

Legal Update

Litigation Alert – Secondary Bondholders Can Assert Claims of Their Predecessors

April 2010

In a decision rendered just last week, New York’s highest court clarified that secondary holders of indenture notes succeed to and may assert the common law rights and claims of their predecessors against the indenture trustee and others.

The issue in *Racepoint Partners, LLC, et al. v. JP Morgan Chase Bank, N.A.*, 2010 Slip Op. 2678, 210 N.Y. LEXIS 64 (April 1, 2010), was whether secondary purchasers of certain Enron indenture notes had stated a claim against JPMorgan Chase, which was the indenture trustee for the notes. The indenture at issue, like virtually every indenture of its kind, provided that the issuer had to file with the trustee, within 15 days after the issuer filed the same with the SEC, copies of the reports the issuer is “required to file” with the SEC pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934. The plaintiffs alleged that the reports Enron filed with the SEC were fraudulent and therefore were not the reports Enron was “required to file,” that Enron was therefore in default under the indenture – and that JPMorgan Chase had actual knowledge of Enron’s fraud and therefore of Enron’s default. The plaintiffs alleged that their predecessors were damaged when JPMorgan Chase failed to exercise its duties as trustee to invoke the trustee’s remedies under the indenture.

Contact Us:

For more information about this topic or any other litigation matter, please contact:

[David Parker](#)
212.880.9880
dparker@kkwc.com

[Norris D. Wolff](#)
212.880.9860
nwolff@kkwc.com

[Marc R. Rosen](#)
212.880.9897
mrosen@kkwc.com

[Jason A. Otto](#)
212.880.9894
jotto@kkwc.com

JPMorgan Chase asserted several defenses, including:

- that the indenture provision at issue, which was governed by New York law, required only delivery to the trustee of copies of the reports that actually had been filed with the SEC.
- that the plaintiffs, who were secondary, distressed purchasers of the notes and themselves had not been damaged, lacked standing to assert the claims.

The New York State Court of Appeals accepted JPMorgan Chase's position on the first defense but along the way, denied the second.

The plaintiffs asserted standing under Section 13-107 of New York's General Obligations Law which provides that, unless expressly reserved in writing, the transfer of any bond vests in the transferee all claims or demands of the transferrer [so spelled in the statute] against the issuer, the indenture trustee or depositary or any guarantor. "Bond" is defined in the statute broadly to include shares and interests in an issue of bonds, notes, debentures or other indebtedness. "Indenture" likewise is broadly defined.

JPMorgan Chase argued that Section 13-107 conflicts with the Trust Indenture Act which requires that plaintiffs show "actual damages." It argued further that Section 13-107 is preempted by the TIA, because it conflicts with the federal statutory framework governing securities. Several years ago, the Court of Appeals declined to decide whether Section 13-107 is preempted by the TIA, finding in that case that the issue had not been sufficiently presented for review. See *Bluebird Partners, L.P. v. First Fidelity Bank, N.A.*, 97 N.Y.2d 456, 462 (2002). New York was one of the last states to adopt a provision like Section 13-107 and now is the only state that still has such a statute. The Court of Appeals noted in *Bluebird* that "New York's attempt to bring its rule into conformity with other jurisdictions has ironically achieved the opposite result." *Id.*

In *Racepoint*, the plaintiffs' predecessors presumably were members of the settling classes in the Enron securities litigation who had released all of their related claims as part of that settlement. While not asserting their predecessors' federal securities laws claims, the plaintiffs were asserting related common law claims. The issue was complicated by the fact that, unlike bank debt, bonds trade in an anonymous market, so the plaintiffs could not know who their predecessors were – *i.e.*, whose claims they were asserting. JPMorgan Chase also had argued below that, since the transfers of the bonds could have taken place anywhere, and plaintiffs could not know where the transfers had taken place, there was no basis to apply New York law to the transfers (as opposed to the indenture itself) in the first place.

Although the thrust of the briefing and argument – and the decision – in the Court of Appeals related to the issue of whether Enron’s delivery of fraudulent reports constituted a default under the indenture, in reaching that decision, the Court of Appeals stated with respect to plaintiffs’ common law claims that “Plaintiffs ... as secondary holders of the notes, are vested with the claims and demands of the sellers” *Racepoint at *66*. While the Court of Appeals handed bondholders a loss on the interpretation of the indenture provision at issue, it nonetheless clarified the ability of secondary bond purchasers to assert against issuers, trustees and guarantors their predecessors’ common law claims.

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