
Article

Fiduciaries with Conflicting Obligations

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This Article addresses a central conflict¹ at the intersection of finance, agency, and trust law: the dilemma of a fiduciary² acting for parties who, *as among themselves*, have conflicting commercial interests.³ Investment securities, for example, are almost always held by multiple investors. Even if investors have a voting mechanism to make decisions, the practical difficulty of soliciting investor votes or sorting out sometimes-conflicting investor directions means, in reality, that many im-

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1. I have recently argued that the "subprime" financial crisis and its subsequent devolution into a larger global financial crisis (hereinafter, the "financial crisis") can be attributed in large part to three causes: conflicts of interest, investor complacency, and overall complexity. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 376 (2008). This Article addresses a subset of the first cause, conflicts of interest.

2. I use the term "fiduciary" in its broad sense as a person who is required to act for the benefit of others. See BLACK'S LAW DICTIONARY 702 (9th ed. 2009) ("A [fiduciary is a] person who is required to act for the benefit of another person on all matters within the scope of their relationship One who must exercise a high standard of care in managing another's money or property."); see also Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046 (1991) ("Familiar forms of fiduciary relationships include trustee-beneficiary, agent-principal, corporate director/officer-corporation and partnership . . .").

3. I use the term "commercial interests" in its broad sense as including financial interests. Similarly, references in this Article to commercial law include financial law.

portant decisions will have to be made by a fiduciary acting for the investors.⁴ In the United States, such a fiduciary is often referred to as a trustee, or as an indenture trustee when the agreement between the investors and the issuer of securities is entitled an indenture.⁵

A fiduciary acting for multiple investors can face difficult challenges even when the investors are of a single, nonconflicting class.⁶ If the securities are in default and the fiduciary has deep pockets, investors sometimes may try to impose liability on the fiduciary for decisions which, viewed in retrospect, are arguably questionable or ill-advised. This poses a dilemma: after default, many decisions—such as whether to accelerate debt

4. Interview with Harold L. Kaplan, Partner, Foley & Lardner LLP; Chair, ABA Bus. Law Section's Comm. on Trust Indentures and Indenture Trs., in Vancouver, B.C., Can. (Apr. 18, 2009) (speaking in the context of a trustee acting for conflicted investors).

5. Counsel for indenture trustees sometimes argue that their clients do not have “the generalized broad-based responsibilities of a common law trustee, or ‘fiduciary,’” because indenture trustees “purely administer[] and implement[] contractual obligations under the indenture.” Harold L. Kaplan & Mark F. Hebbeln, *The Anglo-American Indenture—Covenant Enforcement and Bond Defaults—U.S. Experience and Lessons from Canada and the U.K.*, ESOURCE (ABA Bus. Law Section, Chicago, Ill.), June 2009, at 1, 4, <http://www.abanet.org/buslaw/newsletter/0081/materials/pp1.pdf>. That may well be true absent a default, when indenture trustees tend to have merely ministerial responsibilities. See, e.g., *In re E.F. Hutton Sw. Prop. II, Ltd. v. Union Planters Nat'l Bank*, 953 F.2d 963, 969 (5th Cir. 1992) (“There is no doubt . . . that if an indenture trustee owes any fiduciary duties to the beneficiary above and beyond those duties explicitly recited in the trust indenture, they are much more attenuated than those normally owed by trustees.”). But there is nothing ministerial about the duties of an indenture trustee after default, especially when the indenture trustee is acting for conflicting investors. See ROBERT I. LANDAU & JOHN E. KRUEGER, *CORPORATE TRUST ADMINISTRATION AND MANAGEMENT* 171 (1998) (“The administration of indentures after default is the greatest test of the corporate trust officer’s skill and expertise.”); Martin D. Sklar, *The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?*, 106 *BANKING L.J.* 42, 61 (1989) (observing that in the wake of a default, the indenture trustee “is placed in the position of ‘choosing sides’”). Leading observers virtually admit as much. See, e.g., Kaplan & Hebbeln, *supra*, at 4 (“Having said that [indenture trustees do not assume the generalized broad-based responsibilities of a fiduciary], the indenture trustee’s role under the indenture still can be viewed as including facilitating a level playing field for all bondholders . . . [which entails] ever more difficult issues of balancing countervailing interests in doing what is right.”).

6. The scenario of a fiduciary acting for multiple *nonconflicting* investors of a single class should also be compared with the scenario, discussed *infra* text accompanying notes 97–99, where majority investors of an otherwise nonconflicting class attempt to privately negotiate an exchange offer with the issuer of the securities, intended to give such majority investors an advantage over other investors in their class.

or liquidate collateral—require exquisite judgment calls,⁷ and ex ante no given decision may be clearly right. This type of dilemma, which is examined in a separate Article, is often faced by indenture trustees when acting for public bondholders.⁸

The dilemma rises to a much higher order of magnitude, though, where investors themselves have conflicting interests—such as conflicting priorities or conflicting sources of payment. Then, the fiduciary not only is subject to being second-guessed ex post for decisions that are essentially judgment calls but also faces the difficult task of trying to understand and balance the respective obligations owed to conflicting classes—sometimes called “tranches”—of investors.⁹ This Article focuses on that dilemma. Accordingly, references herein to fiduciary conflicts, to fiduciaries with conflicting obligations, or to the dilemma of fiduciaries with conflicting obligations, pertain to fiduciaries who are conflicted because of conflicts *among* beneficiaries, and not fiduciaries whose own interests are per se in conflict with the interests of beneficiaries.¹⁰

Existing sources of law do not fully capture the dilemma of a fiduciary with conflicting obligations. Agency law focuses more on principal-agent relationships and the agent's duty to a given principal than on conflicts among principals.¹¹ Trust law

7. Fiduciaries are generally required under law to act, at least after a default, as a prudent person in like circumstances. *See, e.g.*, Trust Indenture Act of 1939 § 315(c), 15 U.S.C. § 7700o(c) (2006) (“The indenture trustee shall exercise in case of default . . . the same degree of care and skill . . . as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”); N.Y. REAL PROP. § 126(1) (McKinney 2006) (“In the case of an event of default . . . [the trustee of a trust indenture shall] 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.”); RESTATEMENT (THIRD) OF TRUSTS § 77(1) (2007) (“The trustee has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust.”). This Article's normative analysis assumes this standard of fiduciary action.

8. *See* Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037, 1040 (2008) (“Indenture trustees for defaulted bonds . . . face the conundrum that they are required to act prudently but lack clear guidance on what prudence means.”).

9. *See* BLACK'S LAW DICTIONARY 1635 (9th ed. 2009) (“A [tranche is a] bond issue derived from a pooling of similar debt obligations. A tranche usu[ally] differs from other issues by maturity date or rate of return.”); *infra* notes 14–18 and accompanying text.

10. For a discussion of fiduciaries whose interests are per se in conflict with the interests of beneficiaries, see generally Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 808–16 (1983).

11. *See* RESTATEMENT (THIRD) OF AGENCY § 8.03 (2006) (“An agent has a

recognizes the distinction between, on the one hand, conflicts between fiduciaries and their beneficiaries (regarding which the trustee is governed by a duty of loyalty) and conflicts as among beneficiaries (regarding which the trustee is governed by a duty of impartiality); but because trust law developed in the context of gratuitous trusts, it does not necessarily govern commercial-trust arrangements.¹² And commercial law generally addresses arm's length, not fiduciary, transactions.¹³

I. EXAMPLES OF THE DILEMMA

By increasing the volume of debt securities in default, the financial crisis has brought fiduciary conflicts to the fore.¹⁴ One common conflict scenario involves a fiduciary acting for classes of securities having different sources of payment, such as when principal and interest on assets underlying the securities are separately allocated to different investor classes.¹⁵ The fiduciary, usually referred to in this context as a servicer, is customarily employed to collect the principal and interest, agreeing to act in the "best interests" of the investors.¹⁶ If, as is typical,

duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship."). *But see id.* § 8.06(2) (stating that an agent who acts on behalf of more than one principal in a transaction owes duties of good faith, disclosure, and fair dealing to each principal).

12. *See infra* note 116 and accompanying text.

13. *See* JOANNA BENJAMIN, FINANCIAL LAW 527 (2007) ("The overwhelmingly dominant regulatory project in the financial markets [under British law] predicates an arm's length relationship between the parties to financial positions."); *see also* First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., 919 F.2d 510, 514 (9th Cir. 1990) ("Banks and savings institutions engaged in commercial transactions normally deal with one another at arm's length and not as fiduciaries."). *But see* Reid v. Key Bank of S. Me., 821 F.2d 9, 17 (1st Cir. 1987) ("[C]ourts are split on the issue of whether, and in what circumstances, a confidential [i.e., fiduciary] relation may be implied between a bank and its depositors or loan customers.").

14. *See* Philip Rawlings, *Reinforcing Collectivity: The Liability of Trustees and the Power of Investors in Finance Transactions*, 23 TRUST L. INT'L 14, 14 (2009) ("[C]urrent [financial] problems make it inevitable that trustees will be put under even greater pressure . . .").

15. *See* Schwarcz, *supra* note 1, at 391 (examining whether "structured finance" in the home mortgage context makes it difficult to work out the underlying mortgage loans "because the beneficial owners of the loans are no longer the mortgage lenders but a broad universe of financial-market investors").

16. *Id.* at 392. Although servicers sometimes try to disclaim any fiduciary obligations, courts usually ignore such disclaimers. K.C. McDaniel & Timothy Little, *Form of A/B Note Intercreeitor and Servicing Agreement—2006*, ALL-ABA Course of Study (2009), available at WL SP008 ALI-ABA 1553, 1562 n.7.

the underlying assets are mortgage loans and the servicer wants to restructure one or more such loans (because restructuring may yield greater cash recovery than foreclosing on the mortgages), the best-interests standard gives insufficient guidance. If the servicer restructures the loans by reducing the interest rate, it would adversely affect investors in the interest-only class; but if the servicer restructures the loans by reducing principal, it would adversely affect investors in the principal-only class.¹⁷ In either case, restructuring is likely to spark what some have called “tranche warfare.”¹⁸ As a result, servicers are not restructuring mortgages but, instead, are simply foreclosing on homes, thereby potentially reducing aggregate investor recovery, making mortgagors destitute, and creating the blight of abandoned homes that is feeding the financial crisis.¹⁹

An even more common conflict scenario involves a fiduciary acting, after default, for classes of securities having different priorities. Many debt securities, including securities backed by mortgage loans or other financial assets (and other forms of “securitized debt”),²⁰ typically are issued in multiple classes, each class having a different priority of payment. For example, so-called collateralized-debt-obligation (CDO) transactions customarily involve a dozen or more classes of securities, all backed by the same pools of underlying mortgage loans and

Generally, the existence of a fiduciary relationship is “determined by the law rather than the parties.” Frankel, *supra* note 10, at 820.

17. This example uses only two different allocations to separate investor classes; actual allocations can be even more complex. See Schwarcz, *supra* note 1, at 393 n.101 (observing that sometimes there are additional “prepayment-penalty tranches,” and that different tranches can have different priorities relative to each other).

18. See, e.g., Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 563 (2002) (using the term “tranche warfare”); Randall W. Forsyth, *Tranche Warfare: In CMOs, It's the Institutions vs. Individual Investors*, BARON'S, Aug. 19, 1991, at 12, 12 (same).

19. See Gretchen Morgenson, *So Many Foreclosures, So Little Logic*, N.Y. TIMES, Jul. 5, 2009, at BU1 (quoting Professor Alan M. White's conclusion that in many cases the decision to foreclose “is not rational economic behavior” based on his study of almost 32,000 liquidation sales conducted in June 2009, for which the average loss was 64.7% of the original loan balance). *But see* Christopher Foote et al., *Reducing Foreclosures: No Easy Answers* 22–23 (Fed. Reserve Bank of Atlanta Working Paper Series, Paper No. 2009-15, 2009), available at <http://www.frbatlanta.org/filelegacydocs/wp0915.pdf> (indicating that at least some foreclosure decisions may be based on sound economic analysis).

20. For a detailed explanation of securitized debt, see Schwarcz, *supra* note 1, at 376–79.

other financial assets, but with each class having its own priority vis-à-vis the other classes.²¹

In the simplest example, a class of senior investors and a class of subordinated investors are secured by the same collateral. In deciding whether and how to exercise remedies, the fiduciary (sometimes called in this context a collateral trustee or a security trustee) would have to attempt to understand and balance the interests, after default, of the senior and subordinated investors. There is little guidance, though, on how that should occur.

The English High Court of Justice recently faced such a conflict when Orion Finance Corporation, a huge Cayman Island structured investment vehicle (SIV), defaulted on its payment obligations to senior investors.²² With billions of dollars at stake, the senior investors wanted the collateral trustee to foreclose on the financial assets owned by the SIV, which at the then-collapsed market prices would have yielded barely enough money to repay the senior investors, leaving nothing for subordinated investors.²³ That could have severely compromised the financial condition, and possibly the ultimate viability, of the two large financial institutions that held the subordinated securities.²⁴

The subordinated investors, instead, wanted the collateral trustee to delay foreclosure, hoping to be repaid (or at least to receive some recovery) from a subsequent rise in prices of the underlying financial assets or from collections on those assets.²⁵ Neither the applicable collateral documents (in this case, a security agreement governed by New York law) nor the applicable foreclosure law (the New York Uniform Commercial Code) provided the collateral trustee with clear answers.²⁶

21. *See id.* at 377–78 (describing classes of securities issued in CDO transactions).

22. *See Bank of N.Y. v. Mont. Bd. of Invs.*, [2008] EWHC (Ch) 1594, [16]–[28] (Eng.), 2008 WL 2697055. Professor Rawlings notes that this case “illustrated many of the problems at the heart of the recent financial crisis.” Rawlings, *supra* note 14, at 28.

23. *Bank of N.Y.*, [2008] EWHC (Ch) 1594, [25]–[27]. The senior investors wanted to exercise a particular right on foreclosure, bidding to retain the financial assets, which had been pledged as collateral. *Id.*

24. The author was an expert witness in this case for these financial institutions, as to matters of fiduciary law and foreclosure law. *See id.* [31].

25. *See id.* [27].

26. *See id.* [6]–[7].

The English court held that the senior creditors had no express contractual right to direct the trustee regarding foreclosure.²⁷ It also concluded, applying New York law, that the collateral is “held for the benefit of all the Secured Parties,” meaning the subordinated as well as the senior investors.²⁸ Thus, the trustee “is not the mere agent of the creditors, but is required to exercise a discretion.”²⁹

Similar types of conflicts can arise in any default scenario involving a fiduciary acting for classes of securities having differing priorities or sources of payment.³⁰ This Article will show that the rise of hedge funds and distressed-debt investing can, de facto, create a fiduciary conflict even when the fiduciary acts for a single class of *pari passu* securities.³¹ Furthermore, although this Article focuses on fiduciaries acting for investors in securities, fiduciary conflicts can arise when the investments are commodities and derivative instruments rather than securities³² and when the beneficiaries for whom the fiduciary acts are not even investors.³³

27. *Id.* [43], [55]–[56], [61].

28. *Id.* [58].

29. *Id.* [59]. The court did not attempt to instruct the trustee how that discretion should be exercised.

30. Indeed, a similar type of conflict can even arise in a default scenario involving a fiduciary acting for *pari passu* classes of securities having differing payment maturities. If the payment maturities are not accelerated by the default, the fiduciary will have to determine whether to apply any sum recovered (which likely will be insufficient to pay all the investors) in order of maturities, in which case the earlier-maturing securities will be preferred. *See, e.g.*, Interpleader Complaint at 12–16, *Deutsche Bank Trust Co. v. Victoria Fin. Ltd.*, No. 600071-08 (N.Y. Sup. Ct. Jan. 9, 2008), 2008 WL 4263259 [hereinafter *Deutsche Bank Interpleader Complaint*] (litigating this issue).

31. *See infra* text accompanying notes 96–97.

32. E-mail from Arthur B. Laby, Associate Professor of Law, Rutgers Univ. Sch. of Law-Camden; Former Assistant Gen. Counsel, SEC, to author (Aug. 29, 2009) (on file with author). Professor Laby additionally observes that in the context of the “liquidation and wind-up of an investment adviser or an investment fund, or both . . . conflicts among investors are significant. If asset values continue to fluctuate, even after a fund stops making new investments, the timing of redemptions could be material to the amount the investor receives.” *Id.*

33. *See* E-mail from Myron Glucksman, Former Managing Director, Citicorp Sec., Inc., to author (Sept. 13, 2009) (on file with author). Glucksman explains that:

Some dilemmas for Trustees arise due to the purported permissible contractual powers given to other parties of the transaction [such as parties providing credit protection]. For example, some CDO documents permit the CDS [credit default swap] party (upon an event of default following the failure of a Senior credit test) to direct the Colla-

II. IMPORTANCE OF THE PROBLEM

The dilemma of a fiduciary with conflicting obligations is a real problem not only, as discussed above, because of its broad scope³⁴ and the fact that fiduciaries are increasingly resorting to litigation, with all of its associated costs, to determine their responsibilities.³⁵ The problem is also real because, by focusing on limiting their liability, fiduciaries are acting in ways that can be suboptimal for some or all of their beneficiaries, and (as discussed) sometimes those suboptimal actions can have significant social costs that extend far beyond the actual beneficiaries (e.g., foreclosing on defaulted residential mortgages even when a workout would create more value and preserve home ownership).³⁶ Suboptimality can reach improbable levels, such as fiduciaries with conflicting obligations attempting to substitute reliance on legal opinions for the exercise of business judgment.³⁷

The problem is real also because the dilemma of a fiduciary with conflicting obligations is not easily resolvable through contracting. Because the dilemma can arise in any commercial setting, one or more parties may be unsophisticated and therefore would face high contracting costs.³⁸ But the dilemma is not eas-

teral Manager to sell certain collateral (e.g. cash bonds whose proceeds would be used to pay the CDS party a termination payment) *before* accessing a line of credit under a Super Senior borrowing facility that would also be used to pay the CDS holder. The practical impact is that following one order (the first mentioned above) may leave nothing for the senior creditors while following the other would.

Id.

34. See *supra* notes 30–33 and accompanying text.

35. Robert J. Coughlin et al., *Rule 22 to Resolve a Catch-22: Defensive Maneuvers for Corporate Trustees Faced with Conflicting Claims*, in *NEW DEVELOPMENTS IN SECURITIZATION 2008*, at 771, 777 (PLI Com. L. & Prac. Course Handbook Series No. 14108, 2008), WL 908 PLI/COMM. 771 (“There has been a recent trend of litigation filed by corporate trustees who are confronted with conflicting claims to the assets they hold in securitization transactions.”).

36. See *supra* notes 18–19 and accompanying text.

37. See *infra* text accompanying notes 194–96 (observing that indenture trustees with conflicting obligations often seek to resolve their dilemma by relying on legal opinions that permit and authorize the contemplated fiduciary action—opinions that are rarely forthcoming and, even when forthcoming, are, at least normatively, questionable bases for fiduciary action).

38. See Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 553 (1998) (“Unsophisticated parties face high transaction costs [when contracting] because they cannot draw upon experience in order to allocate terms among writings and because they may not know about the law.”).

ily resolvable through contracting even if *all* the parties are sophisticated. Although contract theory predicts that uncertainty can motivate sophisticated parties to contract for better outcomes,³⁹ the extent to which that occurs for normal two-party contracting is questionable.⁴⁰ Furthermore, the dilemma of a fiduciary with conflicting obligations arises, even in its simplest incarnation, in the context of three-party contracts. Because three-party contracting is more complicated and interactive among the parties, transaction costs may well inhibit complete contracting.⁴¹ Perhaps that helps explain why contracting has been ineffective to date in resolving the uncertainty over fiduciary conflicts.

Another possible reason why contracting has been ineffective in resolving the uncertainty is that contracting terms become “sticky” from historical usage, making it difficult for contracting parties to propose deviations even when they recognize the term is suboptimal.⁴² This “stickiness” is even likelier to occur in the context of fiduciary conflicts because, at least for agreements governing the public issuance of securities, the contracts are negotiated only by the issuer and its underwriters.⁴³

39. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 115 n.22 (1989) (“If no well-established default exists, many contracting parties may explicitly contract for what they want in order to avoid the penalty of ex post uncertainty.”). Professors Ayres and Gertner also argue that “penalty default[] [rules] are appropriate when it is cheaper for the parties to negotiate a term ex ante than for the courts to estimate ex post what the parties would have wanted.” *Id.* at 93.

40. See Eric Posner, *There Are No Penalty Default Rules in Contract Law*, 33 *FLA. ST. U. L. REV.* 563, 565 (2006) (arguing that penalty default rules are theoretical concepts that either “simply do not exist or are not a distinctive doctrinal category”).

41. For example, if the fiduciary and the senior investors agree on a given standard, the subordinated investors may disagree; or if the senior and subordinated investors agree on a different standard, the fiduciary may disagree.

42. See Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 *FLA. ST. U. L. REV.* 651, 651–53 (2006).

43. See, e.g., *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989) (“[Public bond] indentures are often not the product of face-to-face negotiations between the ultimate [bond]holders and the issuing company . . . [Rather,] underwriters ordinarily negotiate the terms of [public bond] indentures with the issuers.”); Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 *J. CORP. L.* 211, 215 (1991) (“Bondholders do not participate in fixing the terms of the usual indenture for publicly held bonds. This task is reserved by the issuer for itself with assistance from the lead underwriter of the issue.”).

Thus, even more so than in the case of two-party contracting, where problems often arise after default that were completely unanticipated *ex ante*,⁴⁴ contracting is unlikely to resolve the problem of fiduciary conflicts. Even worse, as commercial transactions increase in complexity, parties may find it more difficult to agree on contractual rules that anticipate outcomes.⁴⁵

Case-by-case contracting to resolve fiduciary conflicts would also be inefficient for another reason. Being subjected to a range of contractual standards would make it more difficult for fiduciaries, who at least in large commercial transactions are typically financial institutions, to develop and maintain a consistent institutional knowledge of fiduciary best practices.⁴⁶

Therefore there is a need for legal principles, beyond those resulting from case-by-case contracting, to help resolve the problem of fiduciary conflicts. The analysis below examines what these principles should be. It begins by addressing substantive rights and obligations,⁴⁷ asking whether a fiduciary with conflicting obligations should be viewed differently depending on the type of underlying commercial transaction with respect to which the fiduciary acts. After demonstrating that those rights and obligations should be largely independent of the underlying transaction (so long as it is commercial),⁴⁸ this Article focuses on conflicts among investors for which the fiduciary acts, first analyzing those conflicts in the absence of investor directions and then analyzing those conflicts when directions are given.⁴⁹ Thereafter, the analysis addresses potential

44. See, e.g., Deutsche Bank Interpleader Complaint, *supra* note 30, at 12–16 (litigating a completely unanticipated dispute regarding the order in which the collateral trustee should make payment to conflicting investors after default); see also Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 655 (1984) (“The future is always anticipated imperfectly in [financial] contracts, so there will always be some need for ex post adjustments . . .”).

45. Furthermore, because government agencies increasingly are concerning themselves with complex debt instruments insofar as such instruments raise systemic risk or other public policy issues, at least some of those contractual rules may not even hold. See Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 194–96 (2008).

46. Cf. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 85 (1991) (“All firms benefit from a judicial decision clarifying the scope of permissible conduct. The benefit of clarification is . . . identification of a rule around which the parties . . . can transact.”).

47. See *infra* Part III.

48. See *infra* Part III.A.

49. See *infra* Part III.B–C.

procedural solutions to fiduciary conflicts,⁵⁰ such as declaratory-judgment actions and requiring separate fiduciaries for each separate class of investors.

III. SUBSTANTIVE ANALYSIS

A. THE NATURE OF THE DILEMMA

A threshold question is whether the dilemma of a fiduciary with conflicting obligations should be viewed differently depending on the type of underlying commercial transaction for which the fiduciary acts. The answer should turn on whether the type of transaction drives anything material about the nature of the dilemma. Is the nature of the dilemma substantively different, for example, depending on whether the fiduciary acts as an indenture trustee on bonds or other investment securities, or as a collateral trustee for assets securing investment securities, or as a servicer of mortgage loans or other financial assets backing investment securities?

In each type of transaction, the nature of the dilemma is that a fiduciary must act, after default, on behalf of conflicted investors.⁵¹ Because its duty is so divided, the fiduciary cannot act ministerially, as a mere agent,⁵² but must exercise discretion.⁵³ The question is how to exercise that discretion. That question is more concerned with the investor conflict per se than with anything particular about the type of underlying commercial transaction.⁵⁴

Courts examining a fiduciary's conflicting obligations have similarly focused more on the conflict per se than on the type of

50. See *infra* Part IV.

51. This Article focuses on the dilemma of fiduciaries with conflicting obligations *after default*, when that dilemma is most pronounced. See *supra* notes 6–21 and accompanying text.

52. See, e.g., RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006) (imposing only a ministerial duty on an agent, subject to any contrary agreement, “to act with the care, competence, and diligence normally exercised by agents in similar circumstances”).

53. Cf. *Bank of N.Y. v. Mont. Bd. of Invs.*, [2008] EWHC (Ch) 1594, [59] (Eng.), 2008 WL 2697055 (concluding that where collateral is held for the benefit of conflicted investors, the collateral trustee “is not the mere agent of the creditors, but is required to exercise a discretion”).

54. Cf. Frankel, *supra* note 10, at 807–08 (observing that it is the potential for abuse of power inherent in fiduciary relationships, rather than the specific form of the fiduciary relationship, that is relevant when addressing fiduciary self-interest).

underlying commercial transaction.⁵⁵ For example, in the leading case of *Beck v. Manufacturers Hanover Trust Co.*, the fiduciary was a trustee under an indenture securing bonds issued by a railway company.⁵⁶ In analyzing the trustee's fiduciary responsibilities after default,⁵⁷ the court did not distinguish between the trustee and any other type of fiduciary. Indeed, the court observed:

[E]ven if the responsibilities of an indenture trustee may be significantly more narrowly defined than those of an ordinary trustee while the obligation that it is the indenture's purpose to secure remains current, subsequent to the obligor's default . . . the indenture trustee's obligations come more closely to resemble those of an *ordinary fiduciary*, regardless of any limitations or exculpatory provisions contained in the indenture.⁵⁸

The court's rationale was that, after default, bondholders will "be unable to . . . guard against the further impairment of their economic interests."⁵⁹

This Article will therefore analyze the dilemma generically,⁶⁰ using the example of two classes of conflicting investors, one senior and the other subordinated, after default.⁶¹ Although the existence of additional classes of investors with conflicting priorities would exacerbate the conflict, it should not fundamentally change the nature of the fiduciary's duties. Using the two-class example, this Article first analyzes the di-

55. *E.g.*, *Beck v. Mfrs. Hanover Trust Co.*, 632 N.Y.S.2d 520 (App. Div. 1995). This Article recognizes, of course, that normative legal principles should not necessarily follow positive law. *Cf.* ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 18 (2d ed. 1991) (contending that "'oughts' cannot be derived from 'what is'" (citing G.E. MOORE, *PRINCIPIA ETHICA* 10-14 (1971))). The point, however, is that normative principles and positive law coincide in answering the question.

56. *Beck*, 632 N.Y.S.2d at 522.

57. *Id.* at 526 (holding that the trustee "had responsibilities to the trust beneficiaries").

58. *Id.* at 527 (emphasis added); *see also* *LNC Invs., Inc. v. First Fid. Bank*, 935 F. Supp. 1333, 1347 (S.D.N.Y. 1996) (quoting *Beck*, 632 N.Y.S.2d at 527).

59. *Beck*, 632 N.Y.S.2d at 527; *cf.* Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 *BUS. LAW.* 559, 569 n.70 (2003) (arguing that collateral trusts are "closer to a traditional trust, involving the transfer of assets (i.e., collateral) to a fiduciary").

60. This Article assumes, however, that the underlying transaction for which the fiduciary acts is commercial. *See supra* text accompanying notes 32-50.

61. *See* Geoff Fuller & Elizabeth Collett, *Structured Investment Vehicles—The Dullest Business on the Planet?*, 3 *CAPITAL MKTS. L.J.* 376, 379 (2008) (demonstrating that this two-class structure is in fact typical of structured investment vehicles).

lemma of a fiduciary with conflicting obligations in the absence of investor directions and thereafter analyzes that dilemma when there are investor directions.

This is not to say that differences in the underlying transaction type could not affect the analysis. For example, a collateral trustee could not avoid conflicts by resigning when multiple classes of investors are secured by a single pool of collateral.⁶² Similarly, the discretionary options of mortgage servicers may be more limited than those of other fiduciaries.⁶³ Those differences, however, are largely marginal. Where they are significant, this Article will point them out.

B. THE FIDUCIARY WITH CONFLICTING OBLIGATIONS, ABSENT DIRECTIONS

Absent investor directions, any analysis must start with the fundamental assumption that the fiduciary is acting on behalf of all the conflicted investors.⁶⁴ What, then, are the fiduciary's obligations to each class of investors and how should the fiduciary balance those conflicting obligations? Using the generic example of two classes of investors, one senior and the other subordinated, after default,⁶⁵ there are at least three possible ways to balance those obligations: (i) the fiduciary should be neutral towards the conflict; (ii) the fiduciary should favor the senior-investor interests over the subordinated-investor interests; and (iii) the fiduciary should favor the subordinated-investor interests over the senior-investor interests. Determining the appropriate balance requires an understanding of the fiduciary's obligations to each investor class.

Subordination per se does not change the obligation of a firm to pay its respective creditors; it merely requires that subordinated creditors turn over payments received to senior creditors to the extent contractually agreed.⁶⁶ Therefore, the expect-

62. See *infra* note 147 and accompanying text.

63. See *supra* notes 16–18 and accompanying text (explaining that a mortgage servicer usually faces a relatively simple choice: to foreclose on a defaulted mortgage loan, or to work out the loan's indebtedness—though the latter option has its own complications).

64. Cf. *Beck*, 632 N.Y.S.2d at 526, 530 (finding that a trustee, over and above its obligations specified in the indenture, “owed its duty of loyalty . . . to all the trust beneficiaries”); *Bank of N.Y. v. Mont. Bd. of Invs.*, [2008] EWHC (Ch) 1594, [58]–[59] (Eng.), 2008 WL 2697055 (ruling that the trustee is not merely an agent of the senior class).

65. See *supra* notes 60–61 and accompanying text.

66. See, e.g., CHRISTOPHER L. CULP, *STRUCTURED FINANCE AND INSUR-*

tations of both senior and subordinated creditors vis-à-vis the firm should be the same. Logically, therefore, a fiduciary for either class of those creditors should, *except only for the relative priority of the obligations*, have the same obligations.

Prior to a default, those obligations are generally ministerial.⁶⁷ After a default, however, I have demonstrated in another article that a fiduciary's obligations to creditors should be to maximize value for the creditors.⁶⁸ From that perspective, next consider (in the context of the generic example) each of the three possible ways—being neutral towards the conflict; favoring the senior-investor interests over the subordinated-investor interests; favoring the subordinated-investor interests over the senior-investor interests—that a fiduciary could balance, as between these conflicting creditor classes, the obligation to maximize value.

The rationale for a rule making the fiduciary neutral towards the conflict, and thus impartial toward the respective investor interests, is obvious: favoring any particular investors would be inconsistent with a duty to all investors. Thus, in potentially analogous circumstances, the law governing gratuitous trusts imposes a duty of impartiality on a trustee acting for beneficiaries who, as among themselves, have conflicting interests (such as the conflicting interests of an income beneficiary and a remainderman).⁶⁹ The trustee must “deal impartially” with the beneficiaries.⁷⁰

ANCE: THE ART OF MANAGING CAPITAL AND RISK 287–90 (2006) (explaining that the proper way to understand subordination is to view the holders of subordinated securities as selling repayment insurance to all holders of securities that are contractually “senior”).

67. See *supra* note 5.

68. See Schwarcz & Sergi, *supra* note 8, at 1057–60 (explaining why “indenture trustees may well have—and certainly should have—a duty after default of *maximizing* bondholder recovery”); see also ROBERT I. LANDAU & JOHN E. KRUEGER, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT 171 (5th ed. 1998) (“If liquidation or reorganization becomes necessary, the trustee should see that the security holders realize their claims in full or to the greatest extent possible.”); JAMES E. SPIOTTO, DEFAULTED SECURITIES: THE PRUDENT INDENTURE TRUSTEE’S GUIDE XVIII-1 (1990) (“[I]t is the role of the indenture trustee to help maximize the return to the holders, once a default or troubled situation has occurred.”).

69. See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 183 & cmt. a (1990) (explaining that the duty of impartiality applies “whether the beneficiaries’ interests in the trust property are concurrent or successive”).

70. RESTATEMENT (THIRD) OF TRUSTS § 79 (2007) (“A trustee has a duty to administer the trust in a manner that is impartial with respect to the various beneficiaries of the trust”); *id.* § 79 cmt. b (“[I]t is the trustee’s duty, rea-

A duty of impartiality is usually sufficient for gratuitous trusts because the trustee can resolve conflicts by fulfilling the intentions of the trust's settlor.⁷¹ Such a duty is also feasible for gratuitous trusts because the expectations of conflicting gratuitous beneficiaries are usually more easily satisfied than the expectations of conflicting commercial beneficiaries.

Although the interests of senior and residual claimants of a [gratuitous] trust are technically inconsistent, the expectations of all such claimants would be satisfied merely by preserving the value of the trust assets. And preserving such value usually requires relatively ministerial effort on the part of a trustee. It therefore is feasible to operate under a duty of impartiality.⁷²

But a duty of impartiality provides insufficient practical guidance in a commercial context after default. Because there is no analogous figure to the settlor, the fiduciary cannot resolve conflicts by fulfilling the settlor's intentions.⁷³ Because the fiduciary's duty is to maximize, not merely preserve, value, the fiduciary may well need to exercise judgment. And because maximizing value necessarily involves a risk of losing value,⁷⁴ the fiduciary is much more likely to be subject to a lawsuit.⁷⁵ A

sonably and without personal bias, to seek to ascertain and to give effect to the rights and priorities of the various beneficiaries or purposes as expressed or implied by the terms of the trust."); *see also* UNIF. PRINCIPAL & INCOME ACT § 103(b) (amended 2008), 7A U.L.A. pt. III, at 429 (1997) ("[A fiduciary] shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust . . . clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."). Any action taken in accord with the Uniform Principal and Income Act (UPIA) "is presumed to be fair and reasonable to all beneficiaries." *Id.* All provisions of the UPIA are default rules which may be altered by the terms of the trust. *Id.* § 103(a).

71. Comment of Deborah A. DeMott, David F. Cavers Professor of Law, Duke Law School; former Reporter, Restatement (Third) of Agency, at Duke Law School Faculty Workshop on this Article (July 22, 2009) (on file with author); *see* JESSE DUKEMINIER ET AL., *WILLS, TRUSTS, AND ESTATES* 726 (8th ed. 2009) ("[T]rustee must take into account any preferences that the settlor may have expressed in the governing instrument or in some other manner.").

72. Schwarcz, *supra* note 59, at 578. Increasing commercial use of the trust form, however, may trigger future evolution of the trust-law duty of impartiality into a more sophisticated standard. *Cf. id.* at 579 ("If . . . a significant market in residual trust claims were to develop, it is not inconceivable that the law would evolve to impose on trustees a [more sophisticated] duty to such residual claimants . . .").

73. Comment of Deborah A. DeMott, *supra* note 71.

74. *See infra* note 87 and accompanying text.

75. *But cf.* Richard M. Horwood & Lauren J. Wolven, *Managing Litigation Risks of Fiduciaries*, Tax Mgm't Est., Gifts, & Tr. Portfolios (BNA) No. 857, at

duty of impartiality offers little guidance on these issues; it would not even help a fiduciary with conflicting obligations to decide, for example, whether to foreclose on collateral.

Next consider a rule requiring fiduciaries with conflicting obligations to favor senior-investor interests over subordinated-investor interests. The rationale for this rule would be that senior investors—by the very reason of being senior—are contractually favored over subordinated investors. The problem with such a rule, however, is that contractual subordination is typically limited in its scope, leaving (at best) ambiguity over whether senior investors should be favored in actions and decisions not explicitly covered by the contract.⁷⁶ Furthermore, fiduciary duties sometimes might even override contractual provisions.⁷⁷

Finally, consider a rule making fiduciaries with conflicting obligations favor subordinated-investor interests over senior-investor interests. At first blush, such a rule seems perverse, reversing the parties who are contractually favored. There is, nonetheless, a rationale for a limited rule of this nature: in scenarios where payment of principal and interest on the senior-investor interests is protected, their value is already maximized; creditors cannot receive more than principal and accrued interest on their claims.⁷⁸ The fiduciary thus has satisfied its obligation to the senior investors. The fiduciary, therefore, should be able to focus on its obligation to the subordinated investors, to maximize their value. This balancing is arguably Pareto optimal, increasing subordinated-investor value without harming the senior investors.⁷⁹

For example, say that collateral is sufficient after default to repay senior but not subordinated investors in full. This is, in fact, the most common default scenario.⁸⁰ If a delay in fore-

A-3 (Apr. 2, 2007) (observing a trend of increasing litigation against fiduciaries of gratuitous trusts).

76. *Cf. supra* notes 38–41 and accompanying text (explaining the difficulty of resolving conflicting fiduciary obligations through contract).

77. *See infra* notes 101–29 and accompanying text (examining contractarian and noncontractarian axioms underlying fiduciary analysis).

78. U.C.C. §§ 9-608(a)(4), 9-615(d) (2009).

79. *But cf. infra* note 82 (explaining why this may not be perfect Pareto optimality).

80. This can be understood intuitively by recognizing that, in a typical transaction, the total amount of collateral is “sized” to give the subordinated investors relatively little repayment risk and to give the senior investors virtually no repayment risk. *See* STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 2:4 (Adam D. Ford ed.,

closing is likely to increase collateral value, the fiduciary should forestall foreclosure.⁸¹ Because the senior investors would ultimately be repaid with interest, the delay would not materially impact their position.⁸²

It is interesting to observe that this type of limited rule—making fiduciaries with conflicting obligations favor the subordinated-investor interests over the senior-investor interests in scenarios where the senior-investor interests would already be protected—forms the basis of another potentially analogous conflicted-fiduciary-obligation scenario, that of the duty of a corporation's board of directors to shareholders and creditors. So long as the corporation is solvent (and thus able to pay its senior investors, i.e., its creditors), the board has a duty to favor the (subordinated) shareholder interests over creditor interests.⁸³ The implicit rationale is that such a duty maximizes value to all of the corporation's investors.⁸⁴

This analogy appears to be closer to the commercial context addressed by this Article than to gratuitous trust law and its duty of impartiality. Unlike gratuitous trust law, where the trust assets are usually conservatively invested and not placed

3d ed. 2009). This is done by paying senior investors, after default, from the extra collateral originally expected to pay the subordinated investors. *Id.*

81. Even if forestalling foreclosure is likely to increase collateral value, it may well pose some risk of losing collateral value; and at some point a loss of collateral value could even jeopardize repayment of the senior investors. A fiduciary can usually manage this risk, such as by being prepared to foreclose immediately should collateral value fall below a minimum threshold level. *See, e.g.,* Foote et al., *supra* note 19, at 25 (observing that even when borrowers are offered an initial "forbearance," creditors can protect themselves by reserving the right to foreclose if collateral value is declining and the borrower still appears unlikely to cure).

82. This may not be perfect Pareto optimality, because even if the delay in repayment is compensated by the payment of accrued interest, the delay could harm an illiquid investor who needs the payment to avoid default on its own obligations. In general, however, the law regards ultimate payment with accrued interest as a close equivalent to timely payment. *See, e.g.,* U.C.C. § 9-623 (2009) (prescribing a right to redeem collateral covered by the Uniform Commercial Code); 1 MICHAEL T. MADISON ET AL., *THE LAW OF REAL ESTATE FINANCING* § 5:36 (2009) (observing that a mortgagor who defaults has a right at equity to redeem the mortgaged property if he is able to repay the principal and accrued interest prior to a foreclosure sale).

83. *See, e.g.,* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007).

84. *See* Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 315–16 (1999) (discussing the efficiency rationale for shifting directors' duty from shareholders to bondholders in the vicinity of insolvency and commenting on the *Credit Lyonnais* decision in these terms).

at risk,⁸⁵ corporation law contemplates that the board of directors generally should place corporate assets at risk in order to generate profits and growth.⁸⁶ This same goal—to *maximize, rather than merely to preserve, value*—is also the obligation of a fiduciary for commercial investors after default.⁸⁷ Increasing value is “harder [than] merely preserv[ing] value,” making a “duty of impartiality difficult to apply” in a commercial context.⁸⁸ Conversely, a duty to favor subordinated, i.e., residual, beneficiaries would be impractical in the gratuitous trust context, because a fiduciary with conflicting obligations could rarely know, in advance of the senior beneficiary’s death, whether the senior beneficiary would already be protected by the trust assets.⁸⁹

The above analysis addresses the most common default scenario, where subordinated investors but not the senior in-

85. For example, if a husband dies after transferring a life-estate in assets for the benefit of his wife, residual to his children, and the trustee has a significant positive-expected-value opportunity of investing the estate’s assets in a venture with a ninety percent chance of doubling but ten percent chance of losing the assets, the trustee’s duty of impartiality would probably prevent the trustee from making this investment if the wife is destitute and cannot accept this small risk of loss. Schwarcz, *supra* note 59, at 577. Trust law does not absolutely bar a trustee from placing assets at risk, however. If the wife in the foregoing example is independently wealthy, the trustee “would have more leeway to make this investment consistent with the duty of impartiality.” *Id.* at 577 n.122. Also, the settlor may have indicated that the assets should be aggressively invested. See *DUKEMINIER ET AL.*, *supra* note 71, at 726 (“The trustee must take into account any preferences that the settlor may have expressed in the governing instrument or in some other manner.”).

86. See *In re United Artists Theatre Co. v. Walton*, 315 F.3d 217, 233 (3d Cir. 2003) (explaining that the business judgment rule acknowledges that board’s function includes “decisionmaking . . . [involving] the weighing of the potential of risk against the potential of reward”); 18B AM. JUR. 2D *Corporations* § 1470 (2009) (same).

87. See *supra* note 68 and accompanying text; cf. Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 650–52 (2004) (comparing trust law with corporation law).

88. Schwarcz, *supra* note 59, at 578; see also Schwarcz & Sergi, *supra* note 8, at 1058–59 (explaining why the analogy between the fiduciary duties of corporate directors and of fiduciaries with conflicting obligations remains sound).

89. For example, posit a gratuitous trust paying *X*’s expenses for life, remainder to *Y*. A fiduciary with conflicting obligations could not know in advance what those expenses will be because the fiduciary would not know *X*’s lifespan and what *X* spends. Similarly, even if the trust were created to pay *X* \$500 per week for life, remainder to *Y*, a fiduciary with conflicting obligations could not know in advance what those expenses will be because the fiduciary would not know *X*’s lifespan. In a commercial context, however, the amount of the senior-investor interests is calculable, equal to the principal amount invested and accrued, but unpaid, interest to the date of payment.

vestors would be at risk.⁹⁰ In some cases, however, there could be uncertainty as to whether even senior investors will be repaid their principal and accrued interest. In these cases, it is more difficult to say how the fiduciary should balance its obligations to these conflicting classes of investors. Any such balancing, however, should be fact sensitive.

Consider, for example, a scenario in which the collateral is insufficient to pay even the senior investors. The fiduciary has the same obligation, technically, to both the senior investors and the subordinated investors, to maximize their value.⁹¹ If it is uncertain whether delaying foreclosure would increase or decrease collateral value, or if any increase in value would likely be insufficient to pay a material amount of the subordinated claims,⁹² the fiduciary should favor the senior investors over the subordinated investors. The rationale is that senior investors would suffer the first risk of loss and would benefit from the first gain in value, whereas it is unlikely that the fiduciary could materially increase value to the subordinated investors. But if the collateral value is likely to increase to a level sufficient to repay at least a material amount of subordinated claims, the fiduciary should favor the subordinated over the senior investors, the rationale being that increasing value will benefit *both* senior investors and subordinated investors. Thus, where there is uncertainty as to whether even senior investors will be repaid, a fiduciary should balance its obligations to conflicting classes of investors by assessing how favoring particular classes would impact the likelihood and materiality of gains and losses to all classes to which the fiduciary owes obligations.⁹³ Next consider the more dramatic conflict of a fiduciary given directions by a senior class of investors to act in a way that will harm the subordinated class.

90. See *supra* note 80 and accompanying text.

91. See *supra* note 68 and accompanying text.

92. A fiduciary customarily would make these determinations by seeking expert valuation services. *Bank of N.Y. v. Mont. Bd. of Invs.*, [2008] EWHC (Ch) 1594, [20]–[21] (Eng.), 2008 WL 2697055.

93. Thus, the fact that subordinated creditors have relatively minimal covenants compared to senior creditors does not appear to me to be relevant to this analysis.

C. THE FIDUCIARY WITH CONFLICTING OBLIGATIONS, GIVEN DIRECTIONS

In some cases the agreement governing the fiduciary will purport to empower a class of investors, typically the senior class after a default occurs, to give directions to the fiduciary. For example, security agreements sometimes empower senior classes of investors, after default, to direct the collateral trustee regarding foreclosure,⁹⁴ and in securitization transactions the so-called pooling and servicing agreement may empower the senior investors to direct the trustee after default regarding remedies.⁹⁵ This can create a conflict between the interests of the class giving directions and other classes.

A similar conflict can arise even where the directed fiduciary acts for investors in a *single* class of *pari passu* securities.⁹⁶ With the rise of hedge funds and other distressed-debt investors, one or more such investors may gain majority voting control of a particular class of securities. In some cases, these investors have attempted to privately negotiate exchange offers or other arrangements with the issuer of the securities, intended to give the funds an advantage over other investors in their class.⁹⁷

Regardless of how the conflict among investors arises, the fundamental issues concerning the directed fiduciary are the

94. See Laurie S. Goodman et al., *Event of Default Provisions and the Valuation of ABS CDO Tranches*, 17 J. FIXED INCOME, Winter 2007, at 85, 85–86 (observing that security agreements in most CDO transactions enable the controlling class of investors to direct the collateral trustee regarding foreclosure if an overcollateralization test—a required minimum ratio of the value of the underlying collateral to the value of the senior class—is not met).

95. See Gary Barnett, *Understanding CDOs in the Current Market Environment*, in NEW DEVELOPMENTS IN SECURITIZATION 2008, *supra* note 35, at 739, 748.

96. Cf. Schwarcz & Sergi, *supra* note 8, at 1071 (observing that the power of majority bondholders to direct the trustee “raises serious, unresolved issues” such as “whether the majority bondholders should have legal duties to other bondholders and, if so, what should be the standard for those duties” in situations where “[s]ome or all of the majority bondholders . . . have conflicts of interest with other bondholders”).

97. See, e.g., Kaplan & Hebbeln, *supra* note 5, at 21–28 (discussing recent challenges to discriminatory consent solicitations and exchange offers); see also Jeffrey J. Powell, *Doing the Right Thing in Corporate Trust*, ABA TR. & INVESTMENTS, July–Aug. 2008, at 38, 38 (“[M]ost indenture documents instruct the trustee to receive and follow direction from 50 percent of the principal amount of the bondholders.”).

same.⁹⁸ The analysis below therefore focuses—as did the analysis of a fiduciary with conflicting obligations absent directions—on the generic example of two classes of conflicting investors, one senior and the other subordinated. The analysis now assumes, however, that the senior class, pursuant to the agreement governing the fiduciary, is attempting to direct the fiduciary.⁹⁹

As a conceptual matter, one way to think about this dilemma is to ask whether, after such directions are given, this Article's central assumption up to now—that the fiduciary is acting on behalf of all the conflicted investors—remains true. Perhaps, after such directions are given, the fiduciary is acting solely for the directing investors.¹⁰⁰ If it is acting solely for the directing investors, the fiduciary would logically have no obligation to protect the nondirecting investors.

Determining whether a directed fiduciary is acting on behalf of all the conflicted investors or, instead, solely for the directing investors raises its own dilemma. Scholars posit two ways of interpreting fiduciary duties. One way is contractarian, that fiduciary duties should be viewed merely as contractual default terms.¹⁰¹ Fiduciaries then are subject to clear contrac-

98. *Cf. infra* note 105 (discussing the *Beck* case, in which the trustee actually acted for a single class of *pari passu* securities).

99. Although (as discussed) a conflict can also arise where majority investors in a particular class of securities attempt to gain an advantage over other investors in their class, *see supra* note 97 and accompanying text, that distinction should not fundamentally change how the duties of a fiduciary with conflicting obligations should be analyzed. A fiduciary should, nonetheless, try to be sensitive to the possibility that majority investors directing the fiduciary are attempting to gain an advantage over other investors in their class, perhaps by inquiring whether the majority investors are conflicted with other investors of the class (as would occur, for example, when the majority-investor directions are intended to benefit other investments owned by the majority). *See* Interview with Harold L. Kaplan, *supra* note 4.

100. *Cf. supra* notes 52–53 and accompanying text (observing that so long as its duty is divided, the fiduciary cannot act ministerially as a mere agent).

101. *See, e.g.,* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (“Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings. Actual contracts always prevail over implied ones.”); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 660 (1995) (arguing that fiduciary duties governing gratuitous trusts should be seen as contractual default rules); Mariana Pargendler, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV. 1315, 1315 (2008) (arguing that “fiduciary duties are untailored defaults that supply the term that most parties in a certain fiduciary category would have wanted,” and that this is normatively desirable).

tual provisions to which the investors have implicitly (or, in some cases, explicitly) consented.¹⁰² The other way is noncontractarian, that the fiduciary relationship is unique in providing mandatory rules and that fiduciaries have duties that override even clear contractual provisions.¹⁰³ These two ways of interpreting fiduciary duties represent fundamentally divergent axioms.¹⁰⁴

Courts and commentators do not always consciously recognize the existence of these divergent axioms, resulting in ambiguous and sometimes inconsistent rules. In the *Beck* case, for example, the court held that a collateral trustee, *over and above its obligations specified in the indenture*, “owed its duty of loyalty . . . to all the trust beneficiaries.”¹⁰⁵ This suggests a noncon-

102. See Langbein, *supra* note 101, at 660.

103. See, e.g., Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 887 (arguing that applying the conceptual framework of contractual analysis to fiduciary relationships is misleading, in part because many fiduciary duties are mandatory rules); Scott FitzGibbon, *Fiduciary Relationships Are Not Contracts*, 82 MARQ. L. REV. 303, 305 (1999) (“[F]iduciary relationships . . . arise and function in ways alien to contractualist thought, and . . . have value and serve purposes unknown to the contractualists. Notably, that they facilitate the doing of justice, that they promote virtue, and that they enhance freedom in a distinctive way.”); Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99, 103–04 (2008) (arguing that the noncontractual approach better describes fiduciary duties than the contractual approach); Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 72 (2005) (arguing that in the context of trust law the moral content of fiduciary duties should be preserved and courts should enforce only relatively narrow disclaimers of fiduciary duties).

104. Cf. Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573, 579–80 (1998) (describing differences between “proceduralist” and “traditionalist” views of bankruptcy, arguing that these reflect irreconcilable starting points, and that this disagreement results in differing views concerning the goal of bankruptcy proceedings, the effects of case law on parties’ ex ante behavior, and the proper role of judges).

105. *Beck v. Mfrs. Hanover Trust Co.*, 632 N.Y.S.2d 520, 530 (App. Div. 1995) (conflating the duties of loyalty and impartiality). Manufacturers Hanover Trust Co. was a successor trustee for holders of defaulted bonds issued by a railway company. Mexico “for decades had had designs upon obtaining the collateral.” *Id.* at 529. Mexico, therefore, “systematically purchased in excess of 95% of the bonds” and, as dominant bondholder, “had called for an auction” of the collateral. *Id.* It was clear that Mexico, directly or indirectly, would purchase the collateral at the auction, and that, given the absence of other bidders, the purchase price would plainly be the “upset,” or minimum sale, price set by the trustee. *Id.* at 529–30. Presumably at the contractual direction of Mexico—it had this right under section 5 of the Indenture, which provided that holders of seventy-five percent of the amount of the prior lien bonds outstanding were entitled “to direct and to control the method and place of conducting any and all proceedings for any sale of the premises hereby conveyed

tractarian approach. The same opinion, however, earlier includes language suggesting a contractarian approach: “The trustee must in the post-default context act prudently, but only in the exercise of those rights and powers granted in the indenture. The scope of the trustee’s obligation then is still circumscribed by the indenture”¹⁰⁶ Later courts sometimes question *Beck*’s contractarian language, arguing that fiduciaries have extra-contractual fiduciary duties as to “any conduct not specifically prohibited by the indenture which would enable the investors to” obtain repayment.¹⁰⁷

Commentators raise similar inconsistencies.¹⁰⁸ For example, a leading indenture trustees’ lawyer, in the context of examining an attempt by majority investors to gain an advantage over other investors in their class, argues that an indenture trustee with conflicting obligations should “[f]ollow the direction of the majority, but always protect the minority.”¹⁰⁹

The Restatement of Trusts, which most closely examines the dilemma of trustees with conflicting obligations (albeit in a gratuitous-trust context), takes a semicontractarian approach. If the terms of a trust:

confer upon [a particular beneficiary] a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to . . . comply with any exercise of that power, unless . . . the trustee

[i.e., the collateral]”—the trustee set a very low minimum sale price for the collateral, without arranging for a fair third-party valuation. *Id.* at 523–24. The court held that, “[g]iven this state of affairs, it was absolutely crucial to the interests of the trust beneficiaries as beneficiaries, as opposed to the interests of Mexico as a beneficiary/prospective-purchaser, that the collateral be fairly valued by a disinterested party.” *Id.* at 530.

106. *Id.* at 528.

107. *LNC Inv., Inc. v. First Fidelity Bank*, 935 F. Supp. 1333, 1348 (S.D.N.Y. 1996).

108. Compare Rawlings, *supra* note 14, at 15 (“In the US, . . . the obligations of the note trustee do not emerge from a fiduciary duty owed to the note-holders, but are ‘exclusively defined’ by the trust deed.”), and *id.* at 16 (“[U]nder English law note trustees are trustees and as such the courts regard them as under certain core obligations”), with Melanie Ryan & Andrew Yong, *Springwell—Are the English Courts the Venue of Last Resort for Complex Investor Claims?*, 24 J. INT’L BANKING L. & REG. 54, 60 (2009) (“[P]arties to complex financial disputes seeking to enforce the strict contractual terms of a transaction will endeavour to have their case heard before English courts applying English law . . . , whereas those seeking to look behind the contractual documents and perhaps avoid the strict application of their terms are more likely to seek to have their case heard before the New York courts applying New York law . . .”).

109. Powell, *supra* note 97, at 38. This begs the question, of course, of what the minority should be protected against.

knows or has reason to believe that the attempted exercise violates a fiduciary duty that the *power holder* owes to the beneficiaries.¹¹⁰

Applying this rule in a commercial context, one would expect that senior investors—who typically are (and in this Article’s example are assumed to be) the power holders/directing investors—do not generally have fiduciary duties to subordinated investors. Thus, a fiduciary with conflicting obligations would have to comply with directions given by senior investors, even if subordinated investors are harmed. The Restatement makes the answer more complex (and somewhat circular), however, by providing that, except as discussed below, the power holder (in our case, the senior investor) is subject to the same fiduciary duty to other beneficiaries as is the trustee¹¹¹—and the trustee, of course, has a fiduciary duty to the subordinated class.

This circularity is broken only if the “power [is] granted for the sole benefit of the designated power holder.”¹¹² Such a power “is not a fiduciary power.”¹¹³ However, whether a power is granted for the sole benefit of a designated power holder “depend[s] upon trust language and all relevant circumstances” and “no precise rules on the matter can be stated.”¹¹⁴

It is certainly plausible, if this rule were applied in a commercial context, that a power given to senior investors after de-

110. RESTATEMENT (THIRD) OF TRUSTS § 75 (2007) (emphasis added). The power holder may itself be a beneficiary, as in the case of the senior class directing the trustee. *Id.* § 75 cmt. a.

111. *See id.* § 75 cmt. f (stating that the power holder has a duty “not to exercise the power in a manner inconsistent with the fiduciary duties owed to one or more of the beneficiaries”); accord Alexander Trukhtanov, *The Irreducible Core of Trust Obligations*, 123 L.Q. REV. 342, 344 (2007) (“[T]he larger the scope of the protector’s powers [to direct the trustee], the greater the case for treating him as a fiduciary or indeed a quasi-trustee.”).

112. RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. c (2007).

113. *Id.* § 75 cmt. d.

114. *Id.* § 75 cmt. c.; cf. *Fifth Ave. Bank of N.Y. v. Nunan*, 59 F. Supp. 753, 757 (E.D.N.Y. 1945) (holding that New York trust law exempts a directed trustee of a *gratuitous trust* from fiduciary responsibility only if the direction is “express and unambiguous; it cannot be implied”). Query whether a commercial trust, where parties are sophisticated business entities, should be subject to a lower standard than “express and unambiguous.” *Id.* But cf. GEORGE GLEASON BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 541 (1993) (observing that even where terms of the instrument expressly and unambiguously seek to limit the standard of care for which the trustee is responsible, “[t]he grant of broad discretionary powers to the trustee does not relieve him from the duty to use ordinary skill and prudence in his administration of the trust” and that “[a]n exculpatory or immunity clause . . . should not, as such, either reduce or expand the required standard of care”).

fault to direct the trustee or other fiduciary could have been intended to be for the sole benefit of those investors. The fiduciary then would be required to comply with their directions so long as the senior investors do “not abuse the power by exercising it in a manner that is harmful or indifferent to the interests of the other beneficiaries *when such exercise is not reasonably related to the benefit intended for the power holder.*”¹¹⁵

For analysis purposes, the foregoing discussion hypothetically applies the rules of the Restatement of Trusts in a commercial context even though that Restatement does not apply to commercial trusts.¹¹⁶ Nonetheless, the Restatement’s rules, and a contractarian approach generally, appear sensible in a commercial context.¹¹⁷ Investors, for example, are usually sophisticated parties who are, or at least should be, aware of their contractual terms.¹¹⁸ Furthermore, by enabling commercial parties to rely on enforcing contractual provisions, a contractarian approach lowers the cost of financing and conse-

115. RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. d (2007) (emphasis added). *But cf.* Citibank, NA v. MBIA Assurance SA, [2006] EWHC (Ch) 3215, [7] (Eng.), 2006 WL 3835286 (quoting clause 10.4 of a deed of trust among the issuer of Notes, Citibank as trustee, and MBIA as guarantor of the notes, that “[w]hen giving any instructions, consents or waivers under the Transaction Documents, MBIA . . . need have no regard to the interests of the Noteholders, the Trustee or any other Issuer Secured Creditors”); *id.* [48] (enforcing MBIA’s directions because “the Noteholders all take their commercial interests on terms that, and knowing that, MBIA wields the power that it wields. Whether or not this is good business, it is certainly not inimical to a trust structure. It is what the Noteholders have agreed should be the case.”).

116. Part 1, Chapter 1 (Definitions and Distinctions) of the Restatement states, for example, that “[t]he Restatement of Trusts does not deal with such devices as . . . trusts used for purposes of security.” RESTATEMENT (THIRD) OF TRUSTS, ch. 1, introductory note. Section 1, Comment b, of the Restatement reiterates that the “law relating to the use of trusts as a security device . . . is not within the scope of this Restatement.” *Id.* § 1, cmt. b. Although “many” of the rules of the Restatement do apply, different rules are often applicable. *Id.* ch.1, introductory note.

117. *Cf.* UNIF. TRUST CODE § 102 cmt., 7C U.L.A. 411 (2000) (stating that although the Uniform Trust Code applies primarily to gratuitous trusts, it also applies to trusts that have a business or commercial purpose to the extent that neither the trust instrument nor other legislation displace the Code’s provisions).

118. There may be a second, less clearly supported, implicit rationale for this rule: that gratuitous trust directions generally involve specific actions. *See* 76 AM. JUR. 2D *Trusts* § 136 (2005). To the extent this second rationale is the rationale for the rule, it is less likely to have applicability in a commercial-trust context. This is because courts of equity usually are willing to grant specific performance only where money damages is not a remedy, 71 AM. JUR. 2D *Specific Performance* § 10 (2001); for commercial trusts, only money is at stake.

quently lowers rates on the underlying financial assets, such as mortgage loans.¹¹⁹

Perhaps implicitly for these reasons, one commentator recently argued that contractual private ordering will take care of the fiduciary conflict, effectively making subordinate investors—at least in the context of certain CDO and ABS CDO transactions—the “slave” of the super-senior class.¹²⁰ For example, even though the documentation of many CDO transactions include “fire sale protection provisions” intended to prevent the underlying assets from being liquidated unless their market value is sufficient to repay senior and subordinated investor claims, super-senior investors usually have contractual power to direct liquidation in the event of certain contingencies,¹²¹ notwithstanding an insufficiency on the subordinated claims.¹²²

A rigidly contractarian approach to fiduciary conflicts would not be conceptually satisfying, however. Even in a nonfiduciary setting, freedom of contract is not and should not be absolute. Freedom of contract can be limited, for example, by paternalism, policy, and potential externalities.¹²³ Although paternalism is not necessarily relevant to the commercial context of this

119. *Cf.* Citibank, NA v. MBIA Assurance SA, [2007] EWCA (Civ) 11, (2007) 1 All E.R. (Comm.) 475 (Eng.), 2007 WL 2852. A trustee, seeking guidance from an English court, was instructed to follow directions given by the assignee of a contractually empowered investor class, notwithstanding other investor objections, on the basis that commercial parties should be able to rely on contractual provisions. *Id.* [7], [81].

120. Comment of Kenneth Kettering, Assoc. Professor, New York Law School, *following* Keynote Address at New York Law School Symposium: Fear, Fraud, and the Future of Financial Regulation (Apr. 24, 2009); *see also* Aline van Duyn & Michael Mackenzie, ‘Tranche Warfare’ Breaks Out Over CDOs, FIN. TIMES, Apr. 15, 2008, <http://www.ft.com/cms/s/0/9e8e661c-0a85-11dd-b5b1-0000779fd2ac.html>. The authors point out that the “downgrades of some of the bonds backing CDOs are triggering little-noticed ‘event of default’ clauses, which often allow senior noteholders to take control of all the income.” *Id.* What happens next is that “[s]enior noteholders can then accelerate payments from the CDO, which leaves other investors with the prospect of no interest payments for months or years, and also gives them no say in whether or not the instrument should be liquidated.” *Id.*

121. For example, if the discounted value of the underlying collateral assets falls below the amount of a given super-senior class, that class may have the contractual right to terminate the CDO transaction and liquidate the collateral assets. *See* Goodman et al., *supra* note 94, at 85.

122. *See id.*; *see also* Barnett, *supra* note 95, at 748–49.

123. *See, e.g.*, Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 534–52 (1999) (explaining why freedom of contract is not, and should not be, absolute).

Article, fiduciary considerations may well tie into policy and externality limitations on contractual freedom.¹²⁴

In certain cases, for example, a rigidly contractarian approach can trigger market failures. Thus, in the financial crisis, unchecked super-senior investor voting control may well have contributed to the increase in foreclosures on financial assets underlying the securities.¹²⁵ A rigidly contractarian approach can also exacerbate the consequences of market failures. Consider the agency costs that may arise when investment officers, recommending that their institutions purchase subordinated securities, focus too much on the high interest rate on those securities (and thus the high bonus the officers will be paid for re-

124. *Cf. Citibank, NA*, [2007] EWCA (Civ) 11, [58], [82] (observing that a fiduciary has an “irreducible” minimum obligation, but that such minimum was not violated).

125. E-mail from Carolyn P. Richter, Partner, Troutman Sanders LLP, to author (Aug. 5, 2009) (on file with author).

The creation of senior and subordinated tranches logically leads to voting provision[s] in an indenture or pooling and servicing agreement that allow the senior tranche, by contract or as a practical matter, to control or heavily influence the actions taken by the servicer with the borrower. . . . If a senior class is able by contract [sic] or as a practical matter to control the servicer’s actions post-default, the senior class logically will direct the servicer to foreclose and pay the senior tranche, with the remainder of the foreclosure proceeds, if any exist at all, being available to pay the subordinated class that bargained for a riskier position in the distribution scheme [but a higher contractual rate of return]. *This inescapable conflict among the classes leads to an increase in foreclosure rates, negatively impacts the borrower[s], and, in the case of residential mortgages, the community by driving down property values.* This leads one to consider whether multi-tranche issuances of securities backed by a single pool of mortgages is bad for public policy, unless the right of the senior tranche is checked in some manner.

Id. (emphasis added).

At least partly in response to this unchecked voting control, Congress recently enacted a law requiring servicers, when restructuring mortgages for owner-occupied homes, to owe a duty to maximize value to investors as a whole, not to any particular investor groups. *See* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 201(b), 123 Stat. 1632, 1638–39 (amending 15 U.S.C. § 1639a, Truth in Lending Act § 129A). Under an earlier version of § 1639a, this duty was explicitly a default rule. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1403(a), 122 Stat. 2654, 2809 (amending Truth in Lending Act by inserting new section 129A, codified as 15 U.S.C. § 1639a). The current version likewise appears to be a default rule; even though it lacks the explicit language of its predecessor, versions of the bill that would have made this a mandatory rule were not passed. *See* 155 CONG. REC. H2999 (daily ed. Mar. 5, 2009) (reading proposed version of the Helping Families Save Their Homes Act to say, “[n]otwithstanding any other provision of law, and notwithstanding any investment contract between a servicer and a securitization vehicle or investor . . .”).

commending the investment), and not enough on the consequences of those securities defaulting. The investment officers may expect to be at different jobs before a default occurs.¹²⁶ Or, like individuals generally, they may underestimate events, like a default, that are remote.¹²⁷ Or they may feel, and in fact be, secure from being fired if many other investment officers are acting the same way.¹²⁸ In the recent financial crisis, for example, investment officers often recommended that their institutions purchase highly complex mortgage-backed securities they did not fully understand, apparently feeling safe in following the herd.¹²⁹

A contractarian approach should also be limited by some concept of good faith, there being a duty of good faith implied in all contracts.¹³⁰ The Restatement's limitation in this regard—that a fiduciary should not be obligated to follow contractual directions that are not reasonably related to the benefit intended under the contract¹³¹—appears sensible.¹³² This limitation also

126. Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 14 (observing that analysts who have jobs with limited time horizons may have low accountability).

127. See, e.g., John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 294–95 (2004) (citing Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 3 (Daniel Kahneman et al. eds., 1982)).

128. Cf. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1038 (2000) (discussing how herd behavior may have a reputational payoff even if the chosen course of action fails, and arguing that where “the action was consistent with approved conventional wisdom, the hit to the manager’s reputation from an adverse outcome is reduced”); Schwarcz, *supra* note 126, at 14 (discussing findings by Professors Paul M. Healy and Krishna Palepu that investment-fund managers who, believing a stock is overvalued, nonetheless follow the crowd will not be blamed if the stock ultimately crashes).

129. See Steven L. Schwarcz, *Disclosure’s Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1114–15 (examining herd behavior as a partial explanation of the behavior of investment officers in the recent financial crisis).

130. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); cf. DEL. CODE ANN. tit. 6, § 15-103(f) (2005) (“A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a partnership . . . provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”).

131. See *supra* note 115 and accompanying text.

132. See *supra* note 99 and accompanying text (in which a leading indenture trustees’ lawyer suggests that indenture trustees should be sensitive to

has precedent in a somewhat analogous problem of commercial law—the problem of when a bankruptcy court should exclude the vote of an investor “whose acceptance or rejection of [a plan of reorganization] . . . was not in good faith.”¹³³ Although “good faith” is not statutorily defined for this purpose, courts have generally found it to be lacking where the investor “is using *obstructive tactics* and hold-up techniques to extract better treatment for its claim compared to the treatment afforded similarly situated claimholders *in the same class*,” the vote is cast “for the *ulterior purpose* of securing some advantage to which [the investor] would not otherwise be entitled,” or “the motivation behind [the investor’s] vote is *not consistent with a creditor’s protection of its own self-interest*.”¹³⁴ Moreover, the limitation has precedent in corporation law.¹³⁵

the possibility that investors directing them are attempting to gain advantages, not contemplated by the indenture, over other investors); *cf.* Schwarcz & Sergi, *supra* note 8, at 1071 n.258 (asserting that majority bondholders, to avoid or at least mitigate the impact of conflicts, “should have a duty to act in good faith on behalf of all bondholders” of their class, and that a “majority bondholder who, for example, votes strategically [to direct the trustee] to enhance the value of an unrelated investment, such as an equity interest in the issuer, would be violating this duty”).

133. 11 U.S.C. § 1126(e) (2006); *see also id.* § 1126(c)–(d) (excluding votes so designated under § 1126(e)).

134. *In re Adelpia Commc'ns Corp.*, 359 B.R. 54, 60 (S.D.N.Y. 2006) (emphasis added); *see also In re Kovalchick*, 175 B.R. 863, 875 (E.D. Pa. 1994) (stating the same description of bad faith). The most common type of bad faith case is the “ulterior motive” case. *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844 (S.D.N.Y. 1995). Common “badges” of bad faith are said to include votes designed to assume control of the debtor, put the debtor out of business or otherwise gain a competitive advantage, destroy the debtor out of pure malice, or obtain benefits under a private agreement with a third party which depends on the debtor’s failure to reorganize. *Id.* at 844–45. Stated differently, bad faith may be found where “(i) the claimholder attempts to extract or extort a personal advantage *not available to other creditors in its class*, and (ii) the creditor has an ulterior motive . . . that does not relate to its claim.” *Id.* at 844 (emphasis added).

135. Corporation law recognizes that a controlling shareholder may serve his own interests, subject to a fiduciary duty not to misuse the control by promoting his personal interests at the expense of corporate interests or oppressing or defrauding the minority shareholders. *United States v. Byrum*, 408 U.S. 125, 137 (1972). Thus, a controlling shareholder cannot reduce dividend distributions in a manner designed to force the minority to sell its shares at a low price. *Labovitz v. Dolan*, 545 N.E.2d 304, 312–14 (Ill. App. Ct. 1989); *see also id.* at 308 (citing *Meinhard v. Salmon*, 249 N.Y. 458, 463–64 (1928) (Cardozo, C.J.) (stating that a majority shareholder owes a duty of good faith and loyalty to the minority shareholders)); *Dodge v. Ford Motor Co.*, 170 N.W. 668, 681–84 (Mich. 1919).

Limiting in this way the contractarian approach to resolving fiduciary conflicts should even be consistent with the commercial rationale for that approach—lowering the cost of financing.¹³⁶ Financing costs should not rise because directions that are not reasonably related to the benefit intended under the contract are unlikely to have been contemplated by any investors or other parties except, possibly, the investor giving such directions.¹³⁷

A contractarian approach to resolving fiduciary conflicts thus appears sensible to the extent there are contractual directions. In a commercial context, investors are usually sophisticated, and contractual reliance lowers financing costs. But the contractarian approach should not be rigid. Even in a nonfiduciary setting, freedom of contract is not and should not be absolute, and contracts are also limited by concepts of good faith. Thus, a fiduciary should not be obligated to follow directions that are likely to trigger or exacerbate the consequences of significant market failures, especially when the failures could be systemic. Likewise, a fiduciary should not be obligated to follow contractual directions that are not reasonably related to the benefit intended under the contract.

IV. PROCEDURAL ANALYSIS

The analysis above addresses substantive rights and obligations of a fiduciary with conflicting obligations. This Part examines what procedural steps could be taken to reduce fiduciary conflicts or to lessen their impact and make them easier to resolve. These steps would have particular value in jurisdictions where the substantive rights and obligations of a fiduciary with conflicting obligations remain unresolved or ambiguous.

A. PROVIDING ALGORITHMIC CERTAINTY

The most obvious step that, at least theoretically, could be taken to reduce fiduciary conflicts would be to craft contractual

136. See *supra* note 119 and accompanying text.

137. The good faith limitation on the contractarian approach, discussed above, represents a minimum that should be applicable to fiduciary conflicts. The limitation arises in the context of investors voting on a plan of reorganization, but such investors have no fiduciary or other independent obligation to vote for the course of action they believe is fair to others. See *In re Adelpia Commc'ns Corp.*, 359 B.R. at 62. In contrast, fiduciaries with conflicting obligations should attempt to fairly balance their obligations to multiple investor classes.

provisions that provide fiduciaries with algorithmic or otherwise easy-to-follow rules to address conflicts.¹³⁸ In practice, though, this would appear to be an illusory quest; one can never predict all possible conflict issues and their permutations. Therefore, in the “constantly changing environment of a fiduciary relationship, the [fiduciary’s] obligations must be articulated in general and open-ended terms.”¹³⁹

Some conflicts would be easier to anticipate, such as a fiduciary acting for both interest- and principal-only investors or for both senior and subordinated investors. Although it might be tempting to consider regulation restricting investor conflicts, any such regulation would artificially restrict financing flexibility, potentially causing unintended consequences.¹⁴⁰ For example, the senior-subordinate structure is universally recognized and, among other benefits, enables companies and investors to more precisely allocate risks to investment preferences.¹⁴¹ It also represents an effective substitute for third-party guaranties at a time when few third parties are of sufficient creditworthiness for their guaranties to be commercially meaningful.¹⁴² A better approach, perhaps, is to require separate fiduciaries for each class of conflicted investors.

138. In theory, algorithmic or otherwise easy-to-follow contractual rules to address fiduciary conflicts should remove the “fiduciary,” insofar as it follows those rules, from fiduciary duties. *Cf.* *Citibank, NA v. MBIA Assurance SA*, [2007] EWCA (Civ) 11, [82], (2007) 1 All E.R. (Comm.) 475 (Eng.), 2007 WL 2852 (observing that “it would be a surprising interpretation of the documentation, against which the court should lean, if the powers of the trustee were so reduced that it ceases to be a trustee at all . . .”). A noncontractarian would likely argue, though, that the fiduciary’s inherent duties should at least sometimes override mechanical application of those contractual rules. *See, e.g.*, Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 99–107 (2005) (arguing that a duty of care should apply to trustees of gratuitous trusts, and that this duty should be waivable only in specific, narrow contexts).

139. Cooter & Freedman, *supra* note 2, at 1049. Parties nonetheless should strive to craft easy-to-follow rules. *Cf.* Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313, 1322 (2009) (“Parties should write underlying deal documentation that sets clearer and more flexible guidelines . . .”).

140. Regulation may not even be needed, because parties structuring transactions and investors themselves should, when appropriate, want simplification to avoid uncertainty arising out of fiduciary conflicts. *See, e.g.*, Schwarcz, *supra* note 139, at 1322 (recommending that parties in securitization transactions “should try to minimize allocating cash flows to investors in ways that create conflicts”); *cf.* AMERICAN SECURITIZATION FORUM ET AL., RESTORING CONFIDENCE IN THE SECURITIZATION MARKETS 13–14 (2008) (recommending harmonizing and improving securitization servicing standards).

141. SCHWARCZ, *supra* note 80, § 2:4.

142. *Id.*

B. REQUIRING SEPARATE FIDUCIARIES FOR EACH CLASS

Requiring separate fiduciaries for each potentially conflicted investor class could be very expensive. Whether that cost would be justified is ultimately an empirical question.¹⁴³ There may, however, be a middle ground: requiring separate fiduciaries only for conflicted investor classes after default.

The Trust Indenture Act in the United States takes this middle ground. Trustees on public bond issues in the United States are technically obligated to resign conflicting trusteeships—which include trusteeships for non-*pari passu* classes of investors after default—within ninety days of a default.¹⁴⁴ The trustee must continue in the conflict position, nonetheless, until replaced (to the extent needed to resolve the conflict) by one or more successor trustees.¹⁴⁵

At best, this compromise would be imperfect. Even in the Trust Indenture Act context, where multiple institutions engage in the trustee business, such replacement can take a “good deal of time,” often occurring after the trustee has been required to make critical decisions.¹⁴⁶ Also, competent successor fiduciaries may not always be available on reasonable terms

143. Compare David Isenberg, *Exercising the Intercreditor Buyout Clause: Lessons from the Trenches*, J. CORP. RENEWAL, Nov. 19, 2008, <http://www.turnaround.org/publications/articles.aspx?objectid=10068> (“If the senior lien facility and junior lien facility are designed to accommodate multiple holders, as most are, a collateral agent or administrative agent will be appointed by the original holders at each priority level to hold the liens as agent.”), and Gary D. Chamblee et al., Draft Model Intercreditor Agreement, ABA Com. Fin. Committee (Apr. 11, 2009), http://www.abanet.org/buslaw/committees/CL190000pub/materials/2009/spring/mica_draft_20090411.pdf (providing for separate collateral agents for first and second lien claimholders, and for a single “control” agent in model agreements designed to reflect standard practices), with Kirk Davenport et al., *Second Lien Financings—Answers to the Most Frequently Asked Questions*, MONDAQ BUS. BRIEFING, Apr. 30, 2004, <http://www.mondaq.com/unitedstates/article.asp?articleid=25777> (noting that most of the “larger second lien bond deals” have employed a single independent collateral trustee for the benefit of the holders of first and second lien debt).

144. Trust Indenture Act of 1939 § 310(b)(i), (b)(iii)(1), 15 U.S.C. § 77jjj(b)(i), (b)(iii)(1) (2006). The U.S. Office of the Comptroller of the Currency has extended a similar requirement to certain issuances of debt not governed by the Trust Indenture Act. 12 C.F.R. § 9.18(8)(i) (2009) (“A bank administering a collective investment fund may not have an interest in that fund other than in its fiduciary capacity. If, because of a creditor relationship or otherwise, the bank acquires an interest in a participating account, the participating account must be withdrawn on the next withdrawal date.”).

145. Trust Indenture Act § 310(b)(i).

146. Interview with Harold L. Kaplan, *supra* note 4.

and conditions.¹⁴⁷ Furthermore, where multiple classes are secured by a single pool of collateral, a collateral trustee cannot avoid conflicts by resigning; any successor collateral trustee would have the same conflicts, the collateral being unitary.

Requiring separate fiduciaries for conflicted investor classes after default also may be misguided. It would help solve the personal dilemma of a fiduciary with conflicting obligations, but it may well exacerbate the inherent conflict between the investors themselves. Separate fiduciaries would have little, if any, incentive to work together to make decisions affecting the classes. It, therefore, appears that neither restricting investor conflicts nor requiring separate fiduciaries for each conflicted investor class would be viable solutions.

C. JUDICIAL PROCEDURES TO ENABLE FIDUCIARIES WITH CONFLICTING OBLIGATIONS TO OBTAIN DIRECTIONS

Another possible approach might be to establish more cost-effective, timely, and otherwise practical judicial procedures to enable fiduciaries with conflicting obligations to obtain needed directions. This Article already has mentioned that English law recognizes a declaratory-judgment type of judicial procedure for this purpose.¹⁴⁸ The discussion below compares these judicial procedures under American and English law.

American law provides two basic types of judicial procedures—interpleader and declaratory judgment actions—that fiduciaries with conflicting obligations could use to resolve disputes.¹⁴⁹ Interpleader, which is available under both federal and state law, is a procedure whereby a party in possession of property that is subject to competing claims may compel the parties asserting those claims to litigate their dispute in a single proceeding.¹⁵⁰ Federal law provides two broadly similar

147. Relatively few institutions are willing, in the author's experience, to become a successor trustee in a default scenario. See E-mail from Zaina M. Zainal, Assistant to Harold L. Kaplan and Mark F. Hebbeln, to author (Aug. 24, 2009) (on file with author) (attaching Kaplan's comments on this Article, which state that trustees for conflicting tranches often find it "not possible or practical" to resign conflicting trusteeships).

148. See *supra* notes 22–29 and accompanying text (discussing this procedure in the English High Court of Justice, Chancery Division). The parties chose this procedure in the *Bank of New York* case "because the matter was urgent and could be settled more quickly under Part 8 of the [English] Civil Procedure Rules." Rawlings, *supra* note 14, at 28.

149. The following discussion of judicial procedures relies heavily on Coughlin et al., *supra* note 35.

150. CHARLES ALAN WRIGHT & MARY KAY KANE, LAW OF FEDERAL COURTS

types of interpleader, rule interpleader and statutory interpleader, with statutory interpleader having more lenient jurisdictional requirements.¹⁵¹ State law—the primary focus of this Article on state law being New York law¹⁵²—is similar to federal interpleader with one exception: it does not require the disputed property to be placed under the court’s control, whereas federal interpleader does.¹⁵³

A fiduciary with conflicting obligations also could seek a declaratory judgment to have a federal or state court determine its rights, prior to taking action that may expose it to liability.¹⁵⁴ Unlike interpleader, however, a declaratory judgment action requires the existence of an “actual controversy.”¹⁵⁵ The federal declaratory judgment procedure allows the court to order a speedy hearing of the controversy.¹⁵⁶ The choice between a federal or a state declaratory judgment procedure may also be influenced by jurisdictional requirements or strategic concerns.¹⁵⁷

Some states provide even more targeted statutory procedures for fiduciaries to obtain judicial directions.¹⁵⁸ These pro-

§ 74, at 534 (6th ed. 2002) (“Interpleader is a form of joinder open to one who does not know to which of several claimants he or she is liable, if liable at all. It permits the person to bring the claimants into a single action, and to require them to litigate among themselves . . .”).

151. *Id.* (“There are two kinds of interpleader available in federal court. A statute, 27 U.S.C.A. § 1335, authorizes interpleader and makes very liberal provisions for jurisdiction, venue, and service of process. Nonstatutory interpleader is available under Rule 22, but the jurisdictional and procedural requirements there are the same as in an ordinary civil action.”).

152. Much of the litigation concerning applications for court direction by fiduciaries with conflicting obligations is governed by the laws of England or New York. *See Ryan & Yong, supra* note 108, at 60.

153. *See* N.Y. C.P.L.R. 1006 (McKinney 2009); *see also* Coughlin et al., *supra* note 35, at 778–79 (noting this distinction between federal and New York interpleader laws).

154. Coughlin et al., *supra* note 35, at 782–83 (quoting *Banos v. Winkelstein*, 78 N.Y.S.2d 832, 834 (App. Div. 1948)).

155. *See id.* at 783. Generally, interpleader requires only a good faith concern that the claimant may be exposed to multiple liability claims, whereas declaratory judgment requires reasonable apprehension of liability and may have a further ripeness requirement. *Compare id.* at 780 (noting the requirement for a good faith showing of conflicting claims), *with id.* at 783 (noting that courts will not grant declaratory judgment in cases of “remote or hypothetical possibilities that may never come to fruition”).

156. FED. R. CIV. P. 57 (“The court may order a speedy hearing of an action for a declaratory judgment . . .”).

157. *See* Coughlin et al., *supra* note 35, at 784–85.

158. *See, e.g.,* N.Y. C.P.L.R. 7701 (McKinney 2009) (providing a legal mechanism for a special proceeding for express trusts).

cedures, however, are usually designed to apply only to gratuitous trusts, so it is uncertain whether they could be used in a commercial context.¹⁵⁹ Delaware law also provides for a summary procedure to resolve commercial disputes if at least one party is a Delaware citizen or business entity and all parties agree to the proceeding.¹⁶⁰ However, there appears to be a lack of case law demonstrating the application of this procedure.

Recent litigation involving fiduciaries with conflicting obligations illustrates, albeit anecdotally, the use of interpleader in resolving fiduciary conflicts.¹⁶¹ It appears that such use can involve relatively lengthy litigation (except for cases that were quickly and voluntarily dismissed).¹⁶² Table 1, below, summarizes the timelines of these cases.

159. See Coughlin et al., *supra* note 35, at 779. N.Y. C.P.L.R. 7701 provides, for example, that a “special proceeding may be brought to determine a matter relating to any express trust except a voting trust, a mortgage, [or] a trust for the benefit of creditors.” N.Y. C.P.L.R. 7701.

160. See DEL. SUP. CT. CIV. R. 124–131. The Summary Proceedings for Commercial Disputes provides for an expedited schedule of service, discovery, trial, and decision.

161. See *infra* notes 163–68 (listing type of interpleader employed in each case). Federal statutory interpleader is the most common of the interpleader options among these cases.

162. The cases that were quickly and voluntarily dismissed appear to have been settled. The potential high cost of lengthy litigation encourages settlement by effectively acting as a type of penalty default rule. Cf. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 598–99 (7th ed. 2007) (observing that when parties to a dispute anticipate high litigation costs, they are more likely to settle). But another interpleader case, *Deutsche Bank Trust Co. v. Victoria Finance Ltd.*, No. 600071-08 (N.Y. Sup. Ct. Jan. 9, 2008), appears to be heading towards a lengthy litigation. See *Deutsche Bank Interpleader Complaint*, *supra* note 30.

Table 1:
Timelines of Selected U.S. Cases

	Complaint Filed	Status
<i>LaSalle Bank v. Citigroup</i> ¹⁶³	7/11/08	Voluntarily dismissed 8/26/08
<i>LaSalle Bank v. BNP Paribas</i> ¹⁶⁴	7/3/08	Motion for Summary Judgment Granted 01/26/10
<i>U.S. Bank v. MBIA</i> ¹⁶⁵	5/22/08	Motion for Summary Judgment Granted 12/02/09
<i>LaSalle Bank v. UBS</i> ¹⁶⁶	4/17/08	Voluntarily dismissed 6/10/08
<i>Deutsche Bank v. LaCrosse</i> ¹⁶⁷	1/29/08	Motion for Summary Judgment Granted 10/27/09
<i>Wells Fargo Bank v. Calyon</i> ¹⁶⁸	12/12/07	Voluntarily dismissed 2/8/08

163. Interpleader Complaint, *LaSalle Bank Nat'l Ass'n v. Citigroup Global Mkts. Ltd.*, No. 08 Civ. 6294 (S.D.N.Y. July 11, 2008), 2008 WL 4486807 (initiating proceedings under federal statutory interpleader); Notice of Dismissal, *LaSalle Bank Nat'l Ass'n*, No. 08 Civ. 6294 (S.D.N.Y. Aug. 26, 2008).

164. Interpleader Complaint, *LaSalle Bank Nat'l Ass'n v. BNP Paribas, London Branch*, No. 08 Civ. 6134 (S.D.N.Y. July 3, 2008), 2008 WL 4486738 (initiating proceedings under federal statutory interpleader); Order Granting Motion for Summary Judgment, *BNP Paribas*, No. 08 Civ. 6134 (S.D.N.Y. Jan. 26, 2010).

165. Interpleader Complaint, *U.S. Bank Nat'l Ass'n v. MBIA Ins. Corp.*, No. 08 Civ. 4791 (S.D.N.Y. May 22, 2008), 2008 WL 2972551 (initiating proceedings under federal statutory interpleader); Order Granting Motion for Summary Judgment, *U.S. Bank Nat'l Ass'n*, No. 08 Civ. 4791 (S.D.N.Y. Dec. 2, 2009).

166. Complaint, *LaSalle Bank Nat'l Ass'n v. UBS AG*, No. 08 Civ. 3692 (S.D.N.Y. Apr. 17, 2008), 2008 WL 2306127 (initiating proceedings under federal rule interpleader); Notice of Dismissal, *UBS AG*, No. 08 Civ. 3692 (S.D.N.Y. June 10, 2008).

167. Interpleader Complaint, *Deutsche Bank Trust Co. Americas v. LaCrosse Fin. Prods., LLC*, No. 08 Civ. 0955 (S.D.N.Y. Jan. 29, 2008) (initiating statutory interpleader action); Memorandum of Law in Support of Motion to File Exhibits Under Seal, *Deutsche Bank Trust Co. Americas*, No. 08 Civ. 0955 (S.D.N.Y. Jan. 31, 2008), 2008 WL 887107 (referring to proceedings under federal statutory interpleader); Order Granting Motion for Summary Judgment, *Deutsche Bank Trust Co. Americas*, No. 08 Civ. 0955 (S.D.N.Y. Oct. 27, 2009).

168. Interpleader Complaint, *Wells Fargo Bank, N.A. v. Calyon*, No. 07-650335 (N.Y. Sup. Ct. Dec. 11, 2007) (initiating proceedings under New York state interpleader); Notice of Discontinuance Without Prejudice, *Calyon*, No. 07-650335 (N.Y. Sup. Ct. Feb. 8, 2008); Interpleader Complaint, *Wells Fargo Bank, N.A. v. Calyon*, No. 08 Civ. 1297 (S.D.N.Y. Feb. 8, 2008), 2008 WL 888995 (refiling case in federal court under statutory interpleader); Order Granting Motion for Summary Judgment, *Calyon*, No. 08 Civ. 1297 (S.D.N.Y. Sept. 29, 2009).

English law, in contrast, appears to provide much speedier judicial procedures by which fiduciaries with conflicting obligations could resolve disputes. As discussed in detail below, such a fiduciary could seek court direction pursuant to Part 8 of the English Civil Procedure Rules (CPR), under the Insolvency Act of 1986, or through an interpleader action. England recently undertook comprehensive reform of its system of civil procedure,¹⁶⁹ resulting in the new CPR, which is designed to combat the expense, slowness, and complexity of the prior system.¹⁷⁰ The CPR's "Overriding Objective" is to deal with cases justly, which includes treating these cases expeditiously and in ways that are proportionate to the amount of money involved, the importance of the case, the complexity of the issues, and the financial positions of the parties.¹⁷¹

Although most court actions in England are initiated under Part 7 of the CPR (the general claim filing procedure),¹⁷² actions not likely to involve substantial factual disputes—such as fiduciary conflicts that involve only contractual interpretation—may be initiated under the more expeditious Part 8.¹⁷³ Under Part 8, for example, the court may immediately set a hearing date once a claim form is submitted,¹⁷⁴ and additional requirements that would apply to a standard Part 7 claim are waived or altered for expediency.¹⁷⁵ Similarly, England's Insolvency Act of 1986 enables an administrative receiver of an insolvent company to obtain court directions.¹⁷⁶

169. See generally PAULA LOUGHLIN & STEPHEN GERLIS, *CIVIL PROCEDURE* 1–8 (2d ed. 2004).

170. *Id.*

171. See U.K. R. CIV. P. 1; see also LOUGHLIN & GERLIS, *supra* note 169, at 10–11 (emphasizing the great practical import of the CPR is judicial interpretation pursuant to the Overriding Objective).

172. See LOUGHLIN & GERLIS, *supra* note 169, at 217.

173. See U.K. R. CIV. P. 8.1(2). Part 8 differs from the general claims procedure in that parties are given much shorter timeframes in which to acknowledge service and submit evidence. *Id.* 8.3 (Acknowledgement of Service); *id.* 8.5 (Filing and Serving Written Evidence); see also LOUGHLIN & GERLIS, *supra* note 169, at 217–23.

174. See U.K. R. CIV. P. Practice Direction 8 (Alternative Procedure for Claims), § 6.1.

175. See, e.g., U.K. R. CIV. P. 8.3 (providing shortened period for acknowledgement of service); *id.* 8.5 (providing shortened period for filing and serving of written evidence); *id.* 8.9 (stating that standard procedures pertaining to statements of the case, defense and reply, and allocation to a case management track do not apply to Part 8 proceedings).

176. See Insolvency Act, 1986, c. 45, § 35 (Eng.).

Interpleader actions in English law have been incorporated into the CPR.¹⁷⁷ A fiduciary with conflicting obligations would be able to file an interpleader motion if it holds property subject to the adverse claims of multiple parties and expects to be sued by those parties.¹⁷⁸ The fiduciary must disavow any interest in the property at stake, must not collude with any claimant, and must be willing to transfer the property into court.¹⁷⁹ The court is given broad powers to rule on such cases.¹⁸⁰

Recent litigation in England involving fiduciaries with conflicting obligations illustrates, again anecdotally, how these procedures compare. Table 2, below, presents the general timelines of the cases being litigated. The *Bank of New York* case and the *Citibank NA v. MBIA Assurance SA* case used the Part 8 procedure, whereas the others—involving insolvent entities with administrative receivers—were commenced under the Insolvency Act.¹⁸¹ Interpleader actions were not used in these cases.

177. U.K. R. CIV. P. Sched. 1, RSC Order 17, Rule 1-17 (providing the procedure used in the Supreme Court, including the Chancery Division, where several recent cases of fiduciaries with conflicting obligations applying for court directions have been heard); ENG. R. CIV. P. Sched. 2, CCR Order 33 Pt. II, Rule 6-11 (providing a very similar procedure for use in the County Courts).

178. U.K. R. CIV. P. Sched. 1, RSC Order 17, Rule 1(1).

179. *Id.* at Rule 3(4)(a)–(b).

180. *See id.* at Rule 8(1).

181. *See infra* notes 182–87 (listing the type of procedure employed in each case).

Table 2:
Timelines of Selected English Cases

	Claim Filed	Hearings	Verdict
<i>In re Sigma Finance Corp.</i> ¹⁸²	11/3/08	11/4/08	11/7/08
<i>In re Golden Key Ltd.</i> ¹⁸³	9/25/08	12/11/08–12/12/08	4/2/09
<i>Bank of New York v. Montana Board of Investments</i> ¹⁸⁴	5/2/08	7/3/08–7/4/08	7/10/08
<i>In re Whistlejacket Capital Ltd.</i> ¹⁸⁵	2/28/08	3/3/08–3/4/08	3/5/08
<i>In re Cheyne Finance Plc</i> ¹⁸⁶	Not before 9/4/07	9/11/07	9/12/07
<i>Citibank NA v. MBIA Assurance SA</i> ¹⁸⁷	11/20/06	11/21/08–12/11/08	12/13/06

182. *In re Sigma Fin. Corp.* (In Administration), [2008] EWHC (Ch) 2997 (Eng.) (listing hearings on November 4, 2008); *id.* [1] (“This is an application pursuant to section 35 of the Insolvency Act by the Receivers . . .”); *In re Sigma Fin. Corp.* (In Administration), [2008] EWCA (Civ) 1303, [1] (Eng.) (“This judgment is given on three appeals from an order of Sales J. made on November 7, 2008, in proceedings issued on November 3 . . .”).

183. *In re Golden Key Ltd.* (In Receivership), [2009] EWHC (Ch) 148 (Eng.) (listing hearings on December 11 and 12, 2008); *id.* [24] (“Receivers now ask for appropriate directions from the court pursuant to section 35 of the Insolvency Act 1986. The proceedings were begun by an originating application issued on 25 September 2008.”).

184. *Bank of N.Y. v. Mont. Bd. of Invs.*, [2008] EWHC (Ch) 1594 (Eng.) (listing hearings on July 3 and 4, 2008); Rawlings, *supra* note 14, at 28–29 (stating that *Bank of N.Y.* was initiated under Part 8); *id.* at 29 n.78 (“Proceedings were filed on 2 May 2008.”).

185. *In re Whistlejacket Capital Ltd.* (In Receivership), [2008] EWHC (Ch) 463 (Eng.) (listing hearings on March 3 and 4, 2008); *id.* [1] (“This is an Originating Application . . . by the receivers of Whistlejacket Capital Limited . . . for directions as to the management of the Company’s business.”); *In re Whistlejacket Capital Ltd.* (In Receivership), [2008] EWCA (Civ) 575, [14] (Eng.) (“The receivers’ application for directions was issued on 28 February.”).

186. *In re Cheyne Fin. Plc* (In Receivership), [2007] EWHC (Ch) 2116, [3] (Eng.) (“The urgency of the matter, it being recognised on all sides that the Receivers need directions today after a hearing yesterday afternoon . . .”); *see id.* [1] (“This is an urgent application for directions by Messrs. Nicholas Edwards, Neville Kahn and Nicholas Dargan, all of Deloitte & Touche LLP, as Receivers of the business and assets of Cheyne Finance Plc, having been appointed on 4th September of this year . . .”).

187. *Citibank NA v. MBIA Assurance SA*, [2006] EWHC (Ch) 3215 (Eng.) (listing hearings on a number of dates from November 21 through December 11, 2006); *id.* [20] (“Citibank had become concerned as to whether it could safely accept the direction of MBIA. It commenced the present proceedings on 20th November as trustee under the deed of charge and trust deed seeking a direction as to whether it had to comply with MBIA’s direction . . .”); E-mail from Alex Southern, Clerk to Jasbir Dhillon, Brick Court Chambers, to Garth Spencer, Research Assistant to Professor Steven L. Schwarcz (Aug. 12, 2009) (on file with author) (confirming that *Citibank v. MBIA* was initiated under Part 8).

Comparing the timelines in Tables 1 and 2, English courts appear to have a pronounced advantage over New York courts in the timely resolution of fiduciary conflicts. The New York cases that were not quickly voluntarily dismissed were litigated for more than a year after their initiation. On the other hand, the English cases were all resolved (not considering appeals) in periods from one week to about six months, depending on their particular urgency.

The English judicial system, therefore, can provide faster resolution of fiduciary conflicts than the New York judicial system. This does not necessarily mean, however, that the English system provides better resolution. At least one commentator has questioned whether the very speed of the English system inadvertently could be a negative, deterring full and complete analysis of issues.¹⁸⁸ English courts have similarly questioned whether expeditious English judicial procedures may come at the expense of thoroughness.¹⁸⁹ In contrast, one may argue that the potential high cost of lengthy litigation in New York courts effectively acts as a type of penalty default rule, encouraging informed settlement.¹⁹⁰

Clearly, the differences between English and New York (or other state) court procedures need to be studied at greater length and more systematically. Perhaps until then, fiduciaries who might be subject to future conflicting obligations should negotiate for the right to decide, on a case-by-case basis, whether to litigate their fiduciary conflicts before either an English *or* a New York court.¹⁹¹ In the *Bank of New York* case,

188. Rawlings, *supra* note 14, at 32 (observing that the speed of the English Part 8 procedure “did not [in the *Bank of New York* case], perhaps, allow for a full discussion of [applicable] law, or investigation of the facts surrounding the disposal” of collateral).

189. See *In re Sigma Fin. Corp. (In Administration)*, [2008] EWCA (Civ) 1303, [1] (Eng.), 2008 WL 5044404 (“[W]e give judgment today, although, for my part at least, I would have preferred to have had more time in which to formulate and express my reasoning; among other things this judgment might then have been shorter.”); *In re Cheyne Fin. Plc.*, [2007] EWHC (Ch) 2116, [3] (“The urgency of the matter . . . means that this judgment has had to be both *extempore* and in a relatively abbreviated form without the full explanation to the uninitiated of the relevant and complex contractual and commercial background which I would have preferred to provide.”). *But see id.* [2] (“I am satisfied that the two alternative constructions have, despite the shortness of time, been fully argued.”).

190. See *supra* note 162.

191. This could be effectuated by the parties to the contract appointing the fiduciary agreeing to submit to jurisdiction in the courts of both England and New York. See Steven L. Schwarcz, *The Universal Language of Cross-Border*

for example, the trustee had this option and, even though the contract was governed by New York law, chose to litigate before an English court.¹⁹²

D. MITIGATING FIDUCIARY LIABILITY BY A BUSINESS JUDGMENT RULE

None of the procedural steps discussed above can fully resolve the dilemma of a fiduciary with conflicting obligations. Furthermore, even in jurisdictions that attempt to balance the substantive rights and obligations of such a fiduciary, ambiguity will remain. No balancing test, for example, is equivalent to a bright-line rule, and any non-bright-line rule entails judgment calls. A judgment call exposes the decider—in our case, the fiduciary—to being second-guessed and potentially exposed to liability. This can influence a fiduciary to act in a manner that minimizes its liability, as opposed to truly acting in the best interests of investors.

This influence has already been mentioned in the context of servicers foreclosing on, rather than restructuring, defaulted mortgages, and there are many other examples.¹⁹³ Indenture trustees with conflicting obligations often are effectively paralyzed from taking action unless they can get an opinion of counsel stating that the action to be taken is authorized and permitted.¹⁹⁴ These opinions, however, are rarely forthcom-

Finance, 8 DUKE J. COMP. & INT'L L. 235, 244 (1998). Of course, a party who believes, *ex ante*, that delay would better serve its interests in the event of a fiduciary conflict might prefer submitting only to jurisdiction in a New York court, and vice versa.

192. See Rawlings, *supra* note 14, at 28.

193. See, e.g., Schwarcz & Sergi, *supra* note 8, at 1041–42 (describing attempts by trustees to minimize their liability rather than to protect investors and observing that trustees “sometimes devote as much of their energies to avoiding personal liability as to protecting bondholders”); E-mail from Philip J. Rawlings, Professor of the Law of Finance, University College London, to author (Sept. 11, 2009) (on file with author) (“There is certainly a view [in the United Kingdom] that bond trustees—in spite of various powers in the bond deed—will not act, except under instructions from the investors so as to obtain an indemnity from the investors against potential liability for wrongful action, and, even if this causes delay and so loss, they are protected because there is no obligation to act.”).

194. Interview with Doneene Damon, outgoing Chair of the ABA Bus. Law Section’s Comm. on Trust Indentures and Indenture Trs., in Vancouver, B.C., Can. (Apr. 18, 2009); see RESTATEMENT (THIRD) OF TRUSTS § 77 cmt. b(2) (2007) (stating that trustees must be prudent in “seeking and considering advice of counsel”).

ing,¹⁹⁵ and even when they are forthcoming it is questionable whether availability of a purely legal opinion should guide fiduciary decisions that involve mixed business and legal considerations.¹⁹⁶

The tendency of fiduciaries with conflicting obligations to minimize their liability at the expense of investors raises a final question: should those fiduciaries who attempt in good faith to prudently exercise their discretion be protected from liability? In the context of trustees acting for nonconflicting classes of investors, for example, I have argued that limiting trustee liability through a business-judgment-type rule would actually improve fiduciary performance under the prudent-man standard, because trustees would then be more likely to exercise independent judgment.¹⁹⁷ The business judgment rule operates as “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”¹⁹⁸ Would a similar limitation on liability be likely to improve the performance of fiduciaries with conflicting obligations?¹⁹⁹

195. Interview with Doneene Damon, *supra* note 194.

196. See Harold L. Kaplan & Mark F. Hebbeln, *Keeping a Level Playing Field: The Evolution of Discriminatory Consent Solicitations and Exchange Offers*, ABA TR. & INVESTMENTS, Mar.–Apr. 2008, at 44, 50–52 (observing that indenture trustees with conflicting obligations are also requesting additional indemnifications and seeking declaratory judgments).

197. See Schwarcz & Sergi, *supra* note 8, at 1073 (“[A]pplying 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.”).

198. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

199. *Cf.* Schwarcz & Sergi, *supra* note 8, at 1040–41 (explaining why indenture trustees on public bonds, presently obligated to act under a “prudent man” standard, should be protected by this type of rule). In this context, one might consider whether a fiduciary could gain protection by choosing the law of a state with such a business-judgment-type rule to govern its performance. For example, if a particular state, e.g., New York, limited fiduciary liability, would an agreement choosing New York law to govern the fiduciary’s performance protect a fiduciary with conflicting obligations? Courts generally respect contractual choice of governing law unless there is no reasonable basis for the choice or application of the chosen law would contravene a fundamental policy of a state with a materially greater interest in the contract. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971); Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363, 371–73 (2003) (analyzing judicial enforcement of contractual choice-of-law provisions). It is not precisely clear which policies are fundamental, however. Laws pertaining to formalities or general matters of contract law are unlikely to be fundamental, whereas a law designed to address an imbalance of bar-

One way to answer this question is through a cost-benefit analysis.²⁰⁰ In the corporate decisionmaking process, the business judgment rule encourages qualified directors to serve by limiting liability risk, encourages inherently risky but value-maximizing transactions, and limits costly judicial involvement that would be ill-suited to evaluating such decisions.²⁰¹ These benefits must be balanced, however, against the rule's costs, which include increased opportunity for self-interested director behavior²⁰² and a possible disincentive to director diligence.²⁰³ Although weighing these costs and benefits would involve empirical questions the answers to which are highly uncertain,²⁰⁴ principles of decision theory suggest that the balancing should take into account only variables about which there is a reasonable degree of certainty.²⁰⁵ In the corporate decisionmaking process, commentators focus on the certain costs of judicial involvement, which weigh heavily in favor of adopting a business judgment rule.²⁰⁶

gaining power may be. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 cmt. g (“[T]o be ‘fundamental,’ a policy must in any event be a substantial one.”). New York’s provisions for contractual choice of law are broadly similar to the Restatement. See *Woodling v. Garrett Corp.*, 813 F.2d 543, 551 (2d Cir. 1987). Indeed, parties may choose New York law to govern their contract even if the contract bears no reasonable relation to the state of New York, so long as the contract relates to a transaction valued over \$250,000. See N.Y. GEN. OBLIG. LAW § 5-1401 (McKinney 2001).

200. See POSNER, *supra* note 162, at 402–04 (discussing cost-benefit analysis). Cost-benefit analysis is sometimes criticized, however, because it is based on disputed premises of autonomy and equality, it sacrifices minority interests for the benefit of majorities, it ignores effects of wealth distribution, and it attempts to quantitatively measure intangible values. See Joseph William Singer, *Normative Methods for Lawyers*, 56 UCLA L. REV. 899, 916–19 (2009).

201. See Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 444–45 (2007).

202. See *id.* at 439.

203. See *id.* at 446 (arguing that a higher risk of liability will result in more diligence).

204. See *id.*

205. See *id.* at 456 (characterizing this as an informal version of the principle of insufficient reason, in which decisions are made on the basis of only what is known, implicitly assuming that “unknown costs and unknown benefits are equally likely and therefore cancel each other out”).

206. *Id.* at 473 (“The one sure effect of increased judicial involvement in business judgment litigation is a substantial rise in litigation costs.”); see also Paul N. Edwards, *Compelled Termination and Corporate Governance: The Big Picture*, 10 J. CORP. L. 373, 388 (1985) (“[T]he strongest justification for the traditional business judgment rule [is] that of keeping the judiciary out of the corporate boardroom due to courts’ institutional inadequacy and the highly discretionary nature of most business decisions . . .”).

Shifting the analysis back to a fiduciary with conflicting obligations, we can see that a business judgment rule should have a similar balancing. Because it is uncertain whether potential liability has prevented qualified fiduciaries from serving, that benefit of a business judgment rule will not be included in the balancing. It is likely, however, that fiduciaries would be more willing, under a business judgment rule, to make the inherently risky decisions that are necessary after default to maximize value,²⁰⁷ so that benefit will be included. Such a rule would also limit the certain costs of ill-suited judicial involvement in second-guessing fiduciary decisions, so that benefit (i.e., of limiting those costs) will be included in the balancing. In contrast, the costs of a business judgment rule—increased opportunity for fiduciary self-interested behavior and a possible disincentive to fiduciary diligence—would be uncertain,²⁰⁸ and there is no reason to believe they would be of the same magnitude as the certain benefits.²⁰⁹ Those costs therefore will not be included in the balancing. The balance thus would appear to weigh in favor of applying a business judgment rule to fiduciaries with conflicting obligations.²¹⁰

This balancing is consistent with a related analysis of whether a business judgment rule should be applied to bond indenture trustees after default. That analysis concluded that it *should* apply, finding that the same reasons supporting such a rule in a corporate decisionmaking context—the need to maximize rather than merely preserve value, the need to attract

207. See *supra* note 68.

208. In a corporate context, for example, the business judgment rule does not apply to protect unconsidered inactions or to protect self-interested transactions by directors. See Robert T. Miller, *Wrongful Omissions by Corporate Directors: Stone v. Ritter and Adapting the Process Model of the Delaware Business Judgment Rule*, 10 U. PA. J. BUS. & EMP. L. 911, 913, 919 (2008).

209. Cf. Gold, *supra* note 201, at 469 (“[T]he decisionmaker should be able to discern that the consideration given dispositive weight is, in some rough sense, of the same order of importance as the discarded imponderables.” (quoting ADRIAN VERMEULE, *JUDGING UNDER UNCERTAINTY: AN INSTITUTIONAL THEORY OF LEGAL INTERPRETATION* 175 (2006))). As a former engineer, I re-crafted that test to ignore uncertain costs only when there is no reason to believe that such costs would be of the same order of magnitude as the certain benefits.

210. Some may object that applying this decision-theory approach to cost-benefit analysis effectively ignores all the costs of a business judgment rule. Still, this approach, “although not ideally rational from the point of view of an omniscient observer, will at least be as rational as can be expected.” Gold, *supra* note 201, at 456–57 (quoting JON ELSTER, *SOLOMONIC JUDGMENTS: STUDIES IN THE LIMITATIONS OF RATIONALITY* 135 (1989)).

highly skilled decisionmakers, the need to provide for an efficient decisionmaking system, and the impracticality of courts evaluating the prudence of complex decisions after the fact—applied to decision making by indenture trustees.²¹¹ These same reasons should apply to decision making by fiduciaries with conflicting obligations, after default. Such a fiduciary should, as discussed, attempt to maximize value. There is increasingly a need to attract highly skilled fiduciaries,²¹² and the present uncertainty surrounding fiduciary conflicts undermines efficient decision making.²¹³ Also, it is impractical for courts, which do not have business judgment or expertise, to evaluate the prudence of complex decisions after they are made.²¹⁴

It, therefore, would appear appropriate for fiduciaries with conflicting obligations to operate under a business judgment rule. It is interesting in this context to note that the English court in the *Bank of New York* case implicitly applied a business judgment rule by holding that the collateral trustee “is required to exercise a discretion,”²¹⁵ thereby effectively insulating the trustee from liability for a good faith exercise.²¹⁶ A business judgment rule would not, of course, define for whose benefit the fiduciary’s judgment is to be exercised.²¹⁷ That would be deter-

211. See Schwarcz & Sergi, *supra* note 8, at 1061–63.

212. Cf. Interview with Doneene Damon, *supra* note 194 (observing that issuers are not yet willing to pay the higher fees that trustees are requesting, and that trustees are beginning to want to be compensated at the top of the payment “waterfall”).

213. See *supra* note 46 and accompanying text.

214. See Corinne Ball et al., *The Board of Directors' Fiduciary Duties*, in *MERGERS & ACQUISITIONS 2009: TRENDS AND DEVELOPMENTS* 131, 166 (PLI Corp. L. & Prac. Course Handbook Series No. B-1713, 2009), WL 1713 PLI/CORP. 131 (“Courts generally acknowledge that they lack the information and skill necessary to evaluate business judgments.”). Ex post evaluations of decision making also can suffer from hindsight bias. See Gold, *supra* note 201, at 443.

215. See *Bank of N.Y. v. Mont. Bd. of Invs.*, [2008] EWHC (Ch) 1594, [59] (Eng.), 2008 WL 2697055.

216. At least one commentator questions, however, whether limiting the liability of a fiduciary with conflicting obligations by a business judgment rule would go far enough. See E-mail from Eric J. Pan, Professor of Law and Director, The Samuel and Ronnie Heyman Center on Corporate Governance, Benjamin N. Cardozo School of Law, to author (May 22, 2009) (on file with author) (asking “how can one decide how a prudent man would balance the competing interests of two conflicting investors?” and suggesting that “the only solution is to give complete discretion to the trustee”). The prudent man standard is the standard of a fiduciary to act, after default, as a prudent person, discussed *supra* note 7.

217. See Gold, *supra* note 201, at 434–42 (discussing uncertainty as to

mined, as applicable, either by the contract or by the rules applicable to balancing conflicting beneficiary interests in the absence of contractual directions.

CONCLUSION

This Article addresses a problem that is both real and theoretically interesting: the dilemma of fiduciaries who, in a commercial or financial context, have conflicting obligations to beneficiaries. By focusing on limiting their liability, fiduciaries with conflicting obligations have been acting in ways that are suboptimal for their beneficiaries, sometimes with significant social costs (such as the many home foreclosures in the financial crisis, in lieu of economically more optimal loan workouts). Because the dilemma is not easily resolvable through contracting, there is a need for legal principles—which existing law does not yet provide.

In pursuit of reasonable normative principles, this Article first analyzes fiduciary conflicts in the absence of beneficiary directions. In that context, this Article argues that the fiduciary should favor subordinated over senior beneficiaries in the most common fiduciary-conflict scenarios.²¹⁸ Although this approach would be incongruous for gratuitous transactions, it makes economic sense in a commercial and financial context, maximizing value for all beneficiaries. The approach also has parallels to how the law treats a somewhat analogous fiduciary-conflict scenario, that of the conflicting duties of a corporation's board of directors to shareholders and creditors.

This Article thereafter examines fiduciary conflicts where there are beneficiary directions. The analysis raises such conceptual questions as whether the fiduciary should still have fiduciary obligations to all the beneficiaries or rather just to the directing beneficiary. The analysis draws on the scholarly debate over whether fiduciary duties are merely contractual default rules or, instead, are unique, sometimes overriding even clear contractual provisions.

whether business judgment is to be exercised exclusively in favor of shareholders or for a broader group of stakeholders).

218. In these scenarios, the senior beneficiaries are reasonably assured to receive payment whereas the subordinated beneficiaries are at risk. *See supra* notes 80–89 and accompanying text. In certain less common scenarios, though, this Article argues that a fiduciary with conflicting obligations should balance its obligations to conflicting beneficiaries on a more nuanced case-by-case basis. *See supra* note 191 and accompanying text.

Although treating fiduciary duties as contractual default rules is generally desirable in a commercial and financial context, this Article explains why that treatment should be limited when there are fiduciary conflicts. A fiduciary with conflicting obligations should not be obligated, for example, to follow directions that are not reasonably related to the benefit intended under the contract or that would trigger or exacerbate market failures with systemic consequences. These types of limitations are consistent with the underlying commercial rationale for enabling parties to contract about duties.

Finally, this Article examines procedural steps that might reduce fiduciary conflicts or lessen their impact and make them easier to resolve. These steps would have particular value in jurisdictions where the rights and obligations of a fiduciary with conflicting obligations remain unresolved or ambiguous.