal property and chooses in action, the Ohio Supreme Court got to the heart of its decision stating:

There is no question that the Cheatham IRA purchased its bonds after Huntington allegedly breached the trust indenture. There is likewise no question that the Cheatham IRA has not been assigned any rights to causes of action by a party who held the bonds at a time when the Cheatham IRA alleges that Huntington's alleged breach occurred. The Cheatham IRA has stated that its "class certification effort is based upon the fundamental proposition that the purchase of one of the bonds at issue in this case gives the purchaser all of the rights in that bond that the seller had prior to the sale. That includes any claim that the seller had against Huntington Bank." . . .

The court of appeals erred to the extent that it held that a breach-of-contract claim that accrued before the sale of a bond automatically transferred with the bond under R.C. 1308.16(A). While language in R.C. 1308.16(A) stating that "a purchaser of a certificated or uncertificated security acquires all rights in the security that the transferor had or had power to transfer" might superficially support the conclusion that it provides for the automatic assignment of any rights held by the prior bondholder, the drafting history of this section shows that it does not apply to transfers of chooses in action.

157 Ohio St.3d 358 at para. 17-8.

The implication of these two quotations is perhaps the unintended release of bond indenture trustees and others. The Ohio Supreme Court's praise of the concurring opinion combined with the Court's actual decision seems to mean that an existing claim against the

trustee is destroyed when the security is sold since (a) the selling bondholder cannot bring the claim because that seller was no longer a bondholder, and (b) the Ohio Supreme Court decision holds the security buyer (new bondholder) does not get the breach of contract claim because that claim is not a right “in the security” under UCC 8-302. The only alternative seems to be discarding normal security transfers for transaction-specific claim assignments transfers combined with the security transfer.

In support of its decision, the Ohio Supreme Court notes that federal securities law does not permit the transfer with securities of claims that the selling security owner was misled into its purchase of that security. 157 Ohio St.3d 358 at para. 22. It does not seem to me that this analogy is helpful because of the differences in the two claims. Just because the first the securities buyer was misled that does not mean the securities purchaser was misled by the same false statements. Conversely, after the collateral is allegedly mishandled, all owners of a security are harmed by the decline in the value of their collateral.

The Ohio Supreme Court also reviewed the bond indenture to determine if the security buyer could sue for breach. Like many others, the bond indenture included language stating that the trust indenture is for the “benefit, security and protection of all present and future holders and owners of the Bonds.” According to the Ohio Supreme Court, that language “says nothing about whether a subsequent holder of a bond can sue for a breach of the trust indenture that occurred before the holder came into possession of the bond.” I am not a bond lawyer, but I have not seen bond indentures in which a trustee agrees that a future security owner can sue for alleged breaches of that indenture that occur before the bondholder purchased the security.

After rejecting Cheatham IRA’s effort to analogize its situation to a couple of other cases, the Ohio Supreme Court delivered this warning to distressed buyers:

The Cheatham IRA purchased the bonds at a discount that reflected the ongoing issues with the . . . project. In a real sense, it has suffered no injury from Huntington’s alleged breach of the trust indenture that occurred before it

purchased the bonds because that alleged mismanagement contributed in part to the reduced price the Cheatham IRA paid for the bonds. See *Bluebird Partners, L.P. v. First Fid. Bank*, 896 F. Supp 152, 157 (S.D.N.Y. 1995) (“Market forces assured that the price plaintiff paid for certificates which would never be wholly redeemed reflected their diminished value. The injury was sustained by the sellers who parted with these certificates at a reduced price, not by plaintiff who purchased them at their post-bankruptcy value”); see also *In re Nucorp*, 772 F.2d at 1490 (automatic assignment “would remove the remedy from those to whom the statute provides it * * * by gratuitously giving it to those who were not defrauded and have suffered no injury under the securities law”).

157 Ohio St.3d 358 at para. 35.

There are not many cases regarding this point under UCC 8-302. But, there is this analysis that appears to be contrary to the Ohio Supreme Court’s own analysis:

The defendants also argue that [§ 8.302\(a\)](#) of the Texas Uniform Commercial Code precludes the plaintiffs from bringing any breach of contract claims based on the Warrants that the plaintiffs purchased after the date of the breach. The defendants contend that the right to bring claims for a breach of the Warrant Agreement was not transferred with the Warrants when the plaintiffs purchased them. The argument is unavailing. . . .

The defendants argue that the right to bring a claim for breach of the Warrant Agreement is not a right “in the security” and thus was not automatically transferred to the plaintiffs when they purchased the Warrants after the date of the breach. The defendants concede, however, that they have not been able to locate any cases interpreting [§ 8.302\(a\) of the Texas UCC](#). . . . This Court’s recent decision in *Consolidated Edison, Inc. v. Northeast Utilities*, 318 F. Supp. 2d (S.D.N.Y. 2004), which interprets § 8-302 of the New York UCC—a provision identical to § 8-302 in the Texas UCC—undermines the defendants’ position. In *Consolidated*

Edison, the Court concluded that “rights in the security” includes rights “vis-a-vis the issuer and vis-a-vis other potential holders,” and that the rights against the issuer include contract rights. *Id.* at 192.

R.A. Mackie & Co., et al. v. Petrocorp Incorporated, et.al., 329 F.Supp.2d 477 at para. 25–7.

The cases applying New York and Texas law discussed above^[2] are not easily reconciled with the cases applying Ohio law. So, for now, the lessons are (i) that buyers of distressed securities need to know what law applies to the securities they are buying, (ii) in the future, debt buyers with enough negotiating power might try to get bond indenture provisions that provide for the continued existence of contract claims, and (iii) if warranted by the dollars involved, buyers of distressed securities may need to get a transaction-specific assignment or claims from the security seller.

The Ohio Supreme Court does not discuss the merits of the subject contract claims. It seems, however, that the court was less than impressed with the facts of the claim against the indenture trustee. First, in what the court declared an issue of first impression the court easily ruled against the claimant, and the court did not make any suggestions concerning rectifying the current claimants’ problems or how future security buyers could obtain ownership of claims.^[3]

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^[1] The trial court was asked to certify a class of more than 50 bondholders who, on November 14, 2014 (the date of final distribution), owned bonds secured by the project. The bank opposed class certification, arguing that individual members of the proposed class of bondholders purchased their bonds at different times, so the evidence and legal issues on the breach-of-contract claim would differ based on when the class members acquired the bonds.

[2] Although they apply different state's laws, both decisions were by the same federal judge.

[3] The only discussed resolution for transferring claims is that individual selling security owners would sign an assignment to the buyer. That idea seems unrealistic in the day of book entry securities and electronic markets where sellers and buyers are anonymous to each other.

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