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Fiduciaries With Conflicting Obligations¹

Steven L. Schwarcz²

Abstract: This article examines the dilemma of a fiduciary acting for parties who, as among themselves, have conflicting commercial interests—an inquiry fundamentally different from that of the traditional study of conflicts between fiduciaries and their beneficiaries. Existing legal principles do not fully capture this dilemma because agency law focuses primarily on an agent’s duty to a given principal, not on conflicts among principals; trust law focuses primarily on gratuitous transfers; and commercial law generally addresses arm’s length, not fiduciary, relationships. The dilemma has become critically important, however, as defaults increase in the multitude of conflicting securities (e.g., classes of securities of the same issuer having different priorities or sources of payment) that are typical of modern finance. A fiduciary, such as a trustee, acting for investors in these securities faces the difficult task of trying to understand and balance the respective obligations owed to conflicting classes and the risk of being sued no matter how the balancing is performed.

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¹ Copyright © 2009/2010 by Steven L. Schwarcz. An earlier version of this article was entitled *Fiduciary Conflicts*. Also, portions of this article are based in part on the author’s Keynote Address: *The Conflicted-Trustee Dilemma*, at New York Law School’s 2009 symposium on “Fear, Fraud, and the Future of Financial Regulation.”

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I. Introduction

This article addresses a central type of conflict³ in the intersection of finance, agency, and trust law: the dilemma of a fiduciary⁴ acting for parties who, *as among themselves*, have conflicting commercial interests.⁵ Investment securities (“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 important decisions will have to be made by a fiduciary acting for the investors.⁶ In the United States, such a fiduciary is often referred to as a trustee (or as an indenture trustee

³ 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, complacency, and complexity. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 (2008). This article addresses a subset of the first cause, conflicts.

⁴ I use the term “fiduciary” in its broad sense as a person who is required to act for the benefit of others. *Cf.* BLACK’S LAW DICTIONARY (8th ed.) (defining a “fiduciary” as a “person who is required to act for the benefit of another person on . . . matters within the scope of their relationship” and, in a secondary meaning, as “[o]ne 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) (observing that “[f]amiliar forms of fiduciary relationships include trustee-beneficiary, agent-principal, corporate director/officer-corporation”).

⁵ 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.

⁶ Interview with Harold L. Kaplan (partner at Foley & Lardner LLP and Chair of the American Bar Association Section on Business Law’s Committee on Trust Indentures and Indenture Trustees), April 18, 2009, Vancouver, Canada (speaking in the context of a trustee acting for conflicted investors).

when the agreement between the investors and the issuer of securities is entitled an indenture).⁷

A fiduciary acting for multiple investors can face difficult challenges even when the investors are of a single, non-conflicting, class.⁸ If the securities are in default and the fiduciary is a deep pocket, investors sometimes may try to impose liability on the fiduciary for decisions which, viewed in retrospect, can be argued to be questionable or ill-advised. This poses a dilemma: after default, many decisions—such as whether to accelerate debt or liquidate collateral—require exquisite judgment calls,⁹ and ex-ante no

⁷ 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.” Committee on Trust Indentures and Indenture Trustees & Trust Indentures Subcommittee of the Committee on Business Bankruptcy, *The Anglo-American Indenture—Covenant Enforcement and Bond Defaults—U.S. Experience and Lessons from Canada and the U.K.*, Apr. 16, 2009 (hereinafter “*The Anglo-American Indenture*”) (prepared for the ABA Section on Business Law Spring 2009 meeting in Vancouver), at 4. 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 v. Union Planters Nat’l Bank*, 953 F.2d 963, 969 (5th Cir. 1992). But there is nothing ministerial about the duties of an indenture trustee after default, especially when the indenture trustee is acting for conflicting investors. Robert I. LANDAU & JOHN E. KRUEGER, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT 171 (1998); Martin D. Sklar, *The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?*, 106 BANKING L. J. 42 (1989). Leading observers virtually admit as much. See, e.g., *The Anglo-American Indenture*, *supra* at 4: “Having said that [indenture trustees do not have 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.” See also *infra* note 17 (observing that the existence of a fiduciary relationship is “determined by the law rather than the parties”).

⁸ The scenario of a fiduciary acting for multiple *non-conflicting* investors of a single class should also be compared with the scenario, discussed *infra* note 93 and accompanying text, where majority investors of an otherwise non-conflicting 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.

⁹ Fiduciaries are generally required 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 . . . in case of default . . . use 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. LAW §126 (McKinney 2006) (the trustee

given decision may be clearly right. This type of dilemma, which is examined in a separate article, often faces indenture trustees acting for public bondholders.¹⁰

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. This article focuses on that dilemma (and 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, not fiduciaries whose interests are per se in conflict with the interests of beneficiaries).¹¹

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.¹² Trust law

shall “[i]n the case of an event of default . . . 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. *Cf.* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 776–77 (1988) (grafting a normative analysis onto positive law, in that case taking the existence of corporate reorganizations in bankruptcy law as a given to put forth a suggestion to improve the reorganization process).

¹⁰ See Steven L. Schwarcz & Gregory Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037 (2008) (focusing on the indenture trustee’s collective-action problem).

¹¹ 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 (1983).

¹² See RESTATEMENT (THIRD) OF AGENCY § 8.03 (2006) (“An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship”). *But cf. id.* §8.06(2) (stating that an agent acting on behalf of more than one principal in a transaction owes duties of good faith, disclosure, and fair dealing to each principal). *Also cf. infra* note 50 and accompanying text.

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.¹³ And commercial law generally addresses arm's length, not fiduciary, transactions.¹⁴

Examples of the Dilemma. By increasing the volume of debt securities in default, the financial crisis has brought fiduciary conflicts to the fore.¹⁵ 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.¹⁶ 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.¹⁷ If, as is typical, 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

¹³ See *infra* note 111 and accompanying text.

¹⁴ See JOANNA BENJAMIN, *FINANCIAL LAW 527* (Oxford University Press 2007) (observing that under British law “[t]he overwhelmingly dominant regulatory project in the financial markets predicates an arm’s length relationship between the parties to financial positions”). See also, e.g., *Banco Espanol de Credito v. Sec. Pac. Nat. Bank*, 763 F. Supp. 36, 45 (S.D.N.Y. 1991) (“Banks and savings institutions engaged in commercial transactions normally deal with one another at arm’s length and not as fiduciaries”). *But cf.* *Reid v. Key Bank of S. Me.*, 821 F.2d 9, 17 (1st Cir. 1987) (“[C]ourts are split on the issue of whether. . . a confidential relation may be implied between a bank and its depositors or loan customers”).

¹⁵ Cf. Philip Rawlings, *Reinforcing Collectivity: The Liability of Trustees and the Power of Investors in Finance Transactions*, 23 TRUST L. INT’L 14, 14 (issue 1, 2009) (observing that the “current [financial] problems make it inevitable that trustees will be put under even greater pressure”).

¹⁶ *Protecting Financial Markets*, *supra* note 3, at 392-93.

¹⁷ *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 Intercreditor and Servicing Agreement –2006* (ALI-ABA Course of Study, Jan. 15-17, 2009), WL SP008 ALI-ABA 1553, 1599 n.7. Generally the existence of a fiduciary relationship is “determined by the law rather than the parties.” Frankel, *supra* note 11, at 820.

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.¹⁸ In either case, restructuring is likely to spark what some have called “tranche warfare.”¹⁹ 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.²⁰

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”),²¹ 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

¹⁸ This example uses only two different allocations to separate investor classes; actual allocations can be even more complex. *See id.* at 393 n. 101 (observing, from Jon D. Van Gorp, *Capital Markets Dispersion of Subprime Mortgage Risk* 7-8 (Nov. 2007) (unpublished manuscript, on file with author), that sometimes there are additional “prepayment-penalty tranches, and [that] the different tranches [can] ‘have different priorities relative to one another for the purpose of absorbing losses and prepayments on the underlying subprime mortgage loans’”).

¹⁹ Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 562-63 (2002) (using the term “tranche warfare”); Randall W. Forsyth, *Tranche Warfare—In CMOs, It’s the Institution vs. Individual Investors*, BARRON’S, Aug. 19, 1991, at 12 (also using that term).

²⁰ *See, e.g.*, Gretchen Morgenson, *So Many Foreclosures, So Little Logic*, N.Y. TIMES, Jul. 5, 2009, at BU1 (quoting Professor Alan M. White’s statement that in many cases the decision to foreclose “is not rational economic behavior,” and reporting that, for the almost 32,000 liquidation sales that he tracked during the month of July, 2009, the average loss was 64.7 percent of the original loan balance). *But cf.* Christopher Foote, Kristopher Gerardi, Lorenz Goette, & Paul Willen, *Reducing Foreclosures: No Easy Answers*, Federal Reserve Bank of Atlanta Working Paper Series, at 22 (May 2009) (indicating that at least some foreclosure decisions may be based on sound economic analysis).

²¹ For a detailed explanation of securitized debt, *see Protecting Financial Markets*, *supra* note 3, at 376-79.

by the same pools of underlying mortgage loans and other financial assets but each class having its own priority vis-à-vis the other classes.²²

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 was faced with such a conflict when Orion Finance Corporation, a huge Cayman Island structured investment vehicle (SIV), defaulted on its payment obligations to senior investors.²³ 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.²⁴ That could have severely compromised the financial condition, and possibly the ultimate viability, of the two large financial institutions that held the subordinated securities.²⁵

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. 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.

²² *Cf. id.* at 377-78 (describing classes of securities issued in CDO transactions).

²³ *See Bank of New York v. Montana Bd. of Investments*, [2008] E.W.H.C. 1594 (Ch.). Professor Rawlings notes that this case “illustrated many of the problems at the heart of the recent financial crisis.” Rawlings, *supra* note 15, at 28.

²⁴ The senior investors wanted to exercise a particular right on foreclosure, bidding in to retain the financial assets, which had been pledged as collateral.

²⁵ The author was the expert witness in this case for these financial institutions, as to matters of fiduciary law and foreclosure law.

The English court held that the senior creditors had no express contractual right to direct the trustee regarding foreclosure.²⁶ It also concluded, applying New York law, that the collateral is “held for the benefit of all the Secured Parties,” i.e., the subordinated as well as the senior investors.²⁷ Thus, the trustee “is not the mere agent of the creditors, but is required to exercise a discretion.”²⁸ The Court did not attempt to instruct the trustee how that discretion should be exercised.

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.²⁹ The article also 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.³⁰ Furthermore, although the article focuses on fiduciaries acting for investors in securities, fiduciary conflicts can arise when the investments are

²⁶ *Bank of New York v. Montana Bd. of Investors*, *supra* note 23, at paragraphs 43, 55-56, 61.

²⁷ *Id.* at paragraph 58.

²⁸ *Id.* at paragraph 59.

²⁹ 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 moneys 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, or equally and ratably to all investors. *Cf. Deutsche Bank Trust Co. v. Victoria Finance Ltd.*, N.Y. Sup. Ct. Interpleader Complaint, Index No. 600071/2008 (litigating this issue).

³⁰ *See infra* note 93 and accompanying text.

commodities and derivative instruments rather than securities³¹ and when the beneficiaries for whom the fiduciary acts are not even investors.³²

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 scope³³ and the fact that fiduciaries are increasingly resorting to litigation, with all of its associated costs, to determine their responsibilities.³⁴ The problem is also real because, by focusing on limiting their liability, fiduciaries are acting in ways that can be sub-optimal for some or all of their beneficiaries, and (as discussed) sometimes those sub-optimal actions can have significant social costs extending far beyond the actual beneficiaries (such as foreclosing on defaulted residential mortgages even when a workout would create more value and preserve home ownership).³⁵ Sub-optimality can

³¹ E-mail from Arthur B. Laby, Associate Professor of Law, Rutgers-Camden School of Law, and former Assistant General Counsel, Securities & Exchange Commission, to the author (Aug. 29, 2009). Professor Laby additionally observes that “conflicts among investors are significant [in the liquidation and wind-up of an investment adviser or an investment fund, or both]. 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.*

³² E-mail from Myron Glucksman, former Managing Director, Citicorp Securities, Inc., to the author (Sep. 13, 2009) (observing that “[s]ome 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 Collateral 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.”).

³³ See *supra* notes 29-32 and accompanying text.

³⁴ See also Robert J. Coughlin et al, *Rule 22 to Resolve a Catch-22: Defensive Maneuvers for Corporate Trustees Faced with Conflicting Claims* 771, 777 (PLI Comm. L. & Practice Course Handbook Series No. 908, 2008) (discussing, among other things, litigation costs).

³⁵ See *supra* notes 19-20 and accompanying text.

reach improbable levels, such as fiduciaries with conflicting obligations attempting to substitute reliance on legal opinions for the exercise of business judgment.³⁶

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.³⁷ But the dilemma is not easily resolvable through contracting even if *all* the parties are sophisticated. Contract theory predicts that uncertainty can act as a penalty default rule, motivating sophisticated parties to contract for better outcomes.³⁸ Whether or not that will occur in practice for normal two-party contracts,³⁹ the dilemma of a fiduciary with conflicting obligations arises—even in its simplest incarnation—in the context of three-party contracts. Contracting is therefore not only more complicated on its face but also more interactive among the parties.⁴⁰ Perhaps that helps explain why contracting has been ineffective to date in resolving the uncertainty over fiduciary conflicts.

³⁶ See *infra* notes 190-192 and accompanying text (observing that indenture trustees with conflicting obligations often seek to resolve their dilemma by relying on legal opinions stating that the fiduciary action contemplated is authorized and permitted, opinions that are rarely forthcoming and, even when forthcoming, are (at least normatively) questionable bases for fiduciary action).

³⁷ Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 553 (“Unsophisticated parties face high transaction costs because they cannot draw upon experience in order to allocate terms among writings and because they may not know about the law”).

³⁸ See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 115 n. 22 (1989-90) (“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 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.

³⁹ Cf. Eric Posner, *There are no Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563 (2006) (arguing that penalty default rules are theoretical concepts without real applications).

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 sub-optimal.⁴¹ 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.⁴²

Thus, even more so than in the case of two-party contracting, where problems often arise after default that were completely unanticipated *ex ante*,⁴³ contracting is unlikely to resolve the problem of fiduciary conflicts. Even worse, as commercial transactions increase in complexity, parties may find it even more difficult to agree on contractual rules that anticipate outcomes.⁴⁴

⁴⁰ 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.

⁴¹ See Omri Ben-Shahar & John A.E. Pottow, *On The Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006).

⁴² See, e.g., *MetLife v. RJR Nabisco*, 716 F. Supp. 1504, 1509 (SDNY 1989) (observing that “underwriters ordinarily negotiate the terms of [public bond] indentures with the issuers,” and that “those indentures are often not the product of face-to-face negotiations between the ultimate [bond]holders and the issuing company”). Cf. Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211 (1991) (arguing the trust-indenture contracting process results in relatively meager protection for the parties).

⁴³ See, e.g., *Deutsche Bank Trust Co. v. Victoria Finance Ltd.*, N.Y. Sup. Ct. Interpleader Complaint, Index No. 600071/2008 (litigating a completely unanticipated dispute regarding the order in which the collateral trustee should make payment to conflicting investors after default). Cf. Frank 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”).

⁴⁴ 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, e.g., Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193 (2008); Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. (forthcoming issue no. 2, 2009).

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.⁴⁵

There therefore 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,⁴⁶ 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), the 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. Thereafter, the analysis addresses potential procedural solutions to fiduciary conflicts,⁴⁷ such as declaratory-judgment actions and requiring separate fiduciaries for each separate class of investors.

II. 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

⁴⁵ Cf. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1099 (1997) (suggesting that Delaware's detailed judicial opinions serve as narrative examples to inform managerial conduct, and that this is an efficient method of corporate governance); *id.* at 1097 (quoting 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").

⁴⁶ See *infra* Part II.

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.⁴⁸ Because its duty is so divided, the fiduciary cannot act ministerially, as a mere agent,⁴⁹ but must exercise discretion.⁵⁰ 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.⁵¹

Courts examining a fiduciary's conflicting obligations have, similarly, focused more on the conflict per se than on the type of underlying commercial transaction.⁵² For

⁴⁷ See *infra* Part III.

⁴⁸ This article focuses on the dilemma of fiduciaries with conflicting obligations *after default*, when that dilemma is most pronounced. See *supra* notes 8-22 and accompanying text.

⁴⁹ 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”).

⁵⁰ Cf. *Bank of New York v. Montana Bd. of Investors*, *supra* note 23, at paragraph 59 (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”).

⁵¹ Cf. Frankel, *supra* note 11, 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).

⁵² 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.

example, in the leading case of *Beck v. Manufacturers Hanover Trust Co.*,⁵³ the fiduciary was a trustee under an indenture securing bonds issued by a railway company. In analyzing the trustee's fiduciary responsibilities after default,⁵⁴ the court did not distinguish between the trustee and any other type of fiduciary. Indeed, the court observed that "even 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."⁵⁵ The court's rationale was that, after default, bondholders will "be unable to guard against the further impairment of their economic interests."⁵⁶

This article will therefore analyze the dilemma generically,⁵⁷ using the example of two classes of conflicting investors, one senior and the other subordinated, after default.⁵⁸ 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, the article first analyzes the dilemma of a fiduciary with conflicting obligations in the absence of investor directions and thereafter analyzes that dilemma when there are investor directions.

⁵³ *Beck v. Manufacturers Hanover Trust Co.*, 632 N.Y.S. Supp. 2d 520 (Sup. Ct., App. Div., 1995).

⁵⁴ The court ultimately held that the trustee "had responsibilities to the trust beneficiaries." 632 N.Y.S.2d at 526.

⁵⁵ *Id.* at 527 (emphasis added). This language was quoted and reaffirmed in *LNC Investments, Inc. v. First Fidelity Bank*, 935 F. Supp. 1333, 1347 (S.D.N.Y. 1996).

⁵⁶ *Beck*, *supra* note 53, 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").

⁵⁷ The article assumes, however, that the underlying transaction for which the fiduciary acts is commercial. *See supra* notes 30-49 and accompanying text.

⁵⁸ This two-class structure is in fact typical of structured investment vehicles. Geoff Fuller and Elizabeth Collett, *Structured Investment Vehicles – The Dullest Business on the Planet?*, 3 CAPITAL MKT. L.J. 376, 379 (2008).

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.⁵⁹ Similarly, the discretionary options of mortgage servicers may be more limited than those of other fiduciaries.⁶⁰ 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.⁶¹ 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,⁶² 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; (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.⁶³ Therefore, the expectations of both

⁵⁹ See *infra* note 140 and accompanying text.

⁶⁰ See *supra* notes 17-19 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).

⁶¹ Cf. *Beck v. Manufacturers Hanover Trust Co.*, *supra* note 53, 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 New York*, *supra* note 23, at paragraphs 58-59 (ruling that the trustee is not merely an agent of the senior class).

⁶² See *supra* note 57 and accompanying text.

⁶³ See, e.g., CHRISTOPHER L. CULP, *STRUCTURED FINANCE AND INSURANCE: THE ART OF MANAGING CAPITAL AND RISK* 287-290 (2006) (explaining that the proper way to

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.⁶⁴ 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.⁶⁵ 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 remaindermen).⁶⁶ The trustee must “deal impartially” with the beneficiaries.⁶⁷

understand subordination is to view the holders of subordinated securities as selling repayment insurance to all holders of securities that are contractually “senior”).

⁶⁴ See *supra* note 7.

⁶⁵ See Schwarcz & Sergi, *supra* note 10, at 1057-60 (explaining why “indenture trustees may well have—and certainly should have—a duty after default of *maximizing* bondholder recovery”). See also JAMES E. SPIOTTO, *DEFAULTED SECURITIES: THE PRUDENT INDENTURE TRUSTEE’S GUIDE XVIII-1* (1990) (observing that “it is the role of the indenture trustee to help maximize the return to holders, once a default or troubled situation has occurred”); Robert I. LANDAU & JOHN E. KRUEGER, *CORPORATE TRUST ADMINISTRATION AND MANAGEMENT* 171 (1998) (observing that “[i]f liquidation or reorganization becomes necessary, the trustee should see that the security holders realize their claims in full or to the greatest extent possible”).

⁶⁶ RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 183 (1990). The duty of impartiality applies “whether the beneficiaries’ interests in the trust property are concurrent or successive.” *Id.* § 183, cmt. a.

A duty of impartiality is usually sufficient for gratuitous trusts because the trustee can resolve conflicts by fulfilling the intentions of the settlor of the trust.⁶⁸ 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.⁶⁹

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

⁶⁷ 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 (“it is the trustee’s duty, reasonably 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”). The Uniform Principal and Income Act likewise provides that a trustee “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 or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries.” UNIF. PRINCIPAL AND INCOME ACT § 103(b) (1997). Any action taken in accord with the 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.* at 103(a).

⁶⁸ Comment of Deborah A. DeMott, David F. Cavers Professor of Law, Duke Law School, and former Reporter, Restatement (Third) of Agency, at July 22, 2009 Duke Law School faculty workshop on this article.

⁶⁹ *Commercial Trusts as Business Organizations*, *supra* note 56, 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: “The trust law duty of impartiality has not yet needed to address [the situation where residual trust claimants expect a rate of return that compensates them for the money they voluntarily put at risk, thereby creating a conflict with the trust’s senior claimants], because third-party investment in residual trust claims is rare. If, however, 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”

cannot resolve conflicts by fulfilling the settlor's intentions.⁷⁰ 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,⁷¹ the fiduciary is much more likely to be subject to a lawsuit.⁷² A 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 making fiduciaries with conflicting obligations 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. Furthermore, fiduciary duties sometimes might even override contractual provisions.⁷³

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.⁷⁴ 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,

⁷⁰ Comment of DeMott, *supra* note 68.

⁷¹ See *infra* note 83 and accompanying text.

⁷² *But cf.* RICHARD M. HORWOOD & LAUREN J. WOLVEN, MANAGING LITIGATION RISKS OF FIDUCIARIES A-3 (Tax Management 2006) (observing a trend of increasing litigation against fiduciaries of gratuitous trusts).

⁷³ See *infra* notes 97-123 and accompanying text (examining contractarian and non-contractarian axioms underlying fiduciary analysis).

⁷⁴ Uniform Commercial Code §§ 9-608(a)(4), 9-615(d).

to maximize their value. This balancing is arguably Pareto optimal, increasing subordinated-investor value without harming the senior investors.⁷⁵

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.⁷⁶ If a delay in foreclosing is likely to increase collateral value, the fiduciary should forestall foreclosure.⁷⁷ Because the senior investors would ultimately be repaid with interest, the delay would not materially impact their position.⁷⁸

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

⁷⁵ *But cf. infra* note 78 (explaining why this may not be perfect Pareto optimality).

⁷⁶ 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 (3d ed. 2003 & supps.). This is done by paying senior investors, after default, from the extra collateral originally expected to pay the subordinated investors. *Id.*

⁷⁷ 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 20, 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).

⁷⁸ 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. *Cf. See e.g.,* 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

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.⁷⁹ The implicit rationale is that such a duty maximizes value to all of the corporation's investors.⁸⁰

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 conservatively invested and not usually placed at risk,⁸¹ corporation law contemplates that the board of directors generally should place corporate assets at risk in order to generate profits and growth.⁸² This same goal—to *maximize (rather than merely to preserve) value*—is also the obligation of a fiduciary for commercial investors after default.⁸³ Increasing value is “harder [than] merely preserv[ing] value,” making a “duty of impartiality difficult to apply” in a commercial

prior to a foreclosure sale); UCC § 9-623 (similar right regarding collateral covered by the UCC).

⁷⁹ See, e.g., *North Am. Catholic Educ. Programming Foundation v. Gheewalla*, 930 A.2d 92, 101-02 (Sup. Ct. Del. 2007).

⁸⁰ 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).

⁸¹ 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 90% chance of doubling but 10% 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. *Commercial Trusts as Business Organizations*, *supra* note 56, 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.

⁸² See 18B AM. JUR. 2d *Corporations* § 1470 (2009) (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”); *In re United Artist Theatre Co. v. Walton*, 315 F.3d 217, 233 (3d Cir. 2003) (same).

⁸³ See *supra* note 65 and accompanying text.

context.⁸⁴ 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.⁸⁵

The above analysis addressed the most common default scenario, where subordinated investors but not the senior investors would be at risk.⁸⁶ 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.⁸⁷ 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,⁸⁸ 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

⁸⁴ *Commercial Trusts as Business Organizations*, *supra* note 56, at 578. *See also* Schwarcz & Sergi, *supra* note 10, at 1059 (explaining why “the analogy [between the fiduciary duties of corporate directors and of fiduciaries with conflicting obligations] remains sound”).

⁸⁵ 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 now 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.

⁸⁶ *See supra* note 76 and accompanying text.

⁸⁷ *See supra* note 65 and accompanying text.

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.⁸⁹

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.

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,⁹⁰ and in securitization transactions the so-called pooling and servicing agreement may empower the senior investors to direct the trustee after default regarding remedies.⁹¹ This can create a conflict between the interests of the class giving directions and other classes.

⁸⁸ A fiduciary customarily would make these determinations by seeking expert valuation services, as in the *Bank of New York* case.

⁸⁹ 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.

⁹⁰ Laurie S. Goodman, Daniel Newman, Douglas J. Lucas & Frank J. Fabozzi, *Event of Default Provisions and the Valuation of ABS CDO Tranches*, J. FIXED INCOME 85-86 (Winter 2007) (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).

⁹¹ Gary Barnett, *Understanding CDO's in the Current Market Environment*, 908 PLI/Comm 739, 748 (2008).

A similar conflict can arise even where the directed fiduciary acts for investors in a *single* class of *pari passu* securities.⁹² 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.⁹³

Regardless of how the conflict among investors arises, the fundamental issues concerning the directed fiduciary are the same.⁹⁴ 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.⁹⁵

⁹² Cf. Schwarcz & Sergi, *supra* note 10, at 1071 (observing that the power of majority bondholders to direct the trustee “raises serious, unresolved issues [where] [s]ome or all of the majority bondholders . . . have conflicts of interest with other bondholders . . . whether the majority bondholders should have legal duties to other bondholders and, if so, what should be the standard for those duties”).

⁹³ See, e.g., *The Anglo-American Indenture*, *supra* note 7 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 Trusts & Investments 38-39 (July-Aug. 2008) (observing that “most indenture documents instruct the trustee to receive and follow direction from 50 percent of the principal amount of the bondholders”).

⁹⁴ Cf. *infra* note 100 (discussing the *Beck* case, in which the trustee actually acted for a single class of *pari passu* securities).

⁹⁵ 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 93 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). Interview with Harold L. Kaplan, *supra* note 6.

As a conceptual matter, one way to think about this dilemma is to ask whether, after such directions are given, the 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.⁹⁶ If it is acting solely for the directing investors, the fiduciary would logically have no obligation to protect the non-directing 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, however. Scholars posit two ways of interpreting fiduciary duties. One way is contractarian, that fiduciary duties should be viewed merely as contractual default terms.⁹⁷ Fiduciaries then are subject to clear contractual provisions to which the investors have implicitly (or, in some cases, explicitly) consented. The other way is non-contractarian, that the fiduciary relationship is unique in providing mandatory rules and that fiduciaries have duties that override even clear contractual provisions.⁹⁸ These two ways of interpreting fiduciary duties represent fundamentally divergent axioms.⁹⁹

⁹⁶ Cf. *supra* notes 49-50 and accompanying text (observing that so long as its duty is divided, the fiduciary cannot act ministerially as a mere agent).

⁹⁷ See, e.g., Mariana Pargendler, *Modes of Gap Filling: Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV. 1315, 1315 (2008) (arguing that “fiduciary duties are untailed defaults that supply the term that most parties in a certain fiduciary category would have wanted,” and that this is normatively desirable); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995) (arguing that fiduciary duties governing gratuitous trusts should be seen as contractual default rules); 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.”).

⁹⁸ See, e.g., 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); Scott FitzGibbon, *Fiduciary Relationships are not Contracts*, 82 MARQ. L. REV. 303, 305 (1999) (“This Article explores the nature of fiduciary relationships, shows that they arise and function in ways alien to contractualist thought, and that they 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”); Deborah A. DeMott, *Beyond*

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.”¹⁰⁰ This suggests a non-contractarian 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”¹⁰¹ Later courts sometimes question *Beck*’s

Metaphor: An Analysis of Fiduciary Obligation, 1988 DUKE L.J. 879 (1988) (arguing that applying the conceptual framework of contractual analysis to fiduciary relationships is misleading, in part because many fiduciary duties are mandatory rules); Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends*, 56 BUFF. L. REV. 99 (2008) (arguing that the non-contractual approach better describes fiduciary duties than the contractual approach).

⁹⁹ Cf. Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573 (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).

¹⁰⁰ *Beck v. Manufacturers Hanover Trust Co.*, *supra* note 53, at 526, 530 (apparently 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 designs upon obtaining the collateral.” 632 N.Y.S. Supp. 2d 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.* at 529. 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—Mexico had this right under § 5 of the Indenture, which provided that holders of 75% 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 [i.e., the collateral]”—the trustee set a very low minimum sale price for the collateral, without arranging for a fair third-party valuation. 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.

¹⁰¹ *Id.* at 528.

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.¹⁰²

Commentators raise similar inconsistencies.¹⁰³ 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.”¹⁰⁴

The Restatement of Trusts, which most closely examines the dilemma of trustees with conflicting obligations (albeit in a gratuitous-trust context), takes a semi-contractarian approach. If the terms of a trust “confer upon [a particular beneficiary] a power to direct or otherwise control conduct of the trustee, the trustee has a duty to . . . comply with any exercise of that power, unless . . . the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the *power holder* owes to the beneficiaries.”¹⁰⁵

¹⁰² LNC Investments, Inc. v. First Fidelity Bank, 935 F. Supp. 1333, 1348 (S.D.N.Y. 1996).

¹⁰³ Compare Rawlings, *supra* note 15, at 15 (“In the US, . . . the obligations of the note trustee do not emerge from a fiduciary duty owed to the noteholders, but are ‘exclusively defined’ by the trust deed”) and *id.* at 16 (“under 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) (“parties 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”).

¹⁰⁴ Powell, *supra* note 93, at 38. This begs the question, of course, of what the minority should be protected against.

¹⁰⁵ RESTATEMENT (THIRD) 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.* at cmt. a.

Applying this rule in a commercial context, one would expect that senior investors—who typically are (and in the 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 investors) is subject to the same fiduciary duty to other beneficiaries as is the trustee¹⁰⁶—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 a designated power holder.”¹⁰⁷ Such a power “is not a fiduciary power.”¹⁰⁸ 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.”¹⁰⁹

It is certainly plausible, if this rule were applied in a commercial context, that a power given to senior investors after default to direct the trustee or other fiduciary could

¹⁰⁶ *Id.* at 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.R. 342, 344 (2007) (observing that “the 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”).

¹⁰⁷ RESTATEMENT (THIRD) TRUSTS, § 75, at cmt. c.

¹⁰⁸ *Id.* at cmt. d.

¹⁰⁹ *Id.* at cmt. c. *Cf.* *Fifth Ave. Bank 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.” *But cf.* GEORGE GLEASON BOGERT ET AL., *BOGERT’S TRUSTS AND TRUSTEES* § 541 (2008) (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

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.*”¹¹⁰

For analysis purposes, the foregoing discussion hypothetically applied the rules of the Restatement of Trusts in a commercial context even though that Restatement does not apply to commercial trusts.¹¹¹ Nonetheless, the Restatement’s rules, and a contractarian approach generally, appear sensible in a commercial context. Investors, for example, are usually sophisticated parties who are, or at least should be, aware of their contractual terms.¹¹² Furthermore, by enabling commercial parties to rely on enforcing contractual

immunity clause . . . should not, as such, either reduce or expand the required standard of care.”

¹¹⁰ RESTATEMENT (THIRD) TRUSTS, § 75, at 55 (Comment *d*) (emphasis added). *But cf.* Citibank, NA v. MBIA Assurance SA [2006] EWHC 3215 (Ch), at [7] (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.* at [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.”).

¹¹¹ Part 1, Chapter 1 (Definitions and Distinctions) of the Restatement states, for example, that “The Restatement of Trusts does not deal with such devices as . . . trusts used for purposes of security.” *Id.* at 4. Section 1, Comment *b*, of the Restatement reiterates that the “law relating to the use of a trust as a security device . . . is not within the scope of this Restatement.” *Id.* at 7. Although “many” of the rules of the Restatement do apply, “different rules are often applicable.” *Id.* at 4.

¹¹² There may be a second, less clearly supported, implicit rationale for this rule: that gratuitous trust directions generally involve specific actions. 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; for commercial trusts, only money is at stake.

provisions, a contractarian approach lowers the cost of financing and consequently lowers rates on the underlying financial assets, such as mortgage loans.¹¹³

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.¹¹⁴ 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,¹¹⁵ notwithstanding an insufficiency on the subordinated claims.¹¹⁶

A rigidly contractarian approach to fiduciary conflicts would not be conceptually satisfying, however. Even in a non-fiduciary setting, freedom of contract is not and should not be absolute. Freedom of contract can be limited, for example, by paternalism,

¹¹³ Cf. *Citibank, N.A. v. MBIA Assurance SA* [2007] EWCA Civ 11 (trustee, seeking guidance from an English court, 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).

¹¹⁴ Comment of Kenneth Kettering, Associate Professor, New York Law School, after the author’s keynote address (*see supra* note 1) at New York Law School’s April 24, 2009 symposium on “Fear, Fraud, and the Future of Financial Regulation.” Cf. Aline van Duyn & Michael Mackenzie, ‘Tranche warfare’ breaks out over CDOs, *FINANCIAL TIMES*, Apr. 15, 2008, <http://www.ft.com/cms/s/0/9e8e661c-0a85-11dd-b5b1-0000779fd2ac.html> (observing that “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. Senior 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”).

¹¹⁵ 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 90, at 85.

¹¹⁶ *Id.* *See also* Gary Barnett, *Understanding CDO’s in the Current Market Environment*, 908 *PLI/Comm* 739, 748-49 (2008).

policy, and potential externalities.¹¹⁷ Although paternalism is not necessarily relevant to the commercial context of this article, fiduciary considerations may well tie into policy and externality limitations on contractual freedom.¹¹⁸

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.¹¹⁹ A rigidly contractarian approach can also exacerbate the consequences of

¹¹⁷ 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).

¹¹⁸ Cf. *Citibank, N.A. v. MBIA Assurance SA*, *supra* note 113, at paragraphs 58 & 82 (observing that a fiduciary has an “irreducible” minimum obligation, but that such minimum was not violated).

¹¹⁹ E-mails from Carolyn P. Richter, Partner, Troutman Sanders LLP, to the author (Aug. 5, 2009) (emphasis added): “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 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 (despite the tremendous infusion of capital investment that it brings), unless the right of the senior tranche is checked in some manner.” 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 (2009) (to be codified at 15 U.S.C. § 1639a). 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 (2008) (to be codified as amended at 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. H2997, 2009 WL 562376 (March 5, 2009) (reading proposed version of the Helping Families Save Their Homes Act, “[n]otwithstanding any other provision of law, and

market failures. Consider the agency costs that can 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 recommending 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.¹²⁰ Or, like individuals generally, they may underestimate events, like a default, that are remote.¹²¹ Or they may feel, and in fact be, secure from being fired if many other investment officers are acting the same way.¹²² 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.¹²³

A contractarian approach should also be limited by some concept of good faith, there being a duty of good faith implied in all contracts.¹²⁴ The Restatement's limitation

notwithstanding any investment contract between a servicer and a securitization vehicle or investor. . . .”).

¹²⁰ 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).

¹²¹ 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 (1982)).

¹²² Cf. *Rethinking the Disclosure Paradigm*, supra note 120, 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); 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”).

¹²³ Cf. Steven L. Schwarcz, *Disclosure’s Failure in the Subprime Mortgage Crisis*, 2008 U. UTAH L. REV. 1109, 1114-15 (examining herd behavior as a partial explanation of the behavior of investment officers in the recent financial crisis).

¹²⁴ 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

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 contract¹²⁵—appears sensible.¹²⁶ This limitation also 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.”¹²⁷ 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*

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”).

¹²⁵ See *supra* note 110 and accompanying text.

¹²⁶ Cf. Schwarcz & Sergi, *supra* note 10, 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 related investment, such as an equity interest in the issuer, would be violating this duty”). Also cf. *supra* note 95 (in which a leading indenture-trustees’ lawyer suggests that indenture trustees should be sensitive to the possibility that investors directing them are attempting to gain advantages, not contemplated by the indenture, over other investors).

¹²⁷ 11 U.S.C. § 1126(e). See also 11 U.S.C. §§ 1126(c) & (d) (excluding votes so designated under § 1126(e)).

creditor's protection of its own self-interest."¹²⁸ Moreover, the limitation has precedent in corporation law.¹²⁹

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.¹³⁰ 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.¹³¹

A contractarian approach to resolving fiduciary conflicts thus appears sensible to the extent there are contractual directions. In a commercial context, investors are usually

¹²⁸ *In re Adelpia Communications Corp.*, 359 B.R. 54, 60 (2006) (emphasis added). *See also In re Kovalchick*, 175 B.R. 863, 875 (1994) (holding the same). The most common type of bad faith case is the “ulterior motive” case. *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844 (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 under a third party which depends on the debtor’s failure to reorganize. *Id.* at 844-845. Stated differently, bad faith may be found “(i) where a claimholder attempts to extract or distort a personal advantage *not available to other creditors in the class*, or (ii) where a creditor acts in furtherance of an ulterior motive, unrelated to its claim or its interest *as a creditor.*” *Id.* at 844 (emphasis added).

¹²⁹ 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. *U.S. 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, 310 (Ill. App. Ct. 1989) (citing *Meinhard v. Salmon*, 249 N.Y. 458 (N.Y. 1928) (Cardozo, 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 (Mich. 1919).

¹³⁰ *See supra* note 113 and accompanying text.

¹³¹ 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. *In re Adelpia Communications Corp.*, *supra* note 128, at 62. In contrast,

sophisticated, and contractual reliance lowers financing costs. But the contractarian approach should not be rigid. Even in a non-fiduciary 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.

III. Procedural Analysis

The analysis above addressed 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 provisions that provide fiduciaries with algorithmic or otherwise easy-to-follow rules to address conflicts.¹³² In practice, though,

fiduciaries with conflicting obligations should attempt to fairly balance their obligations to multiple investor classes.

¹³² 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, N.A. v. MBIA Assurance SA* [2007] EWCA Civ 11, at [82] (observing that although “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, that point has not been reached in the present case and therefore there is no risk of recharacterising the office of trustee as something else”). A non-contractarian 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).

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.”¹³³

Some conflicts would be easier to anticipate, such as a fiduciary acting for both interest-only 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.¹³⁴ 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. 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.¹³⁵

A better approach, perhaps, is to require separate fiduciaries for each class of conflicted investors.

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

¹³³ Cooter & Freedman, *supra* note 4, 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) (symposium issue on the subprime crisis: going forward), available at http://ssrn.com/abstract_id=1300928 (recommending that “[p]arties should write underlying deal documentation that sets clearer and more flexible guidelines”).

¹³⁴ 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., *The Future of Securitization*, *supra* note 133, 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 7 (2008) (recommending harmonizing and improving securitization servicing standards).

¹³⁵ STRUCTURED FINANCE, *supra* note 76, § 2:4.

question.¹³⁶ 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.¹³⁷ 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.¹³⁸

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

¹³⁶ Compare David Isenberg, *Exercising the Intercreditor Buyout Clause: Lessons from the Trenches*, J. CORP. RENEWAL, Nov. 19, 2008 (“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., *Model Intercreditor Agreement*, 1 (April 24, 2009), http://meetings.abanet.org/webupload/commupload/CL190029/sitesofinterest_files/ModelIntercreditorAgreementDraf42409t.pdf (providing for separate collateral agents for first and second lien claimholders, and for a single “control” agent in model agreement 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, available at <http://www.mondaq.com/article.asp?articleid=25775> (“In most large second lien bond deals, the first and second liens run to, and any possessory collateral is held by, a single independent collateral trustee for the benefit of the holders of the first and second lien debt. . . . In other bond deals and in second lien term loan deals, by contrast, the practice is generally for each of the first and second lien debt holders to have separate collateral agents”).

¹³⁷ 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) (2008) (“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”).

¹³⁸ Trust Indenture Act § 310(b).

critical decisions.¹³⁹ Also, competent successor fiduciaries may not always be available on reasonable terms and conditions.¹⁴⁰ 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.¹⁴¹ The discussion below compares these judicial procedures under American and English law.

¹³⁹ Interview with Kaplan, *supra* note 6.

¹⁴⁰ Relatively few institutions are willing, in the author's experience, to become a successor trustee in a default scenario. *See also* e-mail from Zaina M. Zainal, assistant to Harold M. Kaplan (Aug. 24, 2009) (attaching Mr. Kaplan's additional comments on this article, which state that trustees for conflicting tranches often find it "not possible or practical" to resign conflicting trusteeships).

¹⁴¹ *See supra* notes 23-28 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 15, at 28.

American law provides two basic types of judicial procedures—interpleader and declaratory judgment actions—which fiduciaries with conflicting obligations could use to resolve disputes.¹⁴² 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. Federal law provides two broadly similar types of interpleader, rule interpleader and statutory interpleader,¹⁴³ with statutory interpleader having more lenient jurisdictional requirements.¹⁴⁴ State law—by which this article will focus primarily on New York law¹⁴⁵—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.¹⁴⁶

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.¹⁴⁷ Unlike interpleader, however, a declaratory judgment action requires the existence of an “actual controversy.”¹⁴⁸ The federal declaratory judgment procedure allows the court to order a speedy hearing of the controversy.¹⁴⁹ The choice between a

¹⁴² The following discussion of judicial procedures relies heavily on Coughlin, *supra* note 34.

¹⁴³ Rule interpleader arises under Federal Rule of Civil Procedure 22, statutory interpleader arises under 28 U.S.C. § 1335.

¹⁴⁴ FED. R. CIV. P. 22 (Practice Commentary).

¹⁴⁵ Much of the litigation concerning applications for court direction by fiduciaries with conflicting obligations is governed by the laws of England or New York. Ryan & Yong, *supra* note 103, at 60.

¹⁴⁶ N.Y. C.P.L.R. §1006 (McKinney 2009); Coughlin et al, *supra* note 34, at 778-79.

¹⁴⁷ Coughlin et al, *supra* note 34, at 782 (quoting *Banos v. Winkelstein*, 78 N.Y.S. 2d 832, 834 (1948)).

¹⁴⁸ *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 *with id.* at 783.

¹⁴⁹ Fed. R. Civ. P. 57 (“The court may order a speedy hearing of a declaratory-judgment action”).

federal or a state declaratory judgment procedure may also be influenced by jurisdictional requirements or strategic concerns.¹⁵⁰

Some states provide even more targeted statutory procedures for fiduciaries to obtain judicial directions.¹⁵¹ These procedures, however, are usually designed to apply only to gratuitous trusts, so it is uncertain whether they could be used in a commercial context.¹⁵² 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.¹⁵³ 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.¹⁵⁴ It appears that such use can involve lengthy litigation (except for cases that were quickly voluntarily dismissed¹⁵⁵).¹⁵⁶ Table 1, below, summarizes the timelines of these cases.

Table 1 – Timelines of Selected U.S. Cases

¹⁵⁰ Coughlin et al, *supra* note 34, at 784-85.

¹⁵¹ *See, e.g.*, N.Y. C.P.L.R. § 7701 (McKinney 2008).

¹⁵² Coughlin et al, *supra* note 34, 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, a trust for the benefit of creditors”

¹⁵³ DEL. SUP. CT. CIV. R. 124-31. The Summary Procedure for Commercial Disputes provides for an expedited schedule of service, discovery, trial and decision.

¹⁵⁴ *See infra* notes 157-162 (listing type of interpleader employed in each case). Federal statutory interpleader is the most common of the interpleader options.

¹⁵⁵ The cases that were quickly 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).

¹⁵⁶ Another interpleader case, *Deutsche Bank Trust Co. v. Victoria Finance Ltd.*, N.Y. Sup. Ct. Interpleader Complaint, Index No. 600071/2008, also appears to be heading towards a lengthy litigation.

	Complaint	
	Filed	Status
LaSalle Bank v. Citigroup ¹⁵⁷	7/11/08	voluntarily dismissed 8/26/08
LaSalle Bank v. BNP Paribas ¹⁵⁸	7/3/08	ongoing as of 7/15/09
U.S. Bank v. MBIA ¹⁵⁹	5/22/08	ongoing as of 7/22/09
LaSalle Bank v. UBS ¹⁶⁰	4/17/08	voluntarily dismissed 6/10/08
Deutsche Bank v. Lacrosse ¹⁶¹	1/29/08	ongoing as of 7/28/09
Wells Fargo Bank v. Calyon ¹⁶²	12/12/07	voluntarily dismissed 2/8/08

¹⁵⁷ Interpleader Complaint, LaSalle Bank Nat'l Ass'n v. Citigroup Global Markets Ltd., et al., 2008 WL 4486807, No. 08 Civ. 6294 (S.D.N.Y. July 11, 2008) (initiating proceedings under federal statutory interpleader); LaSalle Bank Nat'l Ass'n v. Citigroup Global Markets Ltd., et al., No. 08 Civ. 6294 (S.D.N.Y. August 26, 2008) (notice of dismissal).

¹⁵⁸ Interpleader Complaint, LaSalle Bank Nat'l Ass'n v. BNP Paribas, London Branch, et al., 2008 WL 4486738, No. 08 Civ. 6134 (S.D.N.Y. July 3, 2008) (initiating proceedings under federal statutory interpleader); LaSalle Bank Nat'l Ass'n v. BNP Paribas, London Branch, et al., No. 08 Civ. 6134 (S.D.N.Y. July 15, 2009) (order declaring subject matter jurisdiction over the action).

¹⁵⁹ Interpleader Complaint, U.S. Bank Nat'l Ass'n v. MBIA Ins. Corp., et al., 2008 WL 2972551, No. 08 Civ. 4791 (S.D.N.Y. May 22, 2008) (initiating proceedings under federal statutory interpleader); U.S. Bank Nat'l Ass'n v. MBIA Ins. Corp., et al., No. 08 Civ. 4791 (S.D.N.Y. July 22, 2009) (motion for summary judgment submitted by MBIA).

¹⁶⁰ Complaint, LaSalle Bank Nat'l Ass'n v. UBS AG, et al., 2008 WL 2306127, No. 08 Civ. 3692 (S.D.N.Y. Apr. 17, 2008) (initiating proceedings under federal rule interpleader); LaSalle Bank Nat'l Ass'n v. UBS AG, et al., No. 08 Civ. 3692 (S.D.N.Y. June 10, 2008) (notice of dismissal).

¹⁶¹ Deutsche Bank Co. Americas v. Lacrosse Financial Products, LLC, et al., No. 08 Civ. 0955 (S.D.N.Y. Jan. 29, 2008) (interpleader complaint filed); Memorandum Of Law In Support Of Motion To File Exhibits Under Seal, Deutsche Bank Co. Americas v. Lacrosse Financial Products, LLC, et al., 2008 WL 887107, No. 08 Civ. 0955 (S.D.N.Y. Jan. 31, 2008) (referring to proceedings under federal statutory interpleader); Deutsche Bank Co. Americas v. Lacrosse Financial Products, LLC, et al., No. 08 Civ. 0955 (S.D.N.Y. Jul. 28, 2009) (order re-captioning case).

¹⁶² Interpleader Complaint, Wells Fargo Bank, N.A. v. Calyon, et al., Index No. 07-650335 (N.Y. Sup. Ct. Dec. 11, 2007), *available at* <https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=beRQdV7wtSw+fOmA3gQYHA==&system=prod> (initiating proceedings under New York state interpleader); Notice of Discontinuance Without Prejudice, Wells Fargo Bank, N.A. v. Calyon, et al., Index No. 07-650335 (N.Y. Sup. Ct. Feb. 8, 2008) *available at*

English law, in contrast, appears to provide much speedier judicial procedures by which fiduciaries with conflicting obligations could resolve disputes. 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,¹⁶³ resulting in the new CPR which is designed to combat the expense, slowness and complexity of the prior system.¹⁶⁴ 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 party.¹⁶⁵

Although most court actions in England are initiated under Part 7 of the CPR (the general claim filing procedure),¹⁶⁶ 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 8.¹⁶⁷ Under Part 8, for example, the court may immediately set a hearing date once a claim form is submitted,¹⁶⁸ and additional

<https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=beRQdV7wtSx15gxED+lQXQ==&system=prod>; Interpleader Complaint, Wells Fargo Bank, N.A. v. Calyon, 2008 WL 888995, No. 08 Civ. 1297 (S.D.N.Y. February 8, 2008) (refiling case in federal court); Wells Fargo Bank, N.A. v. Calyon, No. 08 Civ. 1297 (S.D.N.Y. August 5, 2009) (notice of change of address submitted on behalf of party Calyon).

¹⁶³ See generally PAULA LOUGHLIN & STEPHEN GERLIS, CIVIL PROCEDURE 1-8 (Cavendish Publishing 2d ed. London 2004).

¹⁶⁴ *Id.*

¹⁶⁵ CPR 1. See also ROBERT HILL, HELEN WOOD & SUZANNE FINE, A PRACTICAL GUIDE TO CIVIL LITIGATION 7 (2003) (emphasizing the great practical import of the CPR stating that it is to be interpreted in light of the Overriding Objective).

¹⁶⁶ *Id.* at 119.

¹⁶⁷ CPR 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. CPR 8.3 (Acknowledgement of service); CPR 8.5 (Filing and serving of written evidence); Hill, Wood & Fine, *supra* note 165, at 120-21.

¹⁶⁸ Practice Direction 8 §6.1.

requirements that would apply to a standard Part 7 claim are waived or altered for expediency.¹⁶⁹

Similarly, England's Insolvency Act of 1986 enables an administrative receiver of an insolvent company to obtain court directions.¹⁷⁰ In urgent cases, a court may immediately hear the receiver's application, regardless of notice or attendance to affected parties, and may shorten the standard period of service to these parties.¹⁷¹ The provisions of the CPR, including the Overriding Objective, apply to insolvency proceedings.¹⁷²

Interpleader actions in English law have been incorporated into the CPR.¹⁷³ 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.¹⁷⁴ 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.¹⁷⁵ The court is given broad powers to rule on such cases.¹⁷⁶

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—

¹⁶⁹ See, e.g., CPR 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); CPR 8.3 (providing shortened period for acknowledgement of service); CPR 8.5 (providing shortened period for filing and serving of written evidence).

¹⁷⁰ Insolvency Act, 1986, c. 45, § 35.

¹⁷¹ Insolvency Rules, 1986, § 7.4(6).

¹⁷² *Id.* § 7.51

¹⁷³ CPR sch. 1, RSC Order 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); CPR sch. 2, CCR Order 33 Pt. II (providing a very similar procedure for use in the County Courts).

¹⁷⁴ CPR sch. 1, RSC Order 17 Rule 1.

¹⁷⁵ *Id.* Rule 3(4).

¹⁷⁶ *Id.* Rule 8(1).

involving insolvent entities with administrative receivers—were commenced under the Insolvency Act.¹⁷⁷ Interpleader actions were not used in these cases.

Table 2 – Timelines of Selected English Cases

	Claim Form Filed	Hearings	Verdict
<i>In re Sigma Finance Corp.</i> ¹⁷⁸	11/3/08	11/4/08	11/7/08
<i>In re Golden Key Ltd.</i> ¹⁷⁹	9/25/08	12/11/08 - 12/12/08	4/2/09
<i>Bank of New York v. Mt. Bd. Inv.</i> ¹⁸⁰	5/2/08	7/3/08 - 7/4/08	7/10/08
<i>In re Whistlejacket Capital Ltd.</i> ¹⁸¹	2/28/08	3/3/08 - 3/4/08	3/5/08
<i>In re Cheyne Fin. Plc</i> ¹⁸²	Not before	9/4/07 9/11/07	9/12/07
<i>Citibank v. MBIA Assurance</i> ¹⁸³	11/20/06	11/21/08 - 12/11/08	12/13/06

¹⁷⁷ See *infra* notes 178-183 (listing type of procedure employed in each case).

¹⁷⁸ *In re Sigma Fin. Corp.* (in Receivership), [2008] EWHC 2997 (Ch) (opinion dated November 7, 2008 listing hearings on November 4, 2008); *id.* at [1] (“This is an application pursuant to section 35 of the Insolvency Act by the Receivers”); *In re Sigma Fin. Corp.* (in Receivership), [2008] EWCA Civ 1303, at [1] (“This judgment is given on three appeals from an order of Sales J. made on November 7, 2008, in proceedings issued on November 3”).

¹⁷⁹ *In re Golden Key Ltd.* (in Receivership), [2009] EWHC 148 (Ch) (opinion dated April 2, 2008 listing hearings on December 11 and 12, 2008); *id.* at [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”).

¹⁸⁰ *Bank of New York v. Mt. Bd. Inv.*, [2008] EWHC 1594 (Ch) (opinion dated July 10, 2008 listing hearings on July 3 and 4, 2008); Philip Rawlings, *Reinforcing Collectivity: The Liability of Trustees and the Power of Investors in Finance Transactions*, 23 TRUST L. INT’L 14, 28-29 (2009) (stating that *Bank of New York v. Mt. Bd. Inv.* was initiated under Part 8); *id.* at n.78 (“Proceedings were filed on 2 May 2008”).

¹⁸¹ *In re Whistlejacket Capital Ltd.* (in Receivership), [2008] EWHC 463 (Ch) (opinion dated March 5, 2008 listing hearings on March 3 and 4, 2008); *id.* at [1] (“This is an Originating Application (“the Application”) by the receivers of Whistlejacket Capital Limited (“the Company”) for directions as to the management of the Company’s business”); *In re Whistlejacket Capital Ltd.* (in Receivership), [2008] EWCA Civ 575 at [14] (“The receivers’ application for directions was issued on February 28”).

¹⁸² *In re Cheyne Finance Plc* (in Receivership), [2007] EWHC 2116 (Ch) (opinion dated September 12, 2007); *id.* at [3] (“The urgency of the matter, it being recognised on all sides that the Receivers need directions today after a hearing yesterday afternoon. . .”); see *id.* at [1] (“This is an urgent application for directions by Messrs. Nicholas Edwards,

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 continue to be litigated 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.¹⁸⁴ English courts have similarly questioned whether expeditious English judicial procedures may come at the expense of thoroughness.¹⁸⁵ In contrast, one may argue that the potential high cost of lengthy

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. . . .”).

¹⁸³ *Citibank NA v. MBIA Assurance SA*, [2006] EWHC 3215 (Ch) (opinion dated December 13, 2006 listing hearings on a number of dates from November 21 through December 11, 2006); *id.* at [20] (“Meanwhile, because of QVT’s attitude, 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 (August 12, 2009, 06:09 EST) (relaying confirmation that *Citibank v. MBIA* was initiated under Part 8, from Mr. Dhillon, who represented party QVT Financial LP in that case).

¹⁸⁴ Rawlings, *supra* note 15, 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).

¹⁸⁵ See *In re Sigma Fin. Corp. (in Receivership)*, [2008] EWCA Civ 1303 at [1] (“[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 (in Receivership)*, [2007] EWHC 2116 at 3 (Ch) (“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

litigation in New York courts effectively acts as a type of penalty default rule, encouraging informed settlement.¹⁸⁶

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.¹⁸⁷ In the *Bank of New York* case, 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.¹⁸⁸

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.

which I would have preferred to provide”). *But cf. id.* at [2] (“I am satisfied that the two alternative constructions have, despite the shortness of time, been fully argued”).

¹⁸⁶ *See supra* note 155.

¹⁸⁷ 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. Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT’L LAW 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.

¹⁸⁸ *See supra* note 141.

This influence has already been mentioned in the context of servicers foreclosing on, rather than restructuring, defaulted mortgages, and there are many other examples.¹⁸⁹ 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.¹⁹⁰ These opinions, however, are rarely forthcoming,¹⁹¹ 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.¹⁹²

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 non-conflicting 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

¹⁸⁹ See, e.g., Schwarcz & Sergi, *supra* note 10, 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 the author (Sep. 11, 2009) (observing that “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.”).

¹⁹⁰ Statement of Doneene Damon, outgoing Chair of the American Bar Association Section on Business Law’s Committee on Trust Indentures and Indenture Trustees, April 18, 2009, Vancouver, Canada.

¹⁹¹ *Id.*

¹⁹² Cf. Harold L. Kaplan & Mark F. Hebbeln, *Keeping a Level Playing Field: The Evolution of Discriminatory Consent Solicitations and Exchange Offers*, ABA TRUSTS & INVESTMENTS 44, 50-52 (Mar.-Apr. 2008) (observing that indenture trustees with conflicting obligations are also requesting additional indemnifications and seeking declaratory judgments).

because trustees would then be more likely to exercise independent judgment.¹⁹³ 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.”¹⁹⁴ Would a similar limitation on liability be likely to improve the performance of fiduciaries with conflicting obligations?¹⁹⁵

One way to answer this question is through a cost-benefit analysis.¹⁹⁶ In the corporate decisionmaking process, the business judgment rule encourages qualified directors to serve by limiting liability risk, encourages inherently risky but value-

¹⁹³ Schwarcz & Sergi, *supra* note 10, at 1073 (suggesting that would “lower the cost of public debt while, at the same time, providing public bondholders with greater, not less, protection”).

¹⁹⁴ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

¹⁹⁵ *Cf.* Schwarcz & Sergi, *supra* note 10, 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 (say 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 (1988); Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363 (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 bargaining power may be. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187, at cmt. g. 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. N.Y. GEN. OBLIG. L. § 5-1401 (McKinney 2001).

¹⁹⁶ *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 402 (7th ed. 2007) (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

maximizing transactions, and limits costly judicial involvement that would be ill-suited to evaluating such decisions.¹⁹⁷ These benefits must be balanced, however, against the rule's costs, which include increased opportunity for self-interested director behavior¹⁹⁸ and a possible disincentive to director diligence.¹⁹⁹ Although weighing these costs and benefits would involve empirical questions the answers to which are highly uncertain,²⁰⁰ principles of decision theory suggest the balancing should take into account only variables about which there is a reasonable degree of certainty.²⁰¹ In the corporate decisionmaking process, commentators focus on the certain costs of judicial involvement, which weighs heavily in favor of adopting a business judgment rule.²⁰²

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,²⁰³ 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

quantitatively measure intangible values. Joseph William Singer, *Normative Methods for Lawyers*, 56 U.C.L.A. L. REV. 899, 916-19 (2009).

¹⁹⁷ Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule*, 66 MD. L. REV. 398, 445 (2007).

¹⁹⁸ *Id.* at 439.

¹⁹⁹ *Id.* at 446.

²⁰⁰ *Id.*

²⁰¹ *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”).

²⁰² *Id.* at 473 (observing that “[t]he 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*, 10 J. CORP. L. 373, 388 (1985) (observing that “the 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”).

²⁰³ *See supra* note 65.

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,²⁰⁴ and there is no reason to believe they would be of the same magnitude as the certain benefits.²⁰⁵ 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.²⁰⁶

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 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 decisionmaking by indenture trustees.²⁰⁷ These same reasons should apply to decisionmaking by fiduciaries with conflicting obligations, after default. Such a fiduciary should, as discussed, attempt to maximize

²⁰⁴ 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. Robert T. Miller, *Wrongful Omissions by Corporate Directors*, 10 U. PA. J. BUS. & EMP. L. 911, 913, 919 (2008).

²⁰⁵ Cf. Gold, *supra* note 197, at 469 (quoting ADRIAN VERMEULE, *JUDGING UNDER UNCERTAINTY: AN INSTITUTIONAL THEORY OF LEGAL INTERPRETATION* 175 (2006)) (“[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”). 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.

²⁰⁶ It may be objected 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 197, at 456-57 (quoting JON ELSTER, *SOLOMONIC JUDGEMENTS: STUDIES IN THE LIMITATIONS OF RATIONALITY* 135 (1989)).

²⁰⁷ Schwarcz & Sergi, *supra* note 10, at 1061-63.

value. There is increasingly a need to attract highly-skilled fiduciaries,²⁰⁸ and the present uncertainty surrounding fiduciary conflicts undermines efficient decisionmaking.²⁰⁹ 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.²¹⁰

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,”²¹¹ thereby effectively insulating the trustee from liability for a good faith exercise.²¹²) A business judgment rule would not, of course, define for whose benefit the fiduciary’s judgment is to be exercised.²¹³ That would be determined, as applicable, either by the contract or by the rules applicable to balancing conflicting beneficiary interests in the absence of contractual directions.

IV. Conclusions

²⁰⁸ Cf. Statement of Doneene Damon, *supra* note 190 (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”).

²⁰⁹ See *supra* note 45 and accompanying text.

²¹⁰ Corinne Ball et al, *The Board of Directors’ Fiduciary Duties* 131, 166 (PLI Corp. L. & Practice Course Handbook Series No. 1713, 2009) (“Courts generally acknowledge that they lack the information and skill necessary to evaluate business judgments”). Ex post evaluations of decisionmaking also can suffer from hindsight bias. Gold, *supra* note 197, at 443.

²¹¹ See *supra* note 28 and accompanying text.

²¹² 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. 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 the author (May 22, 2009) (asking “how can one decide how a prudent man [referencing the standard of a fiduciary to act, after default, as a prudent person, discussed *supra* note 9] would balance the competing interests of two conflicting investors?,” and suggesting that “the only solution is to give complete discretion to the trustee”).

²¹³ Cf. Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule*, 66 MD. L. REV. 398, 434-42 (2007) (discussing uncertainty as to whether business judgment

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 sub-optimal 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, the article first analyzes fiduciary conflicts in the absence of beneficiary directions. In that context, the article argues that the fiduciary should favor subordinated over senior beneficiaries in the most common fiduciary-conflict scenarios.²¹⁴ 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.

The 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 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.

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

²¹⁴ In these scenarios, the senior beneficiaries are reasonably assured to receive payment whereas the subordinated beneficiaries are at risk. *See supra* notes 76-85 and accompanying text. In certain less common scenarios, though, the article argues that a

Although treating fiduciary duties as contractual default rules is generally desirable in a commercial and financial context, the 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, the 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.

fiduciary with conflicting obligations should balance its obligations to conflicting beneficiaries on a more nuanced case-by-case basis.