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Ohio Supreme Court rejects bondholders suit against trustee for compensation of losses

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In its opinion in Paul Cheatham I.R.A v. The Huntington National Bank, issued on August 22, 2019, the Ohio Supreme Court held that, absent an express assignment of claims, purchasers of distressed bonds do not have a right to sue the trustee to compensate for the investment losses of prior bondholders.

The matter before the Court arose from Lucas County's 1998 issuance of $6.59 million in tax-exempt revenue bonds to finance the construction of a nursing home. The lease agreement between the project owner, the Foundation for the Elderly and Lucas County stated that the foundation was solely obligated to pay debt charges on the bonds. The Huntington National Bank entered into a trust indenture with Lucas County under which it agreed to collect and distribute bond payments to the bondholders and receive an annual fee.

Who are bondholders?

Bondholders are investors who purchase bonds. In this case, Paul Cheatham I.R.A. became a bondholder by purchasing distressed bonds in the secondary market.

What are distressed bonds?

Distressed bonds are securities of borrowers that are experiencing financial or operational distress, default or bankruptcy.

How did the Lucas County bonds become distressed?

In 2003, the foundation defaulted on its principal and interest payments. Benchmark Healthcare of Toledo assumed the lease but defaulted and declared bankruptcy in 2004. After several failed attempts at reorganization, Huntington foreclosed on the health care facility.

Why did Cheatham purchase the Lucas County Bonds?

Paul Cheatham I.R.A., an investment fund, began purchasing the distressed Lucas County bonds for $0.32 on the dollar after the foundation's initial default in 2003 and continued purchasing the bonds even after Benchmark filed for bankruptcy. The purchases were part of a risky investment strategy carried out in hopes that the value of the bonds would increase. After Huntington foreclosed and collected approximately $340,000, bondholders received only $0.05 on the dollar. Cheatham then filed a class-action suit against Huntington, alleging that Huntington breached the trust indenture by not enforcing remedies and protecting the bondholders against project mismanagement.

Why did Cheatham sue Huntington?

While Huntington's alleged breach of the trust indenture occurred before Cheatham began purchasing the bonds, Cheatham based its claims on Ohio Revised Code Section 1308.16(A), which states a bondholder "acquires all rights in the security that the transferor had or had power to transfer." Cheatham alleged that because the bondholders at the time of the initial default and Huntington's alleged breach had a cause of action and could have sued Huntington, the right to sue Huntington transferred to Cheatham when Cheatham purchased the bonds from the prior bondholders.

Why did the Ohio Supreme Court rule against Cheatham?

The Ohio Supreme Court held that the right to sue a bond trustee does not automatically transfer to a buyer. The Court largely relied upon the drafting history of Ohio Revised Code Section 1308.16(A), the Official Comment to that section and interpretations of other states' versions of Section 8-302(a) of the Uniform Commercial Code.

Finally, the Court was also not persuaded by Cheatham's argument that a right to sue could be inferred from the trust indenture. The Court, however, relied upon expressed limitations in the trust indenture that provided that no transfer of rights between bondholders was intended unless they were expressly conferred at the time of the sale. Since nothing in the trust indenture conferred the right to bring a claim, the Court rejected Cheatham's arguments.

In short, the Court concluded that because the bondholders selling to Cheatham did not expressly assign their right to sue Huntington, no such right transferred. The case was remanded to the trial court for disposition, effectively ending Cheatham's claims against Huntington.