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Ohio Supreme Court: Municipal Bond Buyers Do Not Automatically Acquire Right To Sue.

Ohio law does not automatically transfer to the buyer of a municipal bond the seller's right to sue a financial institution overseeing the repayment of the bonds, the Ohio Supreme Court ruled.

A Supreme Court majority decided Aug. 22 that unless the right to file a lawsuit is expressly assigned to the buyer when a bond is purchased, the buyer does not acquire the right. Writing for the Court majority, Justice Melody J. Stewart stated that purchasers of distressed bonds incorrectly concluded that R.C. 1308.16 gave them the right to sue Huntington Bank for breach of contract. Huntington served as a trustee overseeing the nearly $6.6 million in revenue bonds issued for a Lucas County nursing home that went bankrupt.

Chief Justice Maureen O'Connor and Justices Judith L. French and Michael P. Donnelly joined Justice Stewart's opinion.

Justice Patrick F. Fischer concurred in the judgment. Justice Sharon L. Kennedy concurred in judgment only with a written opinion joined by Justice R. Patrick DeWine.

In 1998, Lucas County issued $6.59 million in revenue bonds to back construction of the Villa North Health Care and Rehabilitation Center. The agreement exempted the bonds from federal taxes but made it clear that Lucas County was not obligated to pay back the borrowed money. Rather, it would pay the bondholders only what it received from the project's owner, the Foundation for the Elderly.

Huntington Bank entered into an agreement with the county, known as a "trust indenture," in which the bank would earn a fee for collecting the bond payments and distributing the funds to the bondholders.

The project ran into difficulties. In 2003, the foundation defaulted on about $420,000 in principal and interest payments. A new entity, Benchmark Health Care of Toledo, assumed the nursing home lease, but it also defaulted by the end of 2003. In May 2004, Huntington informed the bondholders that Benchmark filed for reorganization through Chapter 11 bankruptcy. After two attempts at reorganization, the plan failed in 2009, and Huntington foreclosed on the property.

An investor, through a fund named Paul Cheatham IRA, began purchasing the Villa North bonds in 2003 as part of a risky investment strategy. His investment advisers identified distressed, nontaxable bonds and urge investors to buy them at a discount. The buyers purchased the bonds with the hopes that any problems causing the value of the bonds to drop would be remedied and the bonds' value eventually would increase. Cheatham IRA continued to purchase Villa North bonds, paying 32 cents on the dollar, after Benchmark filed for bankruptcy.

In the end, Huntington was able to collect only about $340,000, paying bondholders 5 cents on the dollar.

Cheatham IRA filed a class action lawsuit against Huntington Bank, alleging the bank breached the

trust indenture, and that Huntington could have done more to protect the bondholders against the mismanagement of the Villa North project. Cheatham asked the Lucas County Common Pleas Court to certify a class of more than 50 bondholders, and the bank objected.

The trial court ruled that Cheatham IRA did not have the same rights to sue as the original bondholders and that they could not be joined together as a class. The court stated that many of the alleged breaches by Huntington occurred before the fund bought the bonds, and that R.C. 1308.16(A) did not transfer to the subsequent bondholders the right to sue for acts that occurred before they bought the bonds.

Cheatham IRA appealed to the Sixth District Court of Appeals, which reversed the trial court and ruled that the fund did acquire the right to sue Huntington. The bank appealed the decision to the Supreme Court, which agreed to hear the case.

Justice Stewart explained that under common law, only the person injured can sue to recover from an injury, unless that person expressly transfers the right to another. The Sixth District found that in the case of securities, Ohio law made an exception, and that R.C. 1308.16(A) gives the purchaser of a security "all rights in the security that that the transferor had or had power to transfer." The Sixth District interpreted "all rights" to include the right of the original bondholder to sue for breach of contract based on a breach that occurred when the original bondholder owned the bond. In this case, Cheatham IRA acquired to right to sue when it bought the bonds, even if the "injury" occurred before they bought the bonds, the appeals court ruled.

The Supreme Court disagreed. The opinion explained that a "chose in action," which includes the right to sue, belongs to the owner of a piece of property. The right to sue does not automatically transfer to a buyer of property, such as a bond. If the agreement to sell does not expressly include the seller's assignment of the right to sue to the buyer, no right transfers, the Court stated.

The majority opinion noted that R.C. 1308.16(A) is Ohio's version of the Uniform Commercial Code's (UCC) section 8-302. Nearly every state adopted similar versions of the UCC to bring uniformity to business laws, and the Court stated the UCC is considered to "make uniform the law among the various jurisdictions." No other jurisdiction has interpreted UCC 8-302 as overruling the common law rule that a right to sue does automatically transfer, the Court stated.

"The Cheatham IRA has been clear that its claim is based on Huntington's alleged failure to act upon notice of the initial default. Only those who owned the bonds at the time of the original default could bring an action for that breach of the trust indenture," the opinion stated.
The Court majority also stated that it expressed no opinion on allegations made by Cheatham IRA against Huntington for actions that occurred after the fund bought the bonds.

In her concurring opinion, Justice Kennedy stated that the Court need look no further than the "plain and unambiguous language of R.C. 1308.16(A)" to conclude that a buyer of a municipal bond does not automatically acquire the right to sue.

R.C. 1308.16(A) provides that a purchaser of a security acquires "all rights in the security that the transferor had or had power to transfer." While the phrase "rights in a security" is not defined in R.C. Chapter 1308, Justice Kennedy wrote that the common dictionary definitions of the words lead to only one interpretation — that the buyer of the bond can acquire only the legally recognized title to the bond that the seller had the power to transfer.

The opinion further stated that "rights in a security" does not encompass the "trust indenture." A trust indenture is an agreement governing a trustee's conduct and the trust beneficiaries' rights. It

is not a security. To find the right to sue based on a violation of the trust indenture, the Court would have to read the term “related to” into the phrase “all rights in the security,” which statutory construction does not permit, she concluded.

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