

Trigger Events and Requirements for Default-Rate Duties Highlighted by Recent Case

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The concept of default-rate interest — interest that accrues on a debt at a higher-than-normal rate if the debtor defaults on terms of the underlying financial instrument — is well known. Default-rate duties, however, may be less recognized. Broadly, trust documents can impose additional duties on a trustee if certain conditions are triggered. A recent opinion from the U.S. Court of Appeals for the Tenth Circuit probed the requirements of one such triggering event.

American Fidelity Assurance Company v. Bank of New York Mellon considered a residential mortgage-backed securities trust for which Bank of New York Mellon served as trustee (Trustee). A Pooling and Servicing Agreement (PSA) governed the trust. The Trustee's obligations under the PSA were, as put forward in the case, "generally ministerial." However, the Trustee incurred additional obligations if an Event of Default occurred and was known to the Trustee. As was relevant in the case, an Event of Default would occur when (1) the Master Servicer failed to perform under the PSA; (2) that failure materially affected the rights of certificate holders; (3) the Master Servicer received notice of its failure; and (4) the Master Servicer did not cure that failure within 60 days.

If this Event of Default occurred, the Trustee assumed "a duty of care and must satisfy additional obligations under the PSA." That said, even if the Event of Default occurred, the Trustee did not acquire these additional obligations under the PSA unless it received "written notice" of the Event of Default. Here, American Fidelity Assurance Company (American Fidelity) invested in the trust but "lost millions of dollars in the wake of the 2008 financial crisis." It filed suit to "hold [the Trustee] accountable for those losses." American Fidelity asserted that the Trustee received written notice of an Event of Default in the form of a letter from a law firm hired by various certificate holders.

American Fidelity thus claimed that the Trustee was required — but failed — to comply with its heightened contractual duties under the PSA. As a result, American Fidelity alleged that the Trustee was liable for breach of contract and breach of fiduciary duty. In addition, American Fidelity alleged that the Trustee was liable for violating the Trust Indenture Act. The Trustee moved for summary judgment on American Fidelity's claims — and the district court granted that motion.

On appeal, the Tenth Circuit agreed with the district court and affirmed its grant of summary judgment

to the Trustee. On American Fidelity's breach of contract and breach of fiduciary duty claims, the Tenth Circuit wrote that American Fidelity had "not shown that [the Trustee] received written notice of an Event of Default." While certificate holders retained a law firm to send the Trustee a letter providing notice that the Master Servicer was failing to perform its duties and that this failure was materially affecting certificate holders, the letter gave 60 days to cure the defaults. Thus, the letter only informed the Trustee that the alleged failures would "ripen" into Events of Default. The letter did not, however, identify an existing Event of Default. As such, it did not trigger the Trustee's additional contractual duties under the PSA.

And on American Fidelity's Trust Indenture Act claim, the Tenth Circuit noted that the Trust Indenture Act "exempts some investments from its scope, including 'any certificate of interest of participation in two or more securities having substantially different rights and privileges.'" The district court found that the certificates at issue fell within that exemption, citing *Retirement Board of the Policemen's Annuity and Benefit Fund of the City of Chicago v. Bank of New York Mellon* in support. 775 F.3d 154 (2d Cir. 2014). There, the Second Circuit wrote that the certificates at issue "had 'different obligors, payment terms, maturity dates, interest rates, and collateral'" and therefore "qualified under the TIA's exemption for securities 'having substantially different rights and privileges.'" Because the certificates at issue here were "virtually identical to those at issue in *Retirement Board*," the district court concluded that they should be similarly exempt under the Trust Indenture Act. The Tenth Circuit agreed.

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