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Compelling a Muni Indenture Trustee to Arbitrate Before FINRA: Kramer Levin

A recent decision out of the federal district court in Nevada, *BOKF, NA v. Estes* D. Nev. March 2, 2018), addressed the interesting question of whether an indenture trustee for municipal bonds could be compelled to arbitrate bondholder claims in front of the Financial Industry Regulatory Authority (FINRA). The court answered in the affirmative, navigating through a labyrinth of rules of FINRA and the Municipal Securities Rulemaking Board (MSRB). The decision creates precedent in the muni bond world, but because it rests on MSRB regulation, it would not ordinarily extend to trustees for corporate debt instruments.

Background

The *Estes* case is yet another outgrowth of the misdoings at Lawson Financial Corporation, a now-demised demised municipal bond underwriter that was effectively shuttered by the Securities and Exchange Commission. (*See* Debt Dialogue, April 2017.) Between 2015 and 2017, the SEC filed complaints against principals of Lawson, Christopher Brogdon and Dwayne Edwards, and issued a cease and desist order against Lawson for fraud and violation of the federal securities laws.

The indenture trustee for the muni bonds underwritten by Lawson was BOKF, N.A., doing business as Bank of Oklahoma, N.A., through its corporate trust department. The SEC also filed complaints against BOKF and the former head of its corporate trust department, Marrien Neilson, for their involvement in the Lawson schemes, with BOKF entering into a consent agreement with the SEC over its alleged role as aider and abettor in the fraud.

In June 2017, a group of holders of bonds underwritten by Lawson initiated arbitration against BOKF under FINRA's Code of Arbitration Procedure (Customer Code; Rule 12000 et seq.), alleging violations by BOKF of the federal securities laws in connection with its service as indenture trustee for the bonds. The bondholders contended that BOKF was subject to FINRA arbitration as a "bank dealer" engaged in municipal securities dealer activities pursuant to the rules of the MSRB.

In November 2017, BOKF brought suit against the bondholders in federal district court seeking a declaration that BOKF was not subject to FINRA arbitration, and also sought related injunctive relief. With the FINRA arbitration set for July 2018, in December 2017, BOKF sought a preliminary injunction enjoining the bondholders from taking any action in furtherance of the arbitration.

The Decision

The court brought the usual principles to bear on BOKF's preliminary injunction and found that BOKF was unlikely to prevail on the merits.

The court began with the observation that arbitration cannot be compelled absent a contractual basis, and BOKF was not a member of FINRA and not directly subject to its rules. The contractual basis advanced by the bondholders were the rules of the MSRB that import FINRA arbitration procedures. Rule G-35 of MSRB rules provides that "every bank dealer … shall be subject to the

[FINRA] Code of Arbitration Procedure … for every claim, dispute or controversy arising out of or in connection with the municipal securities activities of the bank dealer acting in its capacity as such."

In turn, under the FINRA Code, "customers can compel registered members of FINRA to arbitrate certain disputes even when no written arbitration agreement exists."

BOKF raised two arguments in its attempt to halt the arbitration proceedings. First, it reasoned that the bondholders were not its "customers" within the meaning of the FINRA Code, such that they lacked standing to commence an arbitration even assuming that the FINRA Code applied to BOKF. Second, BOKF maintained that its corporate trust department was not a "bank dealer" within the contemplation of MSRB Rule G-35. The court rejected both arguments.

Bondholders as "customers" of an indenture trustee

"Customer" is not affirmatively defined in the FINRA Code, but relying on precedent of the Court of Appeals for the Ninth Circuit, the district court held that the term is to be interpreted broadly. The bondholders had, in the court's view, alleged sufficient circumstances to bring BOKF within the ambit of the "customer" concept, liberally construed. BOKF was indenture trustee, bond registrar, dissemination agent and paying agent. It paid bondholders on their investments and provided bondholders information about their investments. It owed fiduciary duties to bondholders and its fees were paid from the "bondholder's [sic] investment proceeds, which shows a direct investment relationship even though [the bondholders] did not specifically buy the bonds from BOKF."

The court therefore found that BOKF was not likely to succeed on its claim that the bondholders were not its "customers."

The indenture trustee as "bank dealer"

MSRB Rule D-8 defines "bank dealer" as "a municipal securities dealer which is a bank or a separately identifiable department or division of a bank … ." MSRB Rule G-1, in turn, provides that "[a] separately identifiable department or division of a bank … is that unit of the bank which conducts all the activities of the bank relating to the conduct of business as a municipal securities dealer." Finally, municipal securities dealer activities are defined to include underwriting, trading and sales of municipal securities; financial advisory services in connection with the issuance of municipal securities; processing and clearing activities; related research and investment advice; any other activities involving communication with public investors in municipal securities; and maintenance of related records. BOKF contended that its corporate trust department did not engage in any of these defined activities and therefore was not a "bank dealer."

Rejecting BOKF's contention, the court credited the bondholders' position that BOKF engaged in activities beyond mere ministerial function. Among other things, Ms. Neilson, the former head of BOKF's corporate trust department, allegedly served as the primary contact person between BOKF, Lawson and the conduit borrowers, and also provided financial advice and consultation regarding the terms, structuring, and timing of the bond offerings. The bondholders also contended that employees within the corporate trust department, including Ms. Neilson, engaged in research activities on behalf of Lawson. The court credited these allegations and found that these functions fell comfortably within the zone of municipal securities dealer activities, as defined.

Other considerations

In rejecting BOKF's request for preliminary injunction, the court also adverted to what it called "the strong policy in construing the scope of arbitrable issues under FINRA broadly and in favor of

arbitration." The court noted that other courts had held consistently that "forced participation in an arbitration forum that does not have jurisdiction over the dispute is *per se* irreparable harm." Here, however, BOKF did not establish that FINRA lacked jurisdiction.

Some Thoughts

Reading the decision, there is some sense that the court bootstrapped its way to the conclusion. Its denial of the requested preliminary injunction was premised in large measure on the as yet unproven allegations of the bondholders. What can be said is that the court seemed convinced by the cumulative weight of the allegations in the various SEC complaints, particularly those against BOKF and the former head of its corporate trust department, indicating that BOKF was much more than a passive administrator in the web of fraud woven by Lawson and its principals.

Putting aside the particulars, the case is a cautionary tale of a municipal indenture trustee being hauled before a FINRA arbitration panel despite the fact that it is not a FINRA member and that it would not ordinarily be regarded as engaging in municipal securities dealer activities. While indenture trustees ordinarily view themselves as administrative creatures acting within the four corners of their indenture, a demand for arbitration would necessarily arise in circumstances where the trustee was acting outside the zone of ministerial function. In the *BOKF* case, these activities were alleged to have occurred around the time of issuance of the securities, and not down the road when the trustee was pursuing (or not pursuing) remedies after a default. It is unclear therefore whether the rules of the MSRB could be stretched so thin as to reach even post default remedial activities of the trustee. But the warning light is there.

There are no rules in the corporate bonds arena to bind indenture trustees to FINRA arbitration, analogous to MSRB Rule G-35. There would have to be another contractual lever to compel the trustee to appear in a FINRA or other arbitral proceeding. The case nonetheless suggests that where a hook exists to bring a trustee into a retail-friendly arbitration forum, a court may stretch to do so.

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