BOND DEFAULTS AND THE DILEMMA OF THE INDENTURE TRUSTEE

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I. INTRODUCTION

Long-term debt securities, or “bonds,” issued to public investors can suffer a collective-action problem. Bondholders cannot act as a cohesive group where individual bondholder investments are relatively small, mi-

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nimizing economic incentive to take action or cooperate.¹ This is exacerbated by the fact that the identity of bondholders constantly changes, public bonds being actively traded.² Although the rise in institutional bondholding—especially the advent of large, activist, hedge- and private-equity funds and the movement of some of these funds into bond investing—has helped to mitigate the collective-action problem,³ these funds often have conflicts of interest with other bondholders.⁴ Furthermore, the recent collapse of several of these major funds⁵ suggests that the collective-action problem could become more significant in future years.

Custom and law have provided a partial solution to the collective-action problem: for each public bond issue, an indenture trustee—the term derives from an “indenture,” the traditional name for the loan agreement governing a public bond issue—is appointed to act as a type of agent on behalf of the bondholders collectively.⁶ This “solution” is imperfect, however, because the standard of care for indenture trustees remains somewhat ambiguous, generating cost and inefficiency in the public bond markets. A law review article published in 1929 on the liability of indenture trustees commented,

[i]n view of the present importance of the subject, it is noteworthy that there should have been so little written upon it in the fifty years during which this field of the law has been developing. Indeed, the comparatively few cases which deal with the subject leave many of its problems altogether untouched.⁷

1. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1004–05 (2000) (discussing this collective-action problem in the context of public bonds issued by sovereign states).

2. See, e.g., ROBERT I. LANDAU & JOHN E. KRUEGER, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT 26 n.2, 197–99 (1998); Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 DUKE L.J. 1541, 1547–48, 1583 (2001) (both observing that under the indirect holding system for securities, including publicly-issued bonds, it is difficult, costly, and time-consuming to identify the actual beneficial owners of bonds).

3. Memorandum from Members of the ABA Business Law Section Comm. on Trust Indentures and Indenture Trs. to Doneene Damon, Comm. Chair 2–3 (July 26, 2007) (observing that these institutional bondholders have organized ad hoc bondholder committees and can be forthright about expressing their preferences to indenture trustees).

4. *Id.* at 1, app. at 5 (observing that bondholders “are often conflicted” because they own multiple tranches of debt and sometimes also seek to own or acquire the issuer).

5. See also Maria Bartiromo, *Facetime: George Soros: Chairman Soros Fund*, BUS. WK., Oct. 22, 2007, at 28 (quoting Soros as saying that “[b]oth hedge funds and private equities will diminish in importance”).

6. Indenture trustees are typically financial institutions. See THOMSON FINANCIAL, US CAPITAL MARKETS REVIEW: TRUSTEES (FIRST QUARTER 2007) 1 (Mar. 2006), http://www.thomson.com/pdf/financial/league_table/de/1Q2007/1Q07_DE_US_Trustee.

7. Louis S. Posner, *Liability of the Trustee Under the Corporate Indenture*, 42 HARV. L. REV. 198, 199 (1929).

Despite major federal legislation in the form of the Trust Indenture Act of 1939 (TIA),⁸ mandating that an indenture trustee administer all public bond issuances as a representative of bondholders to help enforce their rights,⁹ these comments still have a ring of truth.¹⁰ Indenture trustees do not always live up to their “efficient centralized enforcement” function contemplated by the TIA,¹¹ especially post-default when enforcement is most critical.

An inquiry into the standard of care for indenture trustees is now timely, given the number of bond defaults and predictions of an imminent rise in the rate of defaults as well as the increasingly conflicting role of private creditors in post-default situations.¹² Regarding the former, Moody’s Investors Service in 2006 reported thirty-three defaults of the worst type—payment defaults (including bankruptcies)—in the United States alone on nearly \$7.8 billion of bonds by corporate issuers (issuers).¹³ The outlook is even worse because defaults are most likely on high-yield bonds¹⁴ which, until recently, had been rapidly growing as a percentage of the overall market for publicly-issued bonds.¹⁵ Moody’s expects the payment-default rate for high-yield bonds to triple in the United States,¹⁶ and to quadruple globally,¹⁷ in 2008. Moreover, payment-default rates paint only a small part of the picture: adding non-payment defaults, such as breaches of co-

8. Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (1939) (codified as amended at 15 U.S.C. §§ 77aaa–77bbb (2000)).

9. 15 U.S.C. § 77jj(a)(1).

10. See Efrat Lev, *The Indenture Trustee: Does It Really Protect Bondholders?*, 8 U. MIAMI BUS. L. REV. 47, 48 (1999).

11. See 2 TAMAR FRANKEL, *SECURITIZATION* § 12.26, at 113 (2d ed. 2006) (referring to the indenture trustee under the TIA as an entity that ensures “efficient centralized enforcement of the borrower’s obligations”).

12. See *infra* notes 36–39 and accompanying text.

13. See MOODY’S INVESTORS SERVICE, SPECIAL COMMENT: CORPORATE DEFAULT AND RECOVERY RATES, 1920–2006, at 4 (Feb. 2007), available at http://www.moody.com/cust/content/Content.ashx?source=StaticContent/Free%20Pages/Regulatory%20Affairs/Documents/default_and_recovery_rates_02_07.pdf (reporting on payment defaults, bankruptcies, and distressed bond exchanges).

14. High-yield bonds are also commonly known as “junk bonds.”

15. See Jane Sasseen, *Junk Keeps Defying Gravity*, BUS. WK., Jan. 29, 2007, at 72.

16. See *id.* at 72–73 (reporting the view of a bond market analyst that “the level and severity of defaults may be worse when they finally hit, precisely because weak players are continuing to pile on new debt . . . [and] defaults could eventually approach the [ten percent] rates seen in the early 1990s.”); Stephen Taub, *Moody’s Sees Tripling of U.S. Junk Default Rate*, CFO.COM, Sept. 11, 2007, <http://www.cfo.com/article.cfm/9789102> (predicting the default rate in the United States “could climb to 4.5 percent”). This compares with an average annual default rate since 1983 on high-yield bonds of 4.9% and a peak annual default rate since that date of over ten percent. See Moody’s Investors Service, *supra* note 13, at 4.

17. See John Glover & Patricia Kuo, *Defaults on High-Yield Debt to Quadruple in 2008*, Moody’s Says, INT’L HERALD TRIB., Dec. 7, 2007, at 19, available at <http://www.iht.com/articles/2007/12/06/bloomberg/bxdefault.php>. If the U.S. economy falls into recession, Moody’s estimates that the default rate might rise ten-fold. See Moody’s Investors Service, *supra* note 13, at 5.

venants, the total default rates are certainly far greater than the above data suggest.

This Article's inquiry is additionally timely because public bondholder governance is increasingly recognized as a critical component of the larger realm of corporate governance.¹⁸ In the past, Congress and the legal literature have focused predominantly on the aspects of corporate governance related to equity investors. Given more than eighty percent of capital market financing raised by U.S. corporations now occurs through public bond offerings,¹⁹ greater attention should be devoted to public bondholder governance.

The Standard of Care for Indenture Trustees. Absent default, the indenture trustee's duties to bondholders are straightforward and, indeed, even ministerial.²⁰ In the event of default, however, those duties are governed by a "prudent man" standard.²¹ Both payment and non-payment (sometimes called "technical") defaults trigger that standard.²²

Although a prudent-man standard is widely used and well-developed in other legal contexts,²³ it has received scant attention in the trust-indenture context.²⁴ Indenture trustees for defaulted bonds therefore face the conundrum that they are required to act prudently but lack clear guidance on what prudence means.²⁵ Even worse, this Article argues, the limited guidance that exists derives from misplaced judicial reliance on traditional trust law²⁶ to inform the prudent-man standard.²⁷ A comparison of the role of

18. See e.g., Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211-12 (2006) (examining the role of private creditors in corporate governance); Yakov Amihud, et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 450 (1999) (arguing the "second dimension to corporate governance" is the "legal rules and economic arrangements that mediate the relationship between the firm and its creditors").

19. See Chris O'Leary & Colleen Marie O'Connor, *Rocky Times Ahead? Choppy Water for Stocks While Bonds Sail Smooth; Bankers Watch for Trouble Downstream*, INVESTMENT DEALERS' DIG., July 10, 2006 (stating companies raised \$76 billion through common stock offerings, \$35.7 billion through convertible offerings, \$466 billion through investment grade debt offerings, and \$66 billion through junk bond offerings during the first half of 2006).

20. See *infra* notes 52-54 and accompanying text.

21. 15 U.S.C. § 7700o(c) (2000).

22. See *infra* note 59 and accompanying text (observing that the trust-indenture standard of responsibility is triggered not only by a payment default but also by a technical default such as violation of a covenant).

23. See *infra* Part III (discussing the prudent-man standard in traditional trust and corporation law).

24. See *infra* Subpart II.C (explaining the relevant case law of the prudent-man standard in the trust-indenture context).

25. See LANDAU & KRUEGER, *supra* note 2, at 171, 177 (noting the lack of precedent available to guide an indenture trustee's actions).

26. This Article uses the terms "traditional trust law" and "traditional trustee" to refer to what is otherwise known as the common law of trusts or "gratuitous" trusts. See *infra* Subpart III.A. For a general taxonomy of trust vehicles, see generally Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559 (2003).

27. See e.g., *LNC Inv., Inc. v. First Fid. Bank*, No. 92 Civ. 7584 MBM, 1997 WL 528283, at *7 (S.D.N.Y. Aug. 27, 1997).

indenture trustees in modern securities markets with that of traditional trustees reveals that any analogy between the two is fundamentally misplaced.²⁸

The resulting hodgepodge—a standard of indenture-trustee performance partially lacking guidance and partially misguided—causes indenture trustees to sometimes devote as much of their energies to avoiding personal liability as to protecting bondholders.²⁹ It also can discourage some of the best players from wanting to be appointed as indenture trustees.³⁰ This is especially unfortunate since post-default situations ideally require the “best and the brightest of the corporate trust area.”³¹

Furthermore, liability-avoiding strategies may incongruously entail strict enforcement of an indenture’s remedial provisions, even when inaction by the indenture trustee might be the optimal course for bondholders.³² For example, strict enforcement could unnecessarily force the issuer into bankruptcy, which might result in less recovery for bondholders than an out-of-court restructuring.³³ If the indenture trustee does not act, how-

28. See *infra* Part IV.

29. This emphasis on avoiding liability is perhaps also partially explained by the traditionally low compensation paid to indenture trustees. The low compensation itself may indicate a fundamental market defect, at least part of the explanation for which may be investors’ expectations that the bonds in which they invest will not default, thereby discounting any expected benefit of a highly skilled indenture trustee. For a valuable discussion of market failures in contract law due to cognitive limitations, see Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 216 (1995), which explains, *inter alia*, that people often fail to make rational choices in contracts because they “are unrealistically optimistic.” Monty Python captured the same principle in its sketches on the Spanish Inquisition with the refrain: “NOBODY expects the Spanish Inquisition!” See *Monty Python: The Spanish Inquisition* (BBC television broadcast) (transcript available at <http://people.csail.mit.edu/paulfitz/spanish/script.html> (last visited Mar. 23, 2008)).

30. These players also may be discouraged by the fact that indenture trustees “are paid relatively small fees to act as trustees in transactions involving large sums of money.” American Bankers Association, Corporate Trust Committee, *The Trustee’s Role in Asset-Backed Securities* 4 (Mar. 12, 2003) (position paper, on file with Alabama Law Review). But cf. Memorandum from Members of the ABA Business Law Section Committee, *supra* note 3, at 3 (observing that, “[p]articularly with the consolidation of the corporate trust industry, trustees (usually through specific specialized default units staffed by full time default professionals) have officers with substantial experience, competence and professionalism in the default context, and who are acknowledged to be highly knowledgeable and constructive, and often are among the most experienced members on Creditors’ Committees and in other capacities”).

31. JAMES E. SPIOTTO, *DEFAULTED SECURITIES: THE PRUDENT INDENTURE TRUSTEE’S GUIDE XI-9* (1990) (“Mistakes in administering a defaulted account can cost the corporate trust department its profits for years to come. Successful handling of a default might even be a profitable venture.”); see also *Trust Indentures: Hearings Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce on H.R. 10292*, 75th Cong. 51 (1938) [hereinafter *House 1938 TIA Hearings*] (statement of Harold V. Amberg, Vice President and General Counsel of the First National Bank of Chicago) (testifying that “[t]he decisions that face an indenture trustee when a corporate debtor is in failing circumstances are extremely delicate and difficult”).

32. See, e.g., LANDAU & KRUEGER, *supra* note 2, at 138 (observing that “the [T]rustee may logically be inclined to take immediate action under the remedial provisions [of the indenture] to avoid being subjected to substantial potential liability”).

33. See SPIOTTO, *supra* note 31, at XII-14:

[T]he indenture trustee should be aware that, at times, it may be in the best interests of the holders to be patient and not to proceed immediately to litigation or other remedies. Com-

ever, "it will most likely be liable for negligence."³⁴ The indenture trustee therefore can find itself between the proverbial Scylla and Charybdis—having to decide between forcing the issuer into bankruptcy on one side and facing potential liability for inaction on the other.³⁵

These deficiencies in the post-default governance of public bond issues by indenture trustees contrast unfavorably with the increasingly sophisticated post-default behavior of lenders on private debt.³⁶ Although it is possible that these private-lender actions may benefit public bondholders,³⁷ the interests of private lenders are by no means perfectly aligned with the interests of bondholders. Frequently, private lenders and public bondholders are competing creditors, such as when the bonds are subordinate to the company's other senior debt.³⁸ Bondholders then may need an effective indenture trustee to protect their rights, especially since aggressive bargaining by private lenders can systematically advantage them over the public bondholders.³⁹

This Article explores how the standard of indenture-trustee responsibility should be modified to make indenture trustees more effective. Instead of focusing on the duties of traditional trustees, the Article shows that the post-default duty of an indenture trustee—to maximize bondholder recovery—is functionally the same as the duty of corporate directors to maximize shareholder return.⁴⁰ In that context, courts have devised a "business judgment" rule to protect corporate directors from the same chilling effects of potential liability faced by indenture trustees. This Ar-

plete liquidation or acceleration of debt may not always be in the best interests of the obligor and may adversely affect the obligor's ability to resolve its problems. A forced sale or acceleration may actually impair the security of the holders and cause the bondholders to recover less.

34. Henry F. Johnson, *The 'Forgotten' Securities Statute: Problems in the Trust Indenture Act*, 13 U. TOL. L. REV. 92, 111 (1982) ("Clearly, if the trustee initiates default proceedings, its actions may well result in bankruptcy, the result of which would be that its bondholders receive nothing. On the other hand, if the trustee does not act, it will most likely be liable for negligence. What, then, is 'prudent'?).

35. See *Harris Trust & Sav. Bank v. E-II Holdings, Inc.*, 926 F.2d 636, 638 (7th Cir. 1991) (likening an indenture trustee's position to navigating between Scylla and Charybdis, alluding to a story in Greek mythology in which sailors must decide how to navigate between two monsters, the six-headed Scylla on one side perched atop a cliff to devour passing sailors and Charybdis on the other side churning the sea into a whirlpool).

36. See Baird & Rasmussen, *supra* note 18, at 1211-12 (explaining how private lenders play an increasingly important role in corporate governance matters when a borrower defaults).

37. See *id.* at 1246-47 (detailing some post-default actions by private creditors that should benefit junior lenders, such as bondholders).

38. See *id.* at 1245 (explaining that the private lenders "who wield control [over defaulted debtors] are typically also the most senior" creditors).

39. Cf. Stewart M. Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J.L. & PUB. POL'Y 461, 462 (1988) (arguing in the context of solvent enterprises for the creation of "a legal framework" for public bondholders that "replicates the contractual model that governs the relationship between a corporation and holders of its privately placed debt obligations").

40. See *infra* Subpart IV.A.

ticle contends that a similar rule, superimposed on the indenture trustee's prudent-man standard, would help to correct existing governance deficiencies and achieve some of the unrealized goals of the TIA, while lowering the cost of public debt and providing greater protection for bondholders.

The Article proceeds by first explaining, in Part II, the statutory framework of the TIA and the post-default prudent-man standard applicable to indenture trustees. The Article then examines, in Part III, the prudent-man standard in other contexts, including traditional trust law and corporation law. Part IV compares the role of indenture trustees to traditional trustees and corporate directors. It concludes that because the indenture trustee's duty is to maximize potential returns to bondholders rather than merely safeguard assets, the principal justifications behind the business judgment rule for corporate directors apply equally to indenture trustees. Finally, Part V discusses how this proposed solution compares to some other suggested reforms to the legal framework for indenture trustees.

II. THE DILEMMA OF THE INDENTURE TRUSTEE

A. *The Trust Indenture Act*

Before 1939, no law in the United States specifically protected public bondholders. As a result of the stock market crash of 1929, Congress investigated how to restore investor confidence in the public securities markets.⁴¹ Bond market investors lacked confidence due to a collective-action problem not dissimilar to that previously noted.⁴² Being widely dispersed, bondholders had difficulty coordinating concerted action;⁴³ and because they had relatively small individual claims, bondholders lacked the incentive to incur the costs to overcome the problems caused by dispersion.⁴⁴ Furthermore, this lack of incentive also made individual action by bondholders "impracticable."⁴⁵ For these reasons, bondholders were often "not in a position, realistically, to look after their own interests."⁴⁶

41. Mark Frederick Hoffman, Note, *Decreasing the Costs of Jurisdictional Gridlock: Merger of the Securities and Exchange Commission and the Commodity Futures Trading Commission*, 28 U. MICH. J.L. REFORM 681, 685 (1995).

42. See *supra* note 1 and accompanying text (describing today's bondholder collective-action problem).

43. See 15 U.S.C. § 77bbb(a)(1) (2000) ("[C]oncerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors.").

44. See *id.*

45. See *id.* ("[I]ndividual action by . . . investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action").

46. *Trust Indenture Act: Hearings Before a Subcomm. of the S. Comm. on Banking and Currency on S. 477*, 76th Cong. 34 (1939) [hereinafter *Senate 1939 TIA Hearings*] (statement of Edward C.

During hearings on the bill that would become the TIA, the Securities and Exchange Commission (SEC), on which Congress relied heavily for guidance,⁴⁷ recognized the collective-action problem as a major defect in public bond markets.⁴⁸ In particular, "most indentures [then] provided that the trustee was under no duty to take action to enforce the indenture's remedial provisions until it had received an official demand by a specified percentage of [bondholders],"⁴⁹ but collective action by bondholders, even to generate that demand, was not always assured. In response, the SEC suggested that indenture trustees "be transformed into active trustees with the obligation to exercise that degree of care and diligence which the law attaches to such high fiduciary position[s]."⁵⁰

The bill that finally became law, the TIA, reflects that suggestion, at least after a bond default occurs. An indenture trustee must be appointed for each public bond issue over \$10 million.⁵¹ Prior to default, however, the trustee's duties are entirely ministerial, limited to "such duties as are specifically set out in [the] indenture."⁵² Typical duties include distributing interest and principal payments to investors, maintaining a list of registered bondholders, monitoring covenants and other indenture provisions, and, if the debt is secured, holding the collateral and taking actions to maintain the lien of the indenture.⁵³ Courts generally refuse to infer any additional pre-default duties.⁵⁴

Eicher, Comm'r, Securities and Exchange Commission).

47. See 15 U.S.C. § 77bbb(a).

48. See *Trust Indentures, Hearings Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce, House of Representatives on H.R. 2191 and H.R. 5220*, 76th Cong. 224-25 (1939) [hereinafter *House 1939 TIA Hearings*] (statement of Edmund Burke, Jr., Assistant Director, Reorganization Division of the Securities and Exchange Commission); *Senate 1939 TIA Hearings*, *supra* note 46, at 34-35 (statement of Edward C. Eicher, Comm'r, Securities and Exchange Commission).

49. LANDAU & KRUEGER, *supra* note 2, at 175.

50. SEC. & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VI—TRUSTEES UNDER INDENTURES 110 (1936). This SEC report further recommended transformation of the indenture trustee into "an *active guardian* of [bondholder] interests throughout the entire life of the security." *Id.* at 112 (emphasis added); see also Robertson, *supra* note 39, at 472-73 (discussing the goals of the TIA with regard to the indenture trustee's role).

51. 15 U.S.C. § 777ddd(a)(9).

52. *Id.* § 777ooo(a)(1).

53. LANDAU & KRUEGER, *supra* note 2, at 43.

54. See *supra* note 52 and accompanying text; *E.F. Hutton Sw. Prop. II, Ltd. v. Union Planters Nat'l Bank*, 953 F.2d 963, 969 (5th Cir. 1992) ("[T]he corporate trustee has very little in common with the ordinary trustee, as we generally understand the fiduciary relationship The trustee under a corporate indenture . . . has his rights and duties defined, not by the fiduciary relationship, but exclusively by the terms of the agreement. His status is more that of a stakeholder than one of a trustee." (citing *Hazard v. Chase Nat'l Bank of City of New York*, 287 N.Y.S. 541, 570 (N.Y. Gen. Term 1936))); *Elliot Assoc. v. J. Henry Schroder Bank & Trust Co.*, 838 F.2d 66, 71 (2d Cir. 1988) (indenture trustee has no other duties *except* to avoid conflicts of interest); *Meckel v. Cont'l Res. Co.*, 758 F.2d 811, 816 (2d Cir. 1985); *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418, 432 (5th Cir. 1980). However, although the TIA does not create an implied pre-default fiduciary duty of the indenture trustee, see *supra* note 52 and accompanying text, a state law fiduciary duty may apply. For an argument that full fiduciary duties should apply to the indenture trustee both pre- and post-default, see

After default, the situation changes radically.

B. The Indenture Trustee's Post-Default Duties

After default, the indenture trustee must “exercise . . . such of the rights and powers vested in it by such indenture, and [must] use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”⁵⁵ As one judge has observed, an indenture trustee’s “post-default duties are . . . flexible and less easily defined” than pre-default,⁵⁶ and “more like the duties of a common law fiduciary.”⁵⁷ For these reasons, “[t]he administration of [an] indenture after default is the greatest test of the corporate trust officer’s skill and expertise [there often being] no applicable precedents to follow, and the trustee may find itself navigating in uncharted waters.”⁵⁸

Although a “default” is defined by the applicable indenture, it includes both technical defaults, such as covenant violations, or more fundamental defaults, such as failure to make a scheduled payment of principal or interest or the filing of bankruptcy.⁵⁹ The indenture trustee must notify bondholders of a payment default, but need not notify bondholders of lesser defaults if it determines in good faith that withholding such notice is in the interests of bondholders.⁶⁰

If the indenture trustee decides to take action against the issuer, it must determine whether, under the applicable indenture, it can act alone or whether the bondholders must be brought into the decision. For example,

Martin D. Sklar, *The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?*, 106 BANKING L.J. 42, 43 (1989), which argues that “the indenture trustee should, on grounds of sound precedent and public policy, be held to the standard of a genuine fiduciary both before and after an issuer’s default.”

55. 15 U.S.C. § 7700o(c).

56. *Regions Bank v. Blount Parrish & Co., Inc.*, No. 01-C-0031, 2001 WL 726989, at *5 (N.D. Ill. June 27, 2001).

57. *Id.*

58. LANDAU & KRUEGER, *supra* note 2, at 171.

59. 15 U.S.C. § 7700o(c) defers the definition of “default” to that in the indenture: “[t]he indenture trustee shall exercise in case of default (as such term is defined in such indenture).” (emphasis added).

60. See 15 U.S.C. § 7700o(b).

The “indenture shall automatically be deemed (unless it is expressly provided therein that such provision is excluded) to provide that, except in the case of default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the trustee shall be protected in withholding such notice if and so long as the board of directors, the executive committee, or a trust committee of directors and/or responsible officers, of the trustee in good faith determine that the withholding of such notice is in the interests of the indenture security holders.”

Id.; William A. Johnson, *Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default*, 15 ST. LOUIS U. L.J. 203, 229 (1971) (“Except as to defaults in principal, interest, or sinking fund payments, with respect to which notice is mandatory, the trustee is granted broad discretion by both the Act and by the model provisions in the matter of notifying bondholders of defaults by the obligor.”).

many significant actions, such as changing the amount or maturities of principal and interest payments, typically require bondholder consent (usually unanimous).⁶¹ Because of the collective-action problem, bondholder consent—much less unanimous consent—may be difficult to obtain.⁶²

For actions that do not require bondholder consent, indenture trustees often seek to insulate themselves from potential liability by seeking direction from bondholders. The TIA itself provides a safe harbor for indenture trustees that act in good faith in accordance with the direction of a majority of bondholders.⁶³ One informed commentator observes that a prudent indenture trustee will seek such direction from bondholders *for any* unilateral action by the indenture trustee that entails a degree of risk.⁶⁴

Absent such direction, the indenture trustee is faced with myriad difficult choices. For example, it may have to decide whether (and, if so, when) to try to obtain collateral from the issuer to secure unsecured bonds and what might be offered as a quid pro quo. The indenture trustee also may need to decide whether (and, if so, when) to enforce remedies contained in the indenture, such as accelerating maturities, demanding specific performance of covenants, or—in the case of a payment default—simply suing for any overdue principal or interest.⁶⁵

If the bonds are secured, the indenture trustee faces additional choices presented by the option of foreclosing on the collateral.⁶⁶ Structured-finance and securitization transactions present further choices,⁶⁷ such as

61. See § 15 U.S.C. 77ppp; Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 569 (1995) (explaining how the practical effect of TIA section 316(2) (15 U.S.C. § 77ppp(2)) is to require unanimous consent for changes of the indenture's payment terms). Consent solicitations are sometimes used by issuers to amend the payment terms in an indenture. These solicitations are both time-consuming and extraordinarily expensive for an issuer.

62. See Schwarcz, *supra* note 1, at 1003–04.

63. 15 U.S.C. § 77ooo(d)(3) states that the “indenture shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions protecting the indenture trustee with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of the indenture securities at the time outstanding.”

64. See SPIOTTO, *supra* note 31, at XI-5 (“Before exercising remedies or taking action against the obligor in a situation where the recovery is questionable and the source of the indenture trustee fees and expenses not free from doubt, a wise trustee will seek to receive the written direction, instruction and indemnity of a majority of the holders.”).

65. See *id.* at XII-1–5.

66. See *id.* at XII-6.

67. The TIA applies to many structured finance products; however, because the TIA only applies to publicly issued debt securities, it does not apply to many common securitization transactions where the “SPV issues equity securities” or whenever the securities, regardless of whether they are debt or equity, are privately placed. See FRANKEL, *supra* note 11, § 12.26, at 113; American Bankers Association, Corporate Trust Committee, *supra* note 30, at 8 (“[A] significant portion of all asset-backed transaction documents are not [qualified under the TIA]; they do not impose upon the trustee after the occurrence of a default anything more than its pre-default ministerial duties.”).

In many structured finance transactions that are not qualified under the TIA, an indenture trustee is included but it is required to take post-default actions only in “accordance with the transaction docu-

deciding whether to exercise remedies (for example, notifying obligors or taking over servicing and collection activities) against the financial assets backing the securities.⁶⁸

Where bankruptcy is a possibility, the indenture trustee's choices can further multiply. Most critically, an indenture trustee may have to decide, for example, whether to join an involuntary bankruptcy petition against the issuer.⁶⁹ Once an issuer is in bankruptcy, the indenture trustee may need to decide whether to join a creditors' committee⁷⁰ or, especially where the bonds are subordinated, to attempt to form a separate creditors' committee. The indenture trustee will not be able to vote on a bankruptcy reorganization plan but may have the opportunity to object to such a plan.⁷¹ If the bonds are secured, the indenture trustee also may need to decide whether to make a motion to lift the automatic stay and when to request adequate protection.⁷² Additionally, the indenture trustee may need to decide whether to invest funds that it holds during a bankruptcy proceeding.⁷³

In the event the company selling financial assets (the originator) in structured-finance and securitization transactions enters bankruptcy, the indenture trustee will have the primary responsibility to ensure "continued collection of proceeds of transferred receivables" and to protect investors from "attempts of the originating seller . . . to extend the term of the securitization or to use the receivables as its cash collateral, or to secure new

ments . . . in order to limit the trustee's personal liability and reinforce the notion that the trustee is not responsible for taking any independent action." Sheilah D. Gibson, *The Case for the Expanded Role of Trustees in Securitizations*, 121 BANKING L.J. 387, 392 (2004).

68. See Gibson, *supra* note 67, at 392. An indenture trustee in a securitization deal may be called upon in the event of default to "(i) increase[] monitoring and review of servicing and collections; (ii) provid[e] notice to investors; (iii) [consider liquidation]; (iv) review[] and enforc[e] credit enhancement and (v) prepar[e] for negotiations and possible bankruptcy."). *Id.*

69. See 11 U.S.C. § 303(b)(1) (2000 & Supp. 2007) (allowing an involuntary bankruptcy petition to be filed by three creditors). Generally, however, "[bond]holders are not going to benefit from the bankruptcy experience, and, given the sensitive nature of the decision to initiate the bankruptcy proceedings, an indenture trustee should consider such filing a last resort." See SPIOTTO, *supra* note 31, at XIV-1.

70. See SPIOTTO, *supra* note 31, at XIV-5 (citing *In re Wickes Co.*, Case No. LA826658-WL (Bankr. C.D. Cal. May 13, 1982); *In re Nucorp Energy*, No. 82-03106-K11 (Bankr. S.D. Cal. Oct. 12, 1982)).

71. See *id.* at XIV-13.

72. See, e.g., *LNC Invs., Inc. v. First Fid. Bank*, 173 F.3d 454, 457 (2d Cir. 1999) (adjudicating a claim by bondholders that the indenture trustee breached TIA section 315(c) for waiting too long to make a motion to lift the automatic stay in the bankruptcy of Eastern Airlines, as well as failure to take other measures to obtain additional security); *Bluebird Partners v. First Fid. Bank*, 85 F.3d 970, 972 (2d Cir. 1996) (dismissing TIA claims, for lack of standing, by bondholders against their indenture trustees for not filing a motion to lift the automatic stay earlier in the bankruptcy of Continental Airlines; but affirming \$54 million jury verdict against trustees on state law claims of breach of fiduciary duty and negligence). See generally Aaron R. Cahn & Jeremy B. Hirsch, *Indenture Trustee's Dilemma: When To Seek Adequate Protection*, N.Y. L.J., Oct. 28, 2002, at 13, 17.

73. See *E.F. Hutton Sw. Prop. II v. Union Planters Nat'l Bank*, 953 F.2d 963, 965 (5th Cir. 1992).

financing during the bankruptcy in part based upon the receivables transferred to the SPV.”⁷⁴ The indenture trustee may also need to defend the “true sale” nature of the securitization to prevent the receivables from reverting back to the bankrupt originator.⁷⁵

These are just examples of the many decisions that post-default circumstances may warrant. Regardless of the indenture trustee’s choice, in each of these post-default cases its actions are required to adhere, and will be measured in retrospect by reference, to the prudent-man standard of the TIA.

C. The Prudent-Man Standard of the Trust Indenture Act

As discussed, the TIA’s prudent-man standard requires the indenture trustee, after default, to use the same degree of care and skill in exercising rights and powers under the indenture “as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”⁷⁶ The TIA’s legislative history indicates some intent to apply the same “prudent man” standard to trust indentures as used in traditional trust law.⁷⁷ As an SEC Commissioner explained, “[t]he primary purpose of the bill is to bring all indenture trustees . . . up to the high level of diligence and loyalty now maintained by the more conscientious trust institutions.”⁷⁸ Indenture trustees, however, strongly advocated a more flexible standard. For example, one witness at the Senate’s TIA hearings argued that a trust-law prudent-man standard

certainly will set a large red flag before [the indenture trustee], and indicate to him that in view of his obligations to depositors and stockholders he should lean over backward to carry out all the terms of the indenture to the letter. He will not be a man who can look at the situation clearly and intelligently and act in accordance with his judgment of what is in the best interests of all concerned.⁷⁹

74. Gibson, *supra* note 67, at 392.

75. *See id.*

76. 15 U.S.C. § 7000(c) (2000); *see supra* note 55 and accompanying text.

77. “The standard provided for is substantially the same as that which is applicable in the field of personal trusts, with the addition of the provision which binds the trustee by its misrepresentations as to its skill.” *Senate 1939 TIA Hearings*, *supra* note 46, at 28 (statement of Edward C. Eicher, Comm’r, Securities and Exchange Commission). For a discussion of why the trust-law standard should not automatically be the basis for the TIA’s trust-indenture standard, *see infra* Part IV.

78. *Senate 1939 TIA Hearings*, *supra* note 46, at 32 (statement of Edward C. Eicher, Comm’r, Securities and Exchange Commission).

79. *Id.* at 118 (statement of John K. Starkweather, Chairman, Federal Legislation Committee of the Investment Bankers’ Association of America).

Another witness contended the trust-law prudent-man standard, if applied in a trust-indenture context, would “do more harm to the bondholders . . . than you would benefit them by all the rest of the bill.”⁸⁰ These criticisms of the trust-law prudent-man standard often emphasized scenarios in which inaction by the indenture trustee was the course of action most beneficial to bondholders, whereas a trust-law prudent-man standard would require immediate enforcement of the exact remedial provisions of the indenture.⁸¹

Courts have not clearly resolved these conflicting views, although one unreported decision, *LNC Investments v. First Fidelity Bank*,⁸² relied on a leading treatise and the TIA’s legislative history to conclude that the prudent-man standard for indenture trustees should be interpreted by analogy to traditional trust law.⁸³ In general, though, not much has changed since one commentator remarked in 1971 that “the authorities are in disagreement even as to the basic nature of the corporate trust relationship,”⁸⁴ and indeed courts have not even settled such fundamental issues as the extent, if any, to which an indenture trustee’s post-default duty to bondholders is fiduciary in nature.⁸⁵

This lack of settled case law should not be interpreted to mean that indenture trustees do not face potential litigation resulting from their post-default actions. Most claims against indenture trustees have been brought before courts only to be later settled or dismissed on procedural grounds.⁸⁶

80. *Id.* at 169 (statement of G.S. Canright, Counsel for Corporate Trust Division, Continental Illinois National Bank & Trust).

81. *See id.* at 119–20 (statement of John K. Starkweather, Chairman of the Federal Legislation Committee of the Investment Bankers’ Association of America) (describing default situations where inaction by the indenture trustee is preferable to strict enforcement of the indenture). Uncritically enforcing the exact remedial provisions of the indenture is not unlike the unfortunate situation that has come to pass. *See supra* notes 31–35 and accompanying text.

82. *LNC Investments Inc. v. First Fid. Bank*, No. 92 Civ. 7584 MBM, 1997 WL 528283 (S.D.N.Y. Aug. 27, 1997).

83. *Id.* at *17 (citing 4 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 1628 n.64 (1990)).

84. Johnson, *supra* note 60, at 203.

85. Although an initial draft of section 315(c) of the TIA used the term “fiduciary” (requiring the indenture trustee after default to “use the same degree of care and skill in [exercising rights and powers under the indenture] as a prudent man would exercise under the circumstances if he were a fiduciary”), that term was deleted from the final version. *See Senate 1939 TIA Hearings, supra* note 48, at 12. Recently, however, there appears to be a trend to view the indenture trustee as a “limited fiduciary” in the event of default. *See E.F. Hutton Sw. Prop. II v. Union Planters Nat’l Bank*, 953 F.2d 963, 975 (5th Cir. 1992) (observing a judicial trend to view the indenture trustee as a limited fiduciary after default). Under this view, the limited fiduciary relationship reflects the delineation of indenture-trustee powers in the indenture. *See U.S. Bank Nat’l Assoc. v. U.S. Timberlands Klamath Falls, L.L.C.*, No. Civ.A. 112-N, 2004 WL 1699057 (Del. Ch. July 29, 2004) (holding that “the powers of the Trustee are defined by and limited by the terms of the Indenture” except to the extent the indenture trustee’s actions help to implement “the express purpose of the trust once the issuer is in default of payment and after the trustee has pursued all viable alternatives”); *see also supra* note 55 and accompanying text (observing that, after default, the indenture trustee is limited to exercising “such of the rights and powers vested in it by such indenture”).

86. *See, e.g., Caplin v. Marine Midland Gracc Trust Co. of N.Y.*, 406 U.S. 416, 425 (1972)

A possible consequence of the unsettled case law is ambiguity in the prudent-man standard, creating a chilling effect on indenture trustees and causing the potential deficiencies in post-default governance of public bond issues described above.⁸⁷ As a result, indenture trustees are sometimes viewed as ineffective and unable to meet the goals envisioned by the TIA,⁸⁸ one Congressional witness testifying, for example, that “[n]ot only are trustees redundant, too often they are little more than functionaries, noted mainly for their passivity, inertia and indecision.”⁸⁹

To address these deficiencies, two opposing movements have arisen in recent years advocating reform of the indenture trustee’s role within the TIA framework.⁹⁰ One movement argues for statutory changes to the TIA that would give indenture trustees enhanced and extraordinary powers to act on behalf of bondholders after default—creating a so-called “supertrustee.”⁹¹ The other movement proposes partial repeal of the TIA to eliminate the mandatory indenture trustee.⁹² No one, however, has yet systematically examined the prudent-man standard itself to determine whether its development in other contexts may provide useful insights to help resolve these deficiencies. That is what this Article does next.

III. THE PRUDENT-MAN STANDARD IN OTHER CONTEXTS

The “prudent man” is a well-known standard in traditional trust law and corporation law. As a general proposition, courts often look to ana-

(dismissing for lack of standing a claim by the bankruptcy trustee on behalf of bondholders against the indenture trustee for failure to properly monitor and enforce a covenant); *Bluebird Partners v. First Fid. Bank*, 85 F.3d 970, 975 (2d Cir. 1996) (dismissing for lack of standing a claim by bondholders against the indenture trustees for breach of section 315(c)’s prudent man standard).

87. See *supra* notes 28–39 and accompanying text.

88. See Amihud et al., *supra* note 18, at 476 (describing the indenture trustee as “generally passive”); Baird & Rasmussen, *supra* note 18, at 1216 (arguing the “indenture trustee . . . can do no more than insist on rigid compliance with the bond covenants”); Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1831 n.23 (1991) (stating in regard to the problems of modifying the original indenture, “[t]he indenture trustee has little incentive, or indeed obligation, to bargain on behalf of the bondholders with respect to debt modification. In any event, the trustee lacks the incentives of the sole lender in the rebargaining process.”); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1089 (1995) (explaining “the passivity of [indenture] trustees is well known”).

89. *Capital Markets Deregulation and Liberalization Act of 1995: Hearing on H.R. 2131 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce*, 104th Cong. 278 (1995) [hereinafter *Capital Markets Deregulation Hearings*] (statement of Morey W. McDaniel). Furthermore, while there certainly exists a significant role for the indenture trustee in bankruptcy proceedings, in a number of recent cases the U.S. Trustee challenged the payment of fees and expenses to the indenture trustee for failure to meet the “substantial contribution” test of section 503(b) of the Bankruptcy Code. See *Nixon Peabody LLP, Corporate Trust Alert* (July 25, 2003).

90. See *infra* Part V (discussing in greater detail these proposed reforms).

91. See Amihud et al., *supra* note 18, at 469–84.

92. See *Capital Markets Deregulation Hearings*, *supra* note 89.

logous areas of law as needed to assess fiduciary-like responsibilities.⁹³ The application of analogical reasoning to fiduciary relationships is suspect, however, absent an explanation of “why some similarities . . . are relevant and others not.”⁹⁴ Although at least one court has ruled that the prudent-man standard for indenture trustees should be interpreted by analogy to traditional trust law,⁹⁵ any attempt to analogize an indenture trustee’s duties to those of a traditional trustee should fail absent a rigorous examination of their similarities and differences. Indeed, “mechanical analogies to the features of prototypical fiduciary relations result in rules that are confusing and inappropriate.”⁹⁶ In examining the prudent-man standard in potentially analogous legal contexts, this Part focuses primarily on the underlying in-context rationale for that standard and its interpretations.

A. *Traditional Trust Law*

Although trusts exist in many forms,⁹⁷ traditional trust law is concerned with gratuitous trusts.⁹⁸ Under a gratuitous trust, a settlor “conveys the assets to a trustee to hold for the benefit of a beneficiary” and the settlor “receives no compensation for the conveyance.”⁹⁹

The standard of care applicable to a trustee under traditional trust law is the “prudent man,” and the duty of a trustee under that standard is “to use care and skill to preserve the trust property.”¹⁰⁰ This is primarily a negative duty,¹⁰¹ meaning the trustee should refrain from exposing trust beneficiaries to unreasonable risks. Thus, the traditional trust law duty

93. See DEBORAH A. DEMOTT, *FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP* 3 (1991) (“Courts . . . resort to analogy in order to determine the rules applicable to a fiduciary in a particular situation.”).

94. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 805 (1983).

95. See *supra* note 83 and accompanying text.

96. Frankel, *supra* note 94, at 807.

97. See generally Schwarcz, *supra* note 26, at 562–73 (explaining the principal features of gratuitous and commercial trusts).

98. See CHARLES E. ROUNDS, JR., *LORING: A TRUSTEE’S HANDBOOK* 15–19 §§ 2.1–2.1.1, at 21–23 (2006) (describing the basic features of common law trusts).

99. Schwarcz, *supra* note 26, at 562.

100. AUSTIN W. SCOTT, *THE LAW OF TRUSTS* § 176, at 482 (4th ed. 1987). This Article discusses the common law of trusts. However, one could also look to the law developed for ERISA plans. The federal ERISA statute uses a similar prudent-man standard and courts rely heavily on traditional trust law to interpret the statute. See *Gregg v. Transp. Workers of America Int’l*, 343 F.3d 833, 840 n.3 (6th Cir. 2003) (stating, for the purpose of the ERISA statute, “[c]ourts define ‘prudent person’ as that term is employed in the common law of trusts.”).

101. Modern trust law remains closely tied to its “ancient use” when “[t]he use was a passive trust” merely designed to safeguard property—the duties of the feoffee, the predecessor of the trustee, “were almost entirely negative duties. . . . No active duties and no powers were implied merely because of the relationship.” SCOTT, *supra* note 100, § 164, at 251.

focuses more on preserving, rather than increasing, the value of the assets held in trust.¹⁰²

Traditional trust law does impose certain affirmative duties on trustees, including "to make the trust property productive" through "prudent" investments.¹⁰³ These duties are generally satisfied, however, by investing merely to preserve the purchasing power of the trust.¹⁰⁴ Indeed, some believe that a trustee can satisfy these duties only "by passively investing in index funds."¹⁰⁵ The trustee's duties under traditional trust law are therefore ministerial, requiring "minimal managerial discretion and cost."¹⁰⁶ Furthermore, in judging the prudence of investment decisions, courts focus on the process by which the trustee made the investment decision, not on the decision itself and certainly not on the actual results of the investment.¹⁰⁷

Application of traditional trust-law principles to the trust-indenture context is highly suspect. On a formalistic level, trust indentures are not even actual trusts because no property is held in trust for beneficiaries of trust indentures.¹⁰⁸ More substantively, the trustee of a traditional trust has

102. *Id.* § 174, at 468 (stating that "[i]n making investments the trustee is under a duty . . . [to] use the caution of one who has primarily in view the preservation of the estate entrusted to him").

103. See ROUNDS, *supra* note 98, § 6.2.2, at 340.

104. See *id.* at 342 (defining a reasonable investment strategy for ordinary trustees as one that preserves the purchasing power of the principal).

105. See *id.* § 6.2.2, at 349. "There is a recognition . . . that something akin to a presumption of conservatism in investment policy exists even under the prudent investor standard" for trustees and "[t]he level of suitable risk . . . is generally a function of systematic risk." Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 107 (1990). Systematic risk is that risk which cannot be diversified away (i.e., the inherent market risk). See EUGENE F. BRIGHAM & JOEL F. HOUSTON, *FUNDAMENTALS OF FINANCIAL MANAGEMENT* 175 n.8 (1998).

106. Schwarcz, *supra* note 26, at 581.

107. See ROUNDS, *supra* note 98, § 6.2.2, at 335 ("The safe harbor [of this duty to invest] is . . . [a] trustee is held to a standard of conduct, not performance. Prudence is evaluated at the time of the investment and on an ongoing basis without the benefit of hindsight."); SCOTT, *supra* note 100, §227, at 431-34. In the context of ERISA fiduciaries, the definition of the prudent man similarly focuses on the investigation leading to the investment, rather than the investment itself. For example, in defining the duty of care applicable to an ERISA fiduciary, the Fifth Circuit stated:

In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions. [ERISA's] test of prudence . . . is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed. Thus, the appropriate inquiry is whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.

Bussian v. RJR Nabisco, Inc., 223 F.3d 286, 299 (5th Cir. 2000) (quoting *Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317 (5th Cir. 1999)).

108. Schwarcz, *supra* note 26, at 569 (citing RESTATEMENT (THIRD) OF TRUSTS § 2, cmt. f (Tentative Draft No. 1, 1996)) (arguing that a trust indenture might be viewed as a "hybrid form of a trust"). In the context of an asset-backed securities transaction, however, there can be an actual trust (either

essentially ministerial duties, whereas the post-default duties of an indenture trustee are intended to protect bondholders at a time of turmoil.¹⁰⁹ Part IV of this Article shows that bondholders expect, and the TIA attempts to create, a more active, and at least prudently risk-taking, indenture trustee.

B. Corporation Law

The duty of corporate directors also relies on the prudent-man standard.¹¹⁰ An early Supreme Court case articulated this standard as taking into account how “ordinarily prudent and diligent men . . . under similar circumstances” should act.¹¹¹ Similarly, the Principles of Corporate Governance¹¹² and the ABA’s Model Business Corporation Act¹¹³ have applied a prudent-man standard to the duty of care by corporate directors.

The duty of corporate directors evaluated under the prudent-man standard can be traced back to the Michigan Supreme Court’s decision in *Dodge v. Ford Motor Co.*,¹¹⁴ which held that

[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exer-

statutory or common law) in which the assets are held for the benefit of the investors. E-mail from Vicki O. Tucker, Chair, Committee on Federal Regulation of Securities’ Subcommittee on Structured Financings, American Bar Association, to Steven L. Schwarcz, Stanley A. Star Professor of Law & Business, Duke University School of Law (Sept. 4, 2007) (on file with the Alabama Law Review).

109. See *supra* Subpart II.B (discussing the post-default duties of an indenture trustee).

110. See ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 186–87 (1999).

111. See *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891).

112. See 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS].

113. See MODEL BUS. CORP. ACT § 8.30 (1999). The new MBCA removes the phrase “prudent person” and replaces it with a distinct duty of care: “[t]he members of the board of directors . . . when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.” See *id.* at 8–36 In explaining this modification, the Official Comment explains:

[t]he use of the phrase ‘ordinarily prudent person’ i[s] a basic guideline for director conduct, suggesting caution or circumspection vis-à-vis danger or risk, [and] has long been problematic given the fact that risk-taking decisions are central to the directors’ role. When coupled with the exercise of ‘care,’ the prior text had a familiar resonance long associated with the field of tort law. . . .

For this reason, its use in the standard of care for directors, suggesting that negligence is the proper determinant for measuring deficient (and thus actionable) conduct, has caused confusion and misunderstanding.

Id. § 8.30 cmt., at 8-39.

114. 170 N.W. 668 (Mich. 1919).

cised in the choice of means to attain that end, and does not extend to a change in the end itself.¹¹⁵

Although many view this articulation of the corporate director's duty as maximizing shareholder value,¹¹⁶ at least one court has suggested broadening the duty to require maximizing value of the entire "corporate enterprise."¹¹⁷ For purposes of this Article, it is sufficient to say the duty of corporate directors is to maximize the value of the corporation.

This duty of corporate directors to *maximize value* differs significantly from the duty of traditional trustees to *preserve the value* of trust assets.¹¹⁸ These contrasting duties drive one of the fundamental differences between corporate directors and traditional trustees—the acceptable level of risk they may incur¹¹⁹—which in turn determines the types of decisions they need to make and the degree of discretion they must possess.¹²⁰ Whereas the traditional trustee is cautious and conservative,¹²¹ "risk-taking decisions are central to the [corporate] directors' role."¹²² Although both traditional trustees and corporate directors are theoretically judged by the prudent-man standard,¹²³ the differences in interpreting that standard are reflected in the evolution of the business judgment rule for corporate directors.

The business judgment rule, a judicial add-on to the prudent-man standard,¹²⁴ is intended (among other things) to protect corporate directors who take calculated risks in an attempt to maximize corporate value.¹²⁵ Under the business judgment rule, courts examine a corporate director's "decision only to the extent necessary to verify the presence of a business

115. *Id.* at 684.

116. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 85–86 (2004) (describing this approach as "the shareholder primacy model [of corporate governance, which] both as a normative and a positive matter [posits] that corporate decision-making powers must be exercised so as to maximize shareholder wealth"); Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 32 (2005) ("In the corporate law academy today in the United States, the dominant view is that corporate law requires managers to pursue a single aim: the maximization of stockholder profits.").

117. *See, e.g.*, *Credit Lyonnais Bank Nederland N.V. v. Pathé Commc'ns Corp.*, No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

118. *See* PINTO & BRANSON, *supra* note 110, at 187.

119. *See id.*

120. *See id.*

121. *See* Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1324 (2003) ("Trustees tend to be conservative investors, perhaps in part because the conventional legal constraints have not allowed them to put money behind risky new enterprises.").

122. MODEL BUS. CORP. ACT § 8.30 cmt., at 8-163 (1999).

123. *See* PINTO & BRANSON, *supra* note 110, at 187.

124. *See* DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 5–7 (4th ed. 1993).

125. *See* *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *superseded by statute*, 65 Del. Laws 289 (1986) (explaining that the purpose of the business judgment rule is "to protect and promote the full and free exercise of the managerial power granted to Delaware directors").

decision, disinterestedness and independence, due care, good faith, and the absence of an abuse of discretion.”¹²⁶ In this sense, the business judgment rule does not directly affect the director’s standard of conduct, but is more properly characterized as “a tool of judicial review.”¹²⁷

The “due care” component of the business judgment rule relates to whether a proper investigation preceded the decision.¹²⁸ To that extent it is similar to the “process” approach of traditional trust law.¹²⁹ However it is significantly more difficult for plaintiffs to demonstrate breach of due care under the business judgment rule than under the “process” approach of traditional trust law because of the business judgment rule’s presumption in favor of corporate directors.¹³⁰ To overcome this presumption, “[a] shareholder claiming a lack of due care must demonstrate that a majority of the directors who made the challenged decision were uninformed”¹³¹ to the point of gross negligence.¹³² This presumption in favor of corporate directors is, in practice, one of the most critical aspects of the business judgment rule.¹³³

126. BLOCK ET AL., *supra* note 124, at 3.

127. See *id.* at 3–4; see also Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 437 (1993) (contrasting “standards of conduct and standards of review in corporate law”).

128. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (“Due care in the decision-making context is *process* due care only.”).

129. See ROUNDS, *supra* note 107, § 6.2.2, at 340 (observing that, under traditional trust law, courts focus on the process by which trustees make investment decisions).

130. See BLOCK ET AL., *supra* note 124, at 12 (“A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose.” (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971))); Bainbridge, *supra* note 116, at 87 (“Courts . . . will abstain from reviewing the substantive merits of the directors’ conduct unless the plaintiff can carry the very heavy burden of rebutting that presumption.”).

131. See BLOCK ET AL., *supra* note 124, at 32–33.

132. See *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989) (“The standard for determining ‘whether a business judgment reached by a board of directors was an informed one’ is gross negligence.” (internal citation omitted)); Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 95 (2005) (explaining a plaintiff overcomes the presumption created by the business judgment rule only by showing gross negligence). Although some jurisdictions apply a business judgment rule based on ordinary, as opposed to gross, negligence, see PINTO & BRANSON, *supra* note 110, at 195 n.59, such a rule is thought to provide no real additional protection to directors. See FRANKLIN A. GEVURTZ, CORPORATION LAW 280–81 (2000) (“About the only thing [such a rule] adds are a couple of cautionary notes.”). This Article therefore focuses on a business judgment rule based on gross negligence.

133. See Tamar Frankel, *Presumptions and Burdens of Proof as Tools for Legal Stability and Change*, 17 HARV. J.L. & PUB. POL’Y 759, 759 (1994) (“[L]itigation between corporate shareholders and managements . . . is replete with volatile presumptions and innovative burdens of proof, demonstrating their effectiveness and flexibility as tools for legal stability and change.”); Kent Greenfield & John E. Nilsson, *Gradgrind’s Education: Using Dickens and Aristotle To Understand (And Replace?) The Business Judgment Rule*, 63 BROOK. L. REV. 799, 816 (1997) (“The presumptive aspect of the BJR has often been elevated over—or trumpeted to the exclusion of—the substantive one.”). For example, discovery will not be permitted unless the plaintiffs can plead facts sufficient to “give rise to a possibility that the business judgment rule will not apply.” See *Washington Bancorp. v. Said*, 812 F. Supp. 1256, 1277 n.51 (D.D.C. 1993). Thus, the presumption is most likely able to effectively deter most frivolous litigation. See Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in*

The business judgment rule is used to protect corporate-director performance for four reasons: (1) without such a rule, corporate directors would “tend to be unduly risk-averse”¹³⁴ and would fail to take expected value-maximizing actions;¹³⁵ (2) it “encourages competent individuals to assume directorships”;¹³⁶ (3) it protects the principle of director management, “since if shareholders are granted the right to demand frequent judicial review of board decisions, the result would be to transfer ultimate decision-making authority from the board to any shareholder who is willing to sign a complaint”;¹³⁷ and (4) without such a rule, courts would have to substantively review complex corporate decisions.¹³⁸

The next part of this Article examines whether something similar to a business judgment rule should be used to protect indenture-trustee performance under the prudent-man standard of the TIA.¹³⁹ Even though there are similarities between the business judgment rule and traditional trust law insofar as both look to “process” rather than outcome,¹⁴⁰ traditional

the Close Corporation, 60 NOTRE DAME L. REV. 456, 461 (1985).

134. See Eisenberg, *supra* note 127, at 445 (stating one of the main reasons for the business judgment rule is that “under an ordinary standard of care directors might tend to be unduly risk-averse, because if a highly risky decision had a positive outcome the corporation but not the directors would gain, while if it had a negative outcome the directors might be required to make up the corporate loss. The business-judgment rule helps to offset that tendency.”); see also PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, *supra* note 112, § 4.01 cmt. d (justifying the business judgment rule as necessary “to avoid the risk of stifling innovation and venturesome business activity”).

135. See Eisenberg, *supra* note 127, at 444–45 (explaining how the business judgment rule encourages corporate directors to make decisions based on the highest expected value).

136. BLOCK ET AL., *supra* note 124, at 7.

137. See *id.* at 10 (internal quotation marks omitted).

138. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (“[A]fter-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur’s function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.”).

139. See 15 U.S.C. § 7700o(c) (2000). Although the foregoing rationales for the business judgment rule are presumably not without controversy even in the corporate context, those controversies are beyond this Article’s scope.

140. See BETTY LINN KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT 294 (1989) (noting that courts analyze “the same aspects of conduct to determine whether the fiduciaries acted prudently” in both the corporate and traditional trust contexts). Krikorian also points out that

[n]otwithstanding the variations in legal standards set out by judges, fiduciary cases under state trust law, ERISA, and corporate law make very similar factual examinations. They scrutinize the fiduciary’s information gathering and evaluation process to determine whether alternative courses of action were weighed and the effects of all possibilities projected; whether the fiduciaries sought a range of expert opinions, inquired into the grounds for those opinions, and made their own personal evaluation as well; whether the fiduciaries permitted themselves to be rushed into a decision or demanded the time to make a reasonable inquiry; whether the fiduciaries imposed conditions on the transaction to protect the beneficiaries or shareholders; and whether the fiduciaries monitored the implementation of their decisions.

Id. at 289–90; see also BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT

“[t]rustees and other pension fiduciaries lack the protection accorded corporate officers and directors by the business judgment rule,”¹⁴¹ namely the extra insulation provided by the business judgment rule’s presumption in favor of corporate directors¹⁴² and the rule’s heightened standard of gross negligence.¹⁴³

IV. RE-THINKING THE INDENTURE TRUSTEE’S DUTY AND STANDARD OF CARE

The prudent-man standard determines how an actor should perform his or her duties.¹⁴⁴ The first step of any analysis of the standard thus must focus on the duty to which the actor is subject. In the trust-indenture context, that duty—which falls on the indenture trustee—is at least to try to preserve the amount that bondholders could recover at the time of default.¹⁴⁵ That duty also may, and perhaps should, extend to trying to increase that amount.¹⁴⁶ In traditional trust law, that duty—which falls on the trustee—is to preserve the value of the trust’s assets for the trust’s beneficiaries.¹⁴⁷ In corporation law, that duty—which falls on corporate directors—is to take calculated risks in order to maximize corporate profitability.¹⁴⁸ Once the applicable duty is properly defined, and assuming all else is equal, that duty should be a principal driver of how to apply the prudent-man standard.

The analysis in this Part first shows that the indenture trustee’s duty should be to maximize the potential return to bondholders in the event of default, rather than merely to safeguard existing value. To this extent, the indenture trustee’s duty is much more analogous to that of a corporate director than a traditional trustee. Based on this analogy, the Article hypothesizes that a business judgment rule also should be applied to the actions of indenture trustees. The Article then tests this hypothesis.

A. The Indenture Trustee’s Duty—Beyond Safeguarding Assets

Existing law is not specific as to whether an indenture trustee’s duty, after default, is merely to safeguard existing value or to maximize the po-

MAN RULE 36 (1986) (explaining that ERISA and trust law cases, where similar prudent-man standards apply, “tend also to emphasize process in language similar to business judgment rule cases”).

141. KRIKORIAN, *supra* note 140, at 290.

142. See BLOCK ET AL., *supra* note 124, at 53.

143. See *id.* at 64–65.

144. See SCOTT, *supra* note 100, at 482.

145. See LNC Invs., Inc. v. First Fid. Bank, 173 F.3d 454, 462 (2d Cir. 1999) (“Trustees’ duty to the Bondholders was . . . to act prudently to *safeguard the assets* of the Trust.” (emphasis added)).

146. See SPIOTTO, *supra* note 31, at XVIII-1 (“[T]he indenture trustee’s role is to obtain the best recovery possible for the holders under the circumstances.”).

147. See SCOTT, *supra* note 100, at 482; see also *supra* Subpart III.A.

148. See Lee, *supra* note 116, at 32; see also *supra* Subpart III.B.

tential return to bondholders to try to get them paid in full.¹⁴⁹ The Second Circuit, for example, does not appear to distinguish between a duty “to safeguard the assets [and a duty] to secure . . . repayment of the underlying obligation.”¹⁵⁰ The distinction, however, is akin to the difference between the duty of a traditional trustee to preserve trust property¹⁵¹ and the duty of a corporate director to maximize corporate value.¹⁵²

To understand this difference in the trust-indenture context, consider that, post-default, bondholders ordinarily will not be paid in full (much less receive an increased amount) unless the issuer is able to regain solvency (or decrease its insolvency).¹⁵³ Bondholders thus effectively become senior residual claimants of the issuer—residual claimants because payment of the insolvent portion of bond claims depends on the issuer increasing the value of its assets, and senior residual claimants because bondholder claims, as debt claims, will have priority over shareholder interests.¹⁵⁴ To help the issuer regain solvency, as well as to thread through the intricacies of the default and possible bankruptcy process, bondholders rely on the skills and abilities of indenture trustees to recover bond value,¹⁵⁵ and thus bondholders presumably should value those skills and abilities much more than in a pre-default scenario.

If the trust-indenture duty is simply to try to preserve the amount that bondholders could recover at the time of default, then it is like that of traditional trusts insofar as it involves merely preserving value.¹⁵⁶ To this extent, it should be a positive duty, albeit one that involves fairly ministerial efforts.¹⁵⁷ One might even argue the required affirmative efforts should be less under trust-indenture law than traditional trust law because preserving value is more critical under traditional trust law since beneficiaries of traditional trusts have no ability to diversify their ownership of trust assets.¹⁵⁸ In contrast, bondholders can choose, much like corporate

149. See, e.g., *LNC Invs.*, 173 F.3d at 462.

150. See *id.* (stating the indenture trustee’s duty is “to act prudently to *safeguard the assets* of the Trust,” but in making that statement relying on a New York Appellate Court’s statement that the indenture trustee’s duty is to “exercise [his contractually conferred rights and powers] in order to secure the basic purpose of any trust indenture, the *repayment of the underlying obligation*” (emphasis added) (internal quotation marks omitted)).

151. See SCOTT, *supra* note 100, at 482; see also *supra* Subpart III.A.

152. See Lee, *supra* note 116, at 32; see also *supra* Subpart III.B.

153. See 11 U.S.C. § 507 (2000) (establishing the priority of payments in bankruptcy).

154. See *id.*

155. See PIOTTO, *supra* note 31, at III-1 to -2.

156. See SCOTT, *supra* note 100, at 468, 482; see also *supra* Subpart III.A.

157. In the pre-TIA era, publicly issued bonds were often fully secured. See Lev, *supra* note 10, at 51–52. Thus, the indenture trustee’s duty was to safeguard the value of bondholders’ security interest, which explains why a pre-TIA article stated the indenture trustee’s post-default duty required “various affirmative courses of conduct . . . for the preservation of the security.” See Posner, *supra* note 7, at 203–04. Publicly issued bonds, however, are rarely fully secured in modern times. See generally LANDAU & KRUEGER, *supra* note 2, at 123–25.

158. See Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP.

shareholders, how much, if anything, to invest in any given corporation¹⁵⁹ and can easily re-sell publicly-issued bonds,¹⁶⁰ enabling them to diversify their investments. Just as the ability of corporate shareholders to choose and diversify their equity investments makes it less important that corporate directors be constrained to make secure investments,¹⁶¹ so the ability of bondholders to choose and diversify investments makes it less important that indenture trustees be similarly constrained.

On the other hand, if the trust-indenture duty is to maximize the potential return to bondholders to try to get them paid in full, the duty would resemble that of a corporate director,¹⁶² other things being equal. Before analyzing whether the indenture-trustee duty is merely to preserve value or, rather, to maximize potential return, one must examine whether other things are indeed equal.

The only other factor that appears relevant to that examination is the nature of the parties being protected by indenture trustees under the prudent-man standard. If their nature is similar to that of the parties being protected by the prudent-man standard in traditional trust law, the analogy would fail. If, however, their nature is similar to that of the parties being protected by the prudent-man standard under corporation law, the analogy would be strong.

In traditional trust law, those parties could be anyone—and often are individuals,¹⁶³ even minors.¹⁶⁴ When the TIA was enacted in 1939, most bondholders were also individuals and other small investors.¹⁶⁵ It would have been more reasonable at that time, based solely on the identity of the protected parties, to view the indenture trustee's role as more akin to the role of trustees under traditional trust law.¹⁶⁶ In recent years, however, large institutional investors have dominated the public bond market.¹⁶⁷ The

L. 565, 574–75 (2003) (arguing that corporation law imposes a less stringent standard on directors than does trust law on trustees because shareholders can easily diversify but trust beneficiaries may or may not be able to do so).

159. See Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 681–82 (1996) (“Public bondholders can choose whether to invest.”).

160. See *id.* at 681.

161. See Sitkoff, *supra* note 158, at 574–75.

162. See Lee, *supra* note 116, at 32; see also *supra* Subpart III.B.

163. See GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, *HANDBOOK OF THE LAW OF TRUSTS* 123 (5th ed. 1973).

164. See *id.* at 124.

165. See *id.*

166. The evidence from the legislative history of the TIA certainly supports the proposition that Congress intended the TIA's prudent-man standard to be substantially the same as the prudent-man standard applied in the field of personal trusts. See *House 1938 TIA Hearings*, *supra* note 31, at 40 (statement of William O. Douglas, Chairman, Securities and Exchange Commission). Then-SEC Chairman William O. Douglas testified before Congress that the prudent-man standard of the TIA “is substantially the same standard as that required of trustees under the so-called personal trusts.” *Id.*

167. See Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 583–86 (1995) (analyzing “the Flow of Funds Accounts prepared by the Federal Reserve Board” to conclude “that the market for corporate bonds is heavily dominated by institutional inves-

nature of bondholders is virtually identical to, and indeed bondholders are often the same entities as, the large institutions that control most of the public equity market.¹⁶⁸ Because the nature of the parties protected by the prudent-man standard of trust-indenture law is now similar to that of the parties protected by the prudent-man standard under corporation law, the analogy discussed above remains sound.¹⁶⁹ The Article therefore next turns to the issue posed earlier: whether indenture trustees have—or should have—a duty after default of maximizing, as opposed to merely preserving, bondholder recovery.¹⁷⁰

It appears clear that indenture trustees may well have—and certainly should have—a duty after default of *maximizing* bondholder recovery.¹⁷¹ The fundamental bondholder bargain is to receive “*interest at the prescribed rate plus the eventual return of the principal.*”¹⁷² An issuer in default, however, will likely be unable to repay interest and principal in full. Therefore, to satisfy the bondholder bargain, indenture trustees should work with defaulting issuers to try to maximize payment on the bonds, up to the level of full principal and interest. This parallels how private creditors generally behave after default.¹⁷³

Modern commentators on trust indentures agree with this view. James Spiotto, for example, in his guidebook for indenture trustees states that

it is the role of the indenture trustee to help *maximize the return to the holders*, once a default or troubled situation has occurred. The indenture trustee must insure compliance with the terms of the indenture and when compliance cannot be achieved, the indenture

tors, and . . . individual investors play only a small role”).

168. For example, The Vanguard Group, Fidelity Investments, and American Funds dominate the lists of top twenty-five equity and bond funds (as measured by assets held). See *Largest Bond Funds*, WALL ST. J., July 10, 2006, <http://interactive.wsj.com/documents/mfq06-2-bondfunds.htm>; *Largest Stock Funds*, WALL ST. J., Jan. 4, 2007, <http://online.wsj.com/documents/mfq06-4-stockfunds.htm>. Out of the twenty-five largest equity funds, The Vanguard Group manages five, Fidelity Investments manages seven, and American Funds manages ten. See *Largest Stock Funds*, WALL ST. J., Jan. 4, 2007, <http://online.wsj.com/documents/mfq06-4-stockfunds.htm>. Out of the twenty-five largest bond funds, The Vanguard Group manages eight, Fidelity Investments manages six, and American Funds manages two. See *Largest Bond Funds*, WALL ST. J., July 10, 2006, <http://interactive.wsj.com/documents/mfq06-2-bondfunds.htm>.

169. If at any time the parties protected by the prudent-man standard in either of these contexts no longer typically consist of large institutional investors, the above analysis should be modified accordingly.

170. See SPIOTTO, *supra* note 31, at XVIII-1.

171. See Memorandum from Members of the ABA Business Law Section Committee, *supra* note 3, at 3 (observing that “Modern trustees, particularly through their specialized default professionals, already view their role under the ‘prudent person’ standard as *maximizing* bondholder recoveries”).

172. See *Metro. Life Ins. v. RJR Nabisco, Inc.* 716 F. Supp. 1504, 1518 (S.D.N.Y. 1989) (internal quotation marks omitted).

173. See generally Baird & Rasmussen, *supra* note 18, at 1236–42 (illustrating how private creditors seek to maximize recovery of principal and interest on their loans).

trustee's role is to obtain the *best recovery possible* for the holders under the circumstances.¹⁷⁴

Similarly, Robert Landau and John Krueger in their treatise on corporate trust administration argue that “[i]f liquidation or reorganization becomes necessary, *the trustee should see that the security holders realize their claims in full or to the greatest extent possible.*”¹⁷⁵

An indenture trustee therefore should act to maximize the recovery for bondholders, rather than merely safeguarding existing value. Because that responsibility is like the duty of corporate trustees to maximize shareholder value and unlike the duty of traditional trustees to merely preserve trust assets, this Article hypothesizes that an indenture trustee's duty to act prudently should be tempered, as in corporation law, by a business judgment rule. The Article next tests this hypothesis.

B. The Business Judgment Rule Applied To the Indenture Trustee

For this Article's hypothesis—that an indenture trustee's duty to act as a prudent man should be tempered, as in corporation law, by a business judgment rule—to have validity, at least some of the justifications for this rule in the corporation-law context should also apply in the trust-indenture context. This Part shows that *all* of those justifications apply in that latter context.

Recall the reasons that justify the business judgment rule in corporation law.¹⁷⁶ In that context, equity investors voluntarily put their money at risk and therefore expect a return on their investment.¹⁷⁷ Because of this expectation, the business judgment rule attempts to grant corporate directors the flexibility necessary to fulfill their duty by engaging in “venture-some business activity.”¹⁷⁸ Similarly, the indenture trustee's duty to maximize value, rather than merely preserve it, requires the freedom to take calculated risks.¹⁷⁹ To the extent it can influence the amount of recovery, the indenture trustee should be able to choose courses of action that yield the highest expected value to bondholders (up to, of course, the value

174. SPIOTTO, *supra* note 31, at XVIII-1 (emphasis added).

175. LANDAU & KRUEGER, *supra* note 2, at 171 (emphasis added).

176. See, e.g., *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982); BLOCK ET AL., *supra* note 124, at 7, 10; Eisenberg, *supra* note 127, at 444–45.

177. See Eisenberg, *supra* note 127, at 444–45.

178. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, *supra* note 112, § 4.01 cmt. d. Corporate directors are given broad discretion to engage in risky actions because “shareholders to a very real degree voluntarily undertake the risk of bad business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers.” See BLOCK ET AL., *supra* note 124, at 8 (internal quotation marks omitted).

179. See Baird & Rasmussen, *supra* note 18, at 1233–36 (discussing the calculated risks that creditors generally take after default to try to maximize recovery on their claims).

needed for full repayment) rather than those that preserve value with the least amount of risk. This same principle—maximizing expected value—also serves as a key justification for the business judgment rule.¹⁸⁰

In contrast, one reason why courts have refused to extend the full protection of the business judgment rule to traditional trustees¹⁸¹ is because traditional trusts exist “to provide security for their beneficiaries—not to engage in venturesome business.”¹⁸²

The business judgment rule also exists to encourage highly-skilled professionals to accept positions on corporate boards,¹⁸³ and indeed the TIA was designed to provide bondholders with a higher quality and “conscientious” representative.¹⁸⁴ As in corporation law, application of the business judgment rule in the trust-indenture context should encourage a high caliber of individuals to assume indenture trustee positions by allowing them the freedom to exercise their discretion, ultimately providing greater bondholder protection.

In corporation law, the business judgment rule also serves to preserve the “ultimate decision-making authority [of] the board.”¹⁸⁵ Although the TIA’s system of bondholder governance does not give the indenture trustee plenary power to make all decisions for bondholders,¹⁸⁶ application of the business judgment rule should ultimately lead to a more efficient system of bondholder governance.¹⁸⁷ The TIA gives indenture trustees a variety of powers to act on behalf of bondholders in the event of default,¹⁸⁸ thus minimizing the inefficiency caused by the collective-action problem. The protection afforded by the business judgment rule should lead to indenture trustees more actively (and effectively) exercising these powers, mitigating the need for costly and less efficient decision-making actions

180. See Eisenberg, *supra* note 127, at 444–45.

181. See, e.g., *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996) (rejecting application of the business judgment rule to the investment decisions of a trustee of an ERISA plan); *Donovan v. Mazzola*, 716 F.2d 1226, 1231–32 (9th Cir. 1983) (upholding “prudent person test”); *Lanka v. O’Higgins*, 810 F. Supp. 379, 387–88 (N.D.N.Y. 1992).

182. See KRIKORIAN, *supra* note 140, at 290–91 (describing why “pension and trust fiduciaries need not be given this dispensation from the strict standard of fiduciary law”).

183. See BLOCK ET AL., *supra* note 124, at 7.

184. See *Senate 1939 TIA Hearings*, *supra* note 46, at 32 (statement of Edward C. Eicher, Comm’r, Securities and Exchange Commission); *House 1938 TIA Hearings*, *supra* note 31, at 45 (statement of Robert M. Hanes, Chairman of the Comm. on Fed. Legis. of the American Bankers’ Association and President of the Wachovia Bank & Trust Co. Of Winston-Salem, N.C.) (explaining one of the principle objectives of the TIA “was to bring the procedure of corporate trustees to the high standards set by the best and most responsible persons in the profession”).

185. See BLOCK ET AL., *supra* note 124, at 17 (internal quotation marks omitted).

186. See 15 U.S.C. § 7700o(c) (2000) (“The indenture trustee shall exercise in case of default (as such term is defined in such indenture) [only] *such of the rights and powers vested in it by such indenture.*” (emphasis added)).

187. The term “governance” is commonly used to describe an organization’s “system that facilitates efficient decisionmaking.” See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 192 (2002).

188. See 15 U.S.C. § 7700o.

(e.g., individual bondholders acting on their own;¹⁸⁹ the indenture trustee's refusal to act until it receives direction from the bondholders;¹⁹⁰ or the indenture trustee's refusal to exercise its discretion, opting instead to automatically enforce the indenture's available remedies.).¹⁹¹

The need for a business judgment rule also rests on the impracticality of courts and juries having to evaluate the "prudence" of complex business decisions made by corporate directors.¹⁹² For a variety of professional services (e.g., medical doctors¹⁹³), professionals will be able to "shield themselves from liability . . . by showing that they followed accepted protocols or practices."¹⁹⁴ Corporate directors often cannot benefit from this shield "because almost every business decision is unique."¹⁹⁵ Moreover, "after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information."¹⁹⁶ These same justifications apply to the post-default actions of indenture trustees, which often entail unique and complex considerations of the issuer's potential future solvency compared to the immediately available remedies for bondholders.¹⁹⁷ These decisions often must be made in the face of great uncertainty and extreme time pressure.¹⁹⁸ In contrast, traditional trustees often have the luxury of time and nearly infinite options when considering possible investment options.¹⁹⁹ Thus, "judges or juries are better equipped to determine whether a [traditional] trustee's action, or lack of action, amounts to negligence."²⁰⁰

In short, a business judgment rule could ultimately lower the cost of debt and provide greater protection for bondholders. With the protection afforded by such a rule, indenture trustees may demand less protection for potential liability. Bondholders might feel less compelled to take matters

189. See SPIOTTO, *supra* note 31, at XVII-14 to -15.

190. See *id.* at XI-5.

191. See LANDAU & KRUEGER, *supra* note 2, at 138.

192. See BLOCK ET AL., *supra* note 124, at 21.

193. See Eisenberg, *supra* note 127, at 444 n.31.

194. See *id.* at 444.

195. See *id.*

196. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982).

197. See *supra* Subpart II.B (describing the many complex post-default choices an indenture trustee must make in situations where the issuer may be confronting insolvency or already in bankruptcy proceedings).

198. See LANDAU & KRUEGER, *supra* note 2, at 179 ("Although the trustee is responsible for taking prompt and decisive action, no specific action can be prescribed for every situation, but each must be carefully considered at the time.").

199. See Leslie, *supra* note 132, at 99-100.

200. *Id.* ("Unlike the corporate environment, where management must deal daily with a multitude of variables, and quick action on less than full information may be necessary, the business of trust management is comparatively straightforward. Trustees ordinarily need not make decisions under time pressure, and investment decisions involve relatively clear considerations.").

into their own hands, and also might be willing to accept a lower rate of return with the protection afforded by a specialized professional willing and able to exercise its discretion in the event of default to maximize the return to bondholders. Issuers would be more comfortable knowing that the indenture trustee would be acting on behalf of bondholders, rather than facing unpredictable actions by individual bondholders, and that the indenture trustee would not be uncritically enforcing the indenture's available remedies.²⁰¹ A business judgment rule also would free indenture trustees to exercise their specialized talent and experience for the benefit of bondholders, and would encourage more qualified parties to enter the market for indenture trustees.²⁰²

It should be emphasized that the business judgment rule advocated by this Article should include at least the presumption against liability as well as the gross negligence threshold contemplated by the corporate business judgment rule, which many corporation law scholars argue are the real teeth of the rule.²⁰³ Section 315(d)(2) of the TIA already provides certain protections that might appear to loosely parallel a business judgment rule,²⁰⁴ but in practice that section has proved insufficient because it lacks a presumption against, and adequate threshold for, indenture-trustee liability.²⁰⁵

It therefore appears that the prudent-man standard for indenture trustees after default should be tempered by a business judgment rule that includes a presumption against liability as well as a gross negligence liability threshold. As a final step in the analysis, however, it is appropriate to compare this approach with possible alternatives.

201. See *Senate 1939 Hearings*, *supra* note 45, at 119–20 (statement of John K. Starkweather, Chairman of the Fed. Legis. Comm. of the Investment Bankers' Association of America).

202. The one aspect of applying the business judgment in the trust-indenture context that could raise the cost of debt is the entry of higher quality indenture trustees. However, considering the benefits that would be provided by higher quality indenture trustees, the net effect should be a lower cost of debt.

203. See *Greenfield & Nilsoon*, *supra* note 133, at 816.

204. Section 315(d)(2) provides that each:

indenture shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts.

15 U.S.C. § 7700o(d)(2) (2000). William O. Douglas, then an SEC Commissioner, advocated including § 315(d)(2) in the TIA to try to ensure "a practicable, workable, and safe standard of care for the trust institutions." See *House 1938 TIA Hearings*, *supra* note 31, at 41 (statement of William O. Douglas, Chairman, Securities and Exchange Commission).

205. See 15 U.S.C. § 7700o(d)(2). Although, like the business judgment rule, § 315(d)(2) provides process-oriented protection, recall that traditional trust law is likewise process-oriented, and that the effective difference between the business judgment rule and traditional trust law is the "extra insulation" provided by the business judgment rule's presumption in favor of corporate directors and heightened standard of gross negligence. See BLOCK ET AL., *supra* note 124, at 53; KRIKORIAN, *supra* note 140, at 289–90, 294.

V. ALTERNATIVES

Are there viable alternatives to this Article's proposal for solving the deficiencies in post-default governance by indenture trustees? This Part discusses competing approaches.

A. *Eliminating the Mandatory Indenture Trustee*

Some argue the TIA should not even require an indenture trustee to act on behalf of bondholders.²⁰⁶ In testimony before Congress on possible reforms of the TIA, for example, one witness relied primarily on the change in the characteristics of bond investors—now primarily large institutions, compared to the small individual investors at the time of the TIA's passage in 1939—to argue there is no need to mandate an indenture trustee for every public bond issue: "if institutions want a trustee, they can demand one. If they don't care about a trustee, the law should not compel a company to pay for a trustee no one wants."²⁰⁷

That proposal, however, is at least partially predicated on the existing deficiencies in indenture-trustee post-default governance.²⁰⁸ If those deficiencies are fixed, as this Article suggests, the argument to eliminate the TIA's mandatory trustee requirement becomes less compelling.

Eliminating the TIA's mandatory trustee requirement also would not squarely address the bondholder-governance deficiencies described in this Article. Such deficiencies result from the collective-action problem of bondholder governance, irrespective of whether indenture trustees are voluntarily appointed or mandatory.²⁰⁹ Therefore, for bond issues that continue to rely on indenture trustees—and we believe many would continue to rely²¹⁰—these deficiencies would remain.

206. In the mid-90s, Congress considered further reforms to the TIA and heard testimony that advocated for at least partial repeal of the TIA. See H.R. REP. NO. 104-622, at 40-41 (1996) which states:

In the context of the Subcommittee hearings on [a bill] the Committee notes that three witnesses testified on the proposal to repeal the Trust Indenture Act. Morey W. McDaniel, Esq., an indenture practitioner, questioned the Act's continued utility and supported its repeal, while SunTrust Capital Markets President and CEO R. Charles Shufeldt, testifying on behalf of the ABA Securities Association, argued that the Act still served a useful purpose and opposed repeal. Columbia University Professor of Law John C. Coffee, Jr. testified that there was a 'plausible case for repealing much of the statute' but cautioned Congress to retain necessary protections for bondholders in some form.

207. See *Capital Markets Deregulation Hearings*, *supra* note 89 (statement of Morey W. McDaniel).

208. See *id.* ("[The TIA] requires unanimous consent by bondholders to any change in principal or interest payments. And th[at is] what's wrong with the Act.")

209. See, e.g., Schwarcz, *supra* note 1, at 1004-05.

210. Many public bond issues would likely continue to rely on indenture trustees because a bond issue that starts out with specific institutional investors will eventually have different investors as the bonds are traded. See *id.* Even if all the new investors are institutions, some may want the protection of an indenture trustee. A bond issue's failure to have an indenture trustee thus is likely to reduce the

B. Enhancing the Indenture Trustee's Statutory Powers

The call for greater indenture-trustee power is best illustrated by the "supertrustee" proposal of Professors Yakov Amihud, Kenneth Garbade, and Marcel Kahan.²¹¹ Their central argument is that public bond indentures should contain more covenants, with the goal of lowering agency costs by increasing monitoring of the issuer.²¹² Private bank debt often includes a much more extensive package of covenants than in bond indentures because it is easier for a defaulting issuer to negotiate with private lenders than with public bondholders²¹³ (since indenture trustees do not usually have authority to waive defaults in, or to amend, substantive covenants without bondholder consent).²¹⁴ To induce issuers to agree to include more extensive covenants in public bond indentures, indenture trustees would be exclusively empowered to waive covenant defaults and renegotiate substantive terms of the indenture.²¹⁵

The "supertrustee" proposal has been criticized for taking too much power away from the bondholders in return for greater efficiency.²¹⁶ More fundamentally though, the proposal's baseline assumption, that publicly-issued bonds should contain more covenants, is questionable. Covenants represent a trade-off between a debtor's financial flexibility and reduction of agency costs.²¹⁷ An issuer may be willing to pay more to retain financial flexibility, and public bondholders appear to often prefer higher interest rates to the monitoring and protective features of covenants.²¹⁸ Reforming the TIA to empower supertrustees in order to encourage greater indenture covenants would be very much the tail wagging the dog.

More significantly, though, the "supertrustee" proposal is not inconsistent with this Article's call for a business judgment rule. Indeed, the authors of the "supertrustee" proposal even briefly suggest that their "su-

trading value of the bonds. Furthermore, any initial belief by investors that they will work together in the event of a default is undermined by the fact that, under the indirect holding system for securities, the actual beneficial owners of publicly-traded bonds will be difficult, costly, and time-consuming to identify. *See id.*

211. *See* Amihud et al., *supra* note 18, at 469-70.

212. *See id.* at 470.

213. *See id.* at 465-66.

214. *See id.* at 474, 474 n.93.

215. *See id.* at 469-70.

216. *See* Lev, *supra* note 10, at 116; *see also* Memorandum from Members of the ABA Business Law Section Committee, *supra* note 3, app. at 4-5 (criticizing the super-trustee proposal as unrealistic).

217. *See* Robert C. Nash et al., *Determinants of Contractual Relations Between Shareholders and Bondholders: Investment Opportunities and Restrictive Covenants*, 9 J. CORP. FIN. 201, 202 (2003) ("We find that, for high-growth firms, the desire to maintain flexibility in financing dominates the need to reduce agency costs of debt.").

218. *See* Larry Light, *Bondholder Beware: Value Subject to Change Without Notice*, BUS. WK., Mar. 29, 1993, at 34 ("Bondholders can—and will—fuss all they like. But the reality is, their options are limited: Higher returns or better protection. Most investors will continue to go for the gold.").

pertrustees” be protected “under a liability standard analogous to the ‘business judgment rule.’”²¹⁹

C. *Preserving the Ambiguity of the Prudent-Man Standard*

Although not explicitly proposed in the literature discussing the prudent-man standard, there is an argument that bondholders might actually benefit by retaining the existing ambiguity of the prudent-man standard.²²⁰ In scholarly terms, this argument would follow the theory proposed by Professors Ian Ayres and Robert Gertner to address default rules in contracts—that the then-existing guidance for interpreting incomplete contracts—that courts should try to determine what the parties would have contracted for absent transaction costs—is unsatisfactory.²²¹ They suggest instead that “penalty defaults [be] purposefully set at what the parties would not want—in order to encourage the parties to reveal information to each other or to third parties (especially the courts),”²²² and thereby reach efficient solutions.²²³

In this sense, the ambiguous prudent-man standard under the TIA theoretically may motivate the parties—the issuer, underwriters, indenture trustee, and bondholders—to devise efficient market-driven solutions. In the trust-indenture context, though, the very collective-action problem that undermines bondholder governance²²⁴ prevents the Ayres-Gertner theory from being fully realized.²²⁵ For example, it is often difficult, costly, and time-consuming to ascertain the identities of bondholders,²²⁶ and without that information one cannot obtain bondholder consent.²²⁷ Furthermore, usually only the issuer and its underwriters negotiate the indenture terms.²²⁸

219. See Amihud et al., *supra* note 18, at 478.

220. This argument was originally suggested to the authors by Richard Lasker, Senior Attorney, Cravath, Swaine & Moore LLP.

221. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93 (1989).

222. *Id.* at 91.

223. See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 733 (1992).

224. See, e.g., Schwarcz, *supra* note 1, at 1004–05.

225. More broadly, default rules become “sticky” from historical usage, making it difficult for either contracting party to propose deviations—even when both contracting parties recognize the default rule is sub-optimal. See Omri Ben-Shahar & John A.E. Pottow, *On The Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 651–52 (2006). For a general discussion of these problems and an argument why the market may fail to correct inefficient default rules, see generally *id.*

226. See Schwarcz, *supra* note 1, at 1004–05.

227. See SPOTTO, *supra* note 31, at XI-5 (“Before exercising remedies or taking action against the obligor in a situation where the recovery is questionable and the source of the indenture trustee fees and expenses are not free from doubt, a wise trustee will seek to receive the written direction, instruction and indemnity of a majority of the holders.”).

228. See, e.g., *Metro. Life Ins. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989) (“[P]ublic bond . . . indentures are often not the product of face-to-face negotiations between the

D. Changing the Prudent-Man Standard to an Agency Standard

Another possible alternative would be to change the TIA's underlying post-default prudent-man standard to more of an agency standard.²²⁹ Although this alternative would make it clear that indenture trustees should not be judged by traditional trust-law criteria, an agency standard would not give indenture trustees as much flexibility and freedom of action as this Article's proposal that the prudent-man standard be tempered by a business judgment rule.²³⁰ Changing the TIA's underlying standard also would require a statutory amendment, whereas tempering the prudent-man standard by a business judgment rule can be accomplished at least in part through judicial action.²³¹

Nonetheless, this alternative bears exploring. Unlike the prudent-man standard, the agency standard²³² provides that, "[s]ubject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances."²³³ Thus, agents do not ordinarily have the protection of a gross negligence standard for liability, nor do they have the benefit of a presumption against liability. As mentioned, however, this alternative would remove the performance standard of indenture trustees from the baggage associated with traditional trust law.

There are two arguments why an agency standard might be more appropriate than this Article's proposal. First, the business judgment rule's most accepted application is to decisions made, or actions taken, by directors acting as a corporation's collective institution of governance.²³⁴ Thus, there is confusion whether the rule should apply to the decisions or actions of individual corporate officers.²³⁵ Are decisions and actions of indenture

ultimate [bond]holders and the issuing company. . . . [U]nderwriters ordinarily negotiate the terms of [public bond] indentures with the issuers."); see also Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211, 212-15 (1991) (arguing the trust indenture contracting process results in relatively meager protection for bondholders).

229. We thank Professor Deborah DeMott for proposing this alternative and for suggesting the arguments discussed in this subpart.

230. See Gregory S. Alexander, *Trust Protectors: Who Will Watch the Watchmen?*, 27 CARDOZO L. REV. 2807, 2808 (2006) ("The configuration of the principal-agent relationships in the garden variety trust . . . is already murky.").

231. See GEVURTZ, *supra* note 132, at 278-79.

232. Terminology here is imprecise and confusing. For example, corporate directors have often been thought of as agents of the corporation, see, e.g., Annotation, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers or Employees*, 25 A.L.R. 3d 941, 991-93 (1969), and, indeed, indenture trustees themselves act as a type of agent on behalf of the bondholders. See 15 U.S.C. § 7700o (2000).

233. RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006).

234. See GEVURTZ, *supra* note 132, at 279-80.

235. See *id.* at 282 n.28. Compare Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 440-41 (2005) (arguing against application of the business judgment rule to non-director officers), with MODEL BUS. CORP. ACT § 8.42 cmt. (1999), PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 112, § 4.01, and BAINBRIDGE, *supra* note 187, § 6.4, at 285-

trustees more like those of corporate boards or individual officers? Although the indenture trustee is formally a single entity,²³⁶ we believe its post-default decisions and actions are indeed collective since they are made institutionally,²³⁷ usually the result of discussions among multiple corporate-trust officers with the advice of counsel.²³⁸

The second argument for why an agency standard might be more appropriate than this Article's proposal is that, due to the collective-action problem discussed earlier,²³⁹ bondholders often lack the practical ability to remove an indenture trustee.²⁴⁰ This lack of control suggests that indenture trustees should be constrained, more tightly than under the business judgment rule, to act for the benefit of bondholders.

There are, however, cogent counterarguments. A majority of bondholders typically can replace the indenture trustee,²⁴¹ and even individual bondholders have the power to remove indenture trustees who are conflicted.²⁴² More significantly, tightly constraining indenture trustees can actually backfire, as this Article has argued regarding the prudent-man standard,²⁴³ because indenture trustees will lack motivation to take calculated risks on behalf of bondholders. Whether an agency standard would impose too tight constraints is ultimately an empirical question, but the evidence from non-public lending markets, which are not subject to the TIA,²⁴⁴ suggests an answer. The most common type of multiple-investor loan agreement used in those markets (remember that an indenture is simply the name for a loan agreement governing a public bond issue²⁴⁵) is syndicated bank loan agreements.²⁴⁶ In these agreements, the agent bank performs a role vis-à-vis the lending banks similar to that performed by the indenture trustee vis-à-vis public bondholders.²⁴⁷ The agent bank's

86 (all advocating application of the business judgment rule to non-director officers).

236. See LANDAU & KRUEGER, *supra* note 2, at 40.

237. See *id.* at 41.

238. See SPOTTO, *supra* note 31, at XI-1. Another reason why indenture trustees are, after default, like corporate directors is that in both cases judgment is more important than any particular skill. See LANDAU & KRUEGER, *supra* note 2, at 171.

239. See Schwarcz, *supra* note 1, at 1004-05.

240. See LANDAU & KRUEGER, *supra* note 2, at 206.

241. See *id.*

242. See 15 U.S.C. § 77jjj(b)(iii) (2000) (providing that, in the case of a conflict of interest, "any . . . bona fide holder of [the bonds] for at least six months may . . . petition [a] court . . . for the" indenture trustee's replacement).

243. See *supra* Subpart III.A.

244. See 15 U.S.C. § 77ddd.

245. See LANDAU & KRUEGER, *supra* note 2, at 22 ("The *trust indenture* is a device by which a corporation or governmental entity borrows money from the general public or large institutional investors to issue securities.").

246. See Blaise Gadanecz, *The Syndicated Loan Market: Structure, Development, and Implications*, BIS Q. REV., Dec. 2004, at 75, 75 ("Syndicated [loans] are a very significant source of international financing, with signings of international syndicated loan facilities accounting for no less than a third of all international financing, including bond, commercial paper and equity issues.").

247. See *id.* at 77-79.

performance under syndicated bank loan agreements, however, is customarily subject to a gross negligence standard as under the business judgment rule, not an ordinary negligence standard as under traditional agency law.²⁴⁸

E. Devising an Overall Incentive Structure

Yet another alternative to adopting a business judgment rule liability standard is to consider modifying other incentives of indenture trustees to motivate them to act more effectively. A liability regime, after all, is only a part of an overall incentive structure.²⁴⁹

It is theoretically possible to devise a range of non-liability incentives to help motivate indenture trustees. These incentives might include, for example, giving indenture trustees direct economic interests in the issuer—such as the equivalent of directors and officers owning shares or stock options.²⁵⁰ Direct economic interests could raise serious conflicts issues, however, if those interests are not *pari passu* with the debt interests of bondholders.²⁵¹ Other possible incentive compensation schemes might include increased compensation for post-default efforts, possibly including bonuses based on the degree to which bondholders recover.

Because it would be highly influenced by market conditions and thus a moving target, devising an optimal overall incentive structure is beyond this Article's scope. Instead, the Article's analysis takes existing non-liability incentives as a given.²⁵² To the extent those incentives change over time, this Article's analysis may need to be reconsidered.

248. See e-mail from Eric Marcus, Partner, Kaye Scholer LLP, to Steven L. Schwarcz, Stanley A. Star Professor of Law & Business, Duke University School of Law (July 12, 2007) (on file with Alabama Law Review); e-mail from Steven L. Schwarcz, Stanley A. Star Professor of Law & Business, Duke University School of Law, to Roger DuBroff, Counsel, Kaye Scholer LLP (July 12, 2007) (on file with Alabama Law Review).

249. See, e.g., Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1872–73 (2001).

250. See e-mail from Marcel Kahan, George T. Lowy Professor of Law, NYU School of Law, to Steven L. Schwarcz, Stanley A. Star Professor of Law & Business, Duke University School of Law (Sept. 4, 2007) (on file with Alabama Law Review).

251. One of the TIA's central goals is to avoid conflicts of interests between indenture trustees and bondholders. See, e.g., 15 U.S.C. § 77jjj(b)(iii) (2000) (stating that in the case of a conflict, bona fide bondholders may request trustee's replacement); see also *Elliot Assocs. v. J. Henry Schroeder Bank & Trust*, 838 F.2d 66, 71 (2d Cir. 1988) (“[Indenture] trustee [has duty] to avoid conflicts of interest.”). Compare 15 U.S.C. § 77jjj(b)(iii), with 11 *id.* § 1126(e) (permitting bankruptcy courts to exclude votes on plans of reorganization by entities whose voting “was not in good faith.”). In author Schwarcz's experience, an important possible basis for excluding such votes is a voting entity's conflict of interest resulting from ownership of both debt and equity in the reorganizing debtor.

252. See Lucian Ayre Bebchuck, *A New Approach to Corporate Reorganization*, 101 HARV. L. REV. 775, 775–77 (1988).

F. Empowering Bondholders

The alternatives discussed above focus on the indenture trustee. Another possible approach is to focus on the bondholders themselves.²⁵³ For example, a committee or other governing body of bondholders could be formed, after default, to represent the bondholders. This has the advantage of putting bondholder governance into the hands of parties who actually have financial stakes in the outcome.

The TIA already provides a variant on this approach. TIA permits a majority of bondholders “to direct [the indenture trustee regarding] the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee.”²⁵⁴ Although this frequently occurs,²⁵⁵ it raises serious, unresolved issues. Some or all of the majority bondholders, for example, may have conflicts of interest with other bondholders.²⁵⁶ This raises the question whether the majority bondholders should have legal duties to other bondholders and, if so, what should be the standard for those duties. As with the prudent-man standard of the TIA,²⁵⁷ imposing too strict a standard could undermine the motivation to take risks to try to maximize bondholder recovery.²⁵⁸

In some cases, moreover, it may be difficult to obtain majority-bondholder direction. Where individual bondholder investments are relatively small, for example, few bondholders would be expected to be willing to expend their individual resources for a collective benefit.²⁵⁹ Furthermore, bondholder identities can be difficult to ascertain under the indirect holding system,²⁶⁰ so some bondholders may be unaware of bond defaults. These factors can cause a classic collective-action problem.²⁶¹

253. We thank Dean David Levi for suggesting this alternative, and Professors Mitu Gulati, Stuart Benjamin, and Melissa Jacoby for helping to develop it.

254. See 15 U.S.C. § 77 ppp(a)(1).

255. See *supra* notes 3–4 and accompanying text.

256. See *supra* note 4 and accompanying text.

257. See *supra* Subpart III.A.

258. In a separate article, Professor Schwarcz is examining the issues of majority bondholder governance, conflicts of interest, and the rise of distressed-bond investing by large hedge and private-equity funds. To the extent majority bondholders are not conflicted, a strict standard should not be needed since the economic stake of the majority bondholders and the *pari passu* nature of their bonds should sufficiently ensure that they act on behalf of all bondholders. To avoid or at least mitigate the impact of conflicts, we believe that majority bondholders should have a duty to act in good faith on behalf of all bondholders. A majority bondholder who, for example, votes strategically to enhance the value of an unrelated investment, such as an equity interest in the issuer, would be violating this duty. See 11 U.S.C. § 1126(e) (excluding the votes of parties in interest who do not vote in good faith).

259. This problem would be mitigated to some extent if majority bondholders were at least paid their expenses—although the source of that payment would presumably be the issuer, thereby diluting the assets available for payment of bonds. See *id.* § 503(b)(3)(F) (providing for expenses of members of creditors’ committees in bankruptcy cases from assets of the debtor).

260. See Schwarcz, *supra* note 2, at 1547–48, 1583; Schwarcz, *supra* note 1, at 1004–05.

261. See Schwarcz, *supra* note 2, at 1547–48, 1583; Schwarcz, *supra* note 1, at 1004–05. *But see*

Of all the alternative approaches, we regard an empowering-bondholders approach as the most promising.²⁶² Nonetheless, the issues and concerns identified above would have to be resolved, and there may well be additional issues and concerns that we have missed.

VI. CONCLUSIONS

Instead of effectively representing public bondholders, indenture trustees are sometimes limited participants in post-default situations due to ambiguity over the “prudent man” standard imposed on indenture trustees under the Trust Indenture Act, as well as concern that an indenture trustee’s liability under that standard may be strictly judged by reference to traditional trust law.

Comparing the role of indenture trustees to that of traditional trustees and corporate directors, this Article shows that, after default, an indenture trustee acts—or at least should act—more like a corporate director, taking calculated risks to try to maximize the value paid to bondholders. To induce indenture trustees to take such risks, the Article contends that the prudent-man standard of indenture trustee post-default performance should be tempered by a business judgment rule not unlike that applied to the performance of corporate directors, including a presumption against liability as well as a gross negligence liability threshold. In part, this can be accomplished, as it was under corporation law,²⁶³ through judicial action

e-mail from Vicki O. Tucker, *supra* note 108 (observing that, at least “in the [limited] context of asset-backed securities, there tend to be a relatively small number of large institutional investors who are willing and able to give direction to the trustee”).

262. It is useful to compare this approach with evolving approaches taken in foreign sovereign bond governance, since foreign sovereign bonds, even if sold in the United States, are not subject to the TIA. See Lee C. Buchheit & Elizaheth Karpinski, *Grenada’s Innovations*, J. INT’L BANKING & REG. 227, 230 (2006). In the foreign sovereign bond context, the collective-action problem is increasingly being addressed by collective-action clauses (CACs), allowing a supermajority of bondholders to agree with the issuer on changes to payment terms. See, e.g., Robert Gray, *Collective Action Clauses: Theory and Practice*, 35 GEO. J. INT’L L. 693, 693 (2004); Sergio J. Galvis & Angel L. Saad, *Collective Action Clauses: Recent Progress and Challenges Ahead*, 35 GEO. J. INT’L L. 713, 714–15 (2004). This supermajority replaces the traditional requirement of unanimous consent among bondholders to change payment terms. See *id.* Recent proposals also attempt to resolve the problem of who the sovereign issuer should negotiate with to determine the terms of a restructuring. For example, “a special bondholder representative” may be elected by two-thirds of the bondholders. See GROUP OF TEN, REPORT OF THE G-10 WORKING GROUP ON CONTRACTUAL CLAUSES 3 (Sept. 26, 2002). At least one sovereign borrower, Ecuador, created a group of representative creditors (“eight of the larger institutional holders of its bonds”) to act as a link between it and the bondholders generally. See U.N. INST. FOR TRAINING & RESEARCH [UNITAR], *Sovereign Debtors and Their Bondholders* 14 (2000) (prepared by Lee C. Buchheit). Buchheit argues that the benefit of negotiating terms of a restructuring with representative “bondholders is that the resulting package stands a better chance of acceptance by the bondholder group as a whole.” See *id.* at 15.

263. See, e.g., GEVURTZ, *supra* note 132, at 278–79 (explaining the judicial origin of the business judgment rule in corporation law, inspired by the underlying idea “that courts should exercise restraint in holding directors liable for (or otherwise second guessing) business decisions”).

without the need to amend the Trust Indenture Act itself, though moving to a gross negligence standard may well require amendment of that Act.²⁶⁴

Some may counter, however, that although such a rule would go far to resolve the collective-action problem of bondholder governance,²⁶⁵ its flexibility might exacerbate the agency-cost problem (in that indenture trustees would be less closely subject to bondholder wishes).²⁶⁶ The net effect could be tested empirically, however, by comparing the prices of defaulted bonds before and after implementing such a business judgment rule. For the reasons discussed in this Article, we believe that any such comparison will show that applying a business judgment rule to indenture trustees will lower the cost of public debt while, at the same time, providing public bondholders with greater, not less, protection.

264. See 15 U.S.C. § 7700o(d) (limiting the circumstances under which indenture trustees may be relieved of responsibility).

265. Although this collective-action problem can be, and to some extent already is, mitigated by empowering bondholders to direct the trustee's actions, see *id.* § 77ppp(a)(1), there may be conflicts of interest among bondholders.

266. Cf. Memorandum from Members of the ABA Business Law Section Committee, *supra* note 3, at 3 (noting that bondholders involved with ad hoc bondholder committees might not even want indenture trustees to exercise independent judgment, much less to take calculated risks).