Bond Defaults and the Dilemma of the Indenture Trustee

Steven L. Schwarcz  
*Duke University Law School*

Gregory Sergi  
*Duke University School of Law*

Follow this and additional works at: [http://lsr.nellco.org/duke_fs](http://lsr.nellco.org/duke_fs)

Recommended Citation  
[http://lsr.nellco.org/duke_fs/97](http://lsr.nellco.org/duke_fs/97)

This Article is brought to you for free and open access by the Duke Law School at NELLCO Legal Scholarship Repository. It has been accepted for inclusion in Duke Law School Faculty Scholarship Series by an authorized administrator of NELLCO Legal Scholarship Repository. For more information, please contact tracy.thompson@nellco.org.
BOND DEFAULTS AND THE DILEMMA OF THE
INDENTURE TRUSTEE

STEVEN L. SCHWARCZ*
AND GREGORY M. SERGI**

I. INTRODUCTION ............................................................................................................ 2
II. THE DILEMMA OF THE INDENTURE TRUSTEE ............................................................... 9
   A. The Trust Indenture Act .......................................................................................... 9
   B. The Indenture Trustee’s Post-Default Duties ....................................................... 12
   C. The Prudent-Man Standard of the Trust Indenture Act ........................................ 16
III. THE PRUDENT-MAN STANDARD IN OTHER CONTEXTS .......................................... 20
   A. Traditional Trust Law ........................................................................................... 21
   B. Corporation Law ................................................................................................... 23
IV. RE-THINKING THE INDENTURE TRUSTEE’S DUTY AND STANDARD OF CARE .......... 29
   A. The Indenture Trustee’s Duty—Beyond Safeguarding Assets ............................. 30
   B. The Business Judgment Rule Applied To the Indenture Trustee ......................... 35
V. ALTERNATIVES .......................................................................................................... 40
   A. Eliminating the Mandatory Indenture Trustee ...................................................... 40
   B. Enhancing the Indenture Trustee’s Statutory Powers ........................................... 41
   C. Preserving the Ambiguity of the Prudent-Man Standard ...................................... 43
VI. CONCLUSIONS ........................................................................................................ 44

Copyright © 2007 by Steven L. Schwarcz
* Stanley A. Star Professor of Law & Business, Duke University School of Law;
  Founding Director, Duke Global Capital Markets Center. E-mail:
schwarcz@law.duke.edu.
** JD and LLM in International & Comparative Law, Duke Law School Class of 2007.
The authors wish to thank the Duke Global Capital Markets Center for funding this article.
I. INTRODUCTION

Long-term debt securities, or “bonds,” issued to public investors suffer a collective-action problem. Bondholders rarely can act as a cohesive group because the identity of individual bondholders constantly changes, public bonds being actively traded; and any individual bondholder’s investment is likely to be relatively small, minimizing economic incentive to take action or cooperate.\(^1\) Custom and law have provided a partial solution to this problem: for each public bond issue, an indenture trustee—the term deriving from the fact that the loan agreement governing a public bond issue is traditionally called an “indenture”—is appointed to act as a type of agent on behalf of the bondholders collectively.\(^2\)

This “solution” is sorely deficient, however, because the standard of care for indenture trustees remains intolerably vague, generating cost and inefficiency in the public bond markets. A law review article published in 1929 on the liability of indenture trustees commented,

[i]n view of the present importance of the subject, it is noteworthy that there should have been so little written upon it in the fifty years during which this field of the law has been developing. Indeed, the


comparatively few cases which deal with the subject leave many of its
problems altogether untouched.3

Despite major federal legislation in the form of the Trust Indenture Act of 1939 ("TIA"),4
mandating that an indenture trustee administer all public bond issuances as a
representative of bondholders to help enforce their rights,5 these comments remain as true
today as they were in 1929.6 As a result, indenture trustees do not live up to their
“efficient centralized enforcement” function contemplated by the TIA, especially post-
default when enforcement is most critical.7

An inquiry into the standard of care for indenture trustees is now timely, given the
number of bond defaults and predictions of an imminent rise in the rate of defaults as
well as the increasingly conflicting role of private creditors in post-default situations.8
Regarding the former, Moody’s Investors Service in 2006 reported thirty-three defaults of
the worst type—payment defaults (including bankruptcies)—in the U.S. alone on nearly
$7.8 billion of bonds by corporate issuers ("issuers").9 The outlook is even worse,
because defaults are most likely on high-yield bonds10 which are rapidly growing as a
percentage of the overall market for publicly-issued bonds.11 Moody’s expects the

5 Id., § 310(a)(1).
7 See TAMAR FRANKEL, 2 SECURITIZATION § 12.26 (2006) (referring to the goal of the
TIA to establish the indenture trustee as an “efficient centralized enforcement” entity for
publicly issued bonds).
8 See infra notes 31–34 and accompanying text.
9 See Moody’s, Default and Recovery Rates of Corporate Bond Issuers, 1920-2006, at 4
(Feb. 2007) (reporting on payment defaults, bankruptcies, and distressed bond
exchanges).
10 High-yield bonds are also commonly known as “junk bonds”.

Trustees-After-Default.doc
payment-default rate for high-yield bonds to rise to approximately three percent by the end of 2007. Moreover, payment-default rates paint only a small part of the picture: adding non-payment defaults, such as breaches of covenants, the total default rates are certainly far greater than the above data suggest.

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

12 See Moody’s, *Supra* note 9, at 5; Sassen, *Supra* note 11, at 72-73 (reporting the view of a bond market analyst that “the level and severity of defaults may be worse when they finally hit, precisely because weak players are continuing to pile on new debt . . . [and] defaults could eventually approach the [ten percent] rates seen in the early 1990s.”). This compares with an average annual default rate since 1983 on high-yield bonds of 4.9 percent and a peak annual default rate since that date of over ten percent. See Moody’s, *Supra* note 9, at 4.
14 See Chris O’Leary & Colleen Marie O’Connor, *Rocky Times Ahead?; Choppy Water for Stocks While Bonds Sail Smooth*, Investment Dealers’ Dig., July 10, 2006 (stating companies raised $76 billion through common stock offerings, $35.7 billion through convertible offerings, $466 billion though investment grade debt offerings, and $66 billion through junk bond offerings during the first half of 2006).
The Standard of Care for Indenture Trustees. Absent default, the indenture trustee’s duties to bondholders are straightforward and, indeed, even ministerial. In the event of default, however, those duties are governed by a post-Depression “prudent man” standard. Both payment and non-payment (sometimes called “technical”) defaults trigger the prudent-man standard, on which this article will focus.

Although a prudent-man standard is widely used and well-developed in other legal contexts, it has received scant attention in the trust-indenture context. Indenture trustees for defaulted bonds therefore face the conundrum that they are required to act prudently but lack real guidance on what prudence means. Even worse, this article argues, the limited guidance that exists derives from misplaced judicial reliance on traditional trust law to inform the prudent-man standard. A comparison of the role of indenture trustees in modern securities markets with that of traditional trustees reveals that any analogy between the two is fundamentally misplaced.

---

15 See infra note 45–47 and accompanying text.
16 TIA § 315(c).
17 Cf. infra note 52 and accompanying text (observing that the trust-indenture standard of responsibility is triggered not only by a payment default but also by a technical default such as violation of a covenant).
18 See infra Part III (discussing the prudent-man standard in traditional trust and corporation law).
19 See infra Part II.C (explaining the relevant case law of the prudent-man standard in the trust-indenture context).
20 See LANDAU & KRUEGER, supra note 1, at 171.
21 This article uses the terms “traditional trust law” and “traditional trustee” to refer to what is otherwise known as the common law of trusts or “gratuitous” trusts. See infra Part III.A. For a general taxonomy of trust vehicles, see Steven L. Schwarz, Commercial Trusts as Business Organizations: Unraveling the Mystery, 58 BUS. L. 559 (2003).
22 See e.g., LNC Investments v. First Fidelity Bank, No. 92 Civ. 7584 MBM, 1997 WL 528283, at *7 (S.D.N.Y. Aug. 27, 1997).
23 See infra Part IV.
The resulting legal mess—a standard of indenture-trustee performance partially lacking guidance and partially misguided—causes indenture trustees to often devote as much of their energies to avoiding personal liability as to protecting bondholders.\(^{24}\) It also means that fewer and fewer players are willing to be appointed as indenture trustees and those that are may not always be of the quality needed to protect investors.\(^{25}\) This is especially unfortunate since post-default situations ideally require the “best and the brightest of the corporate trust area.”\(^{26}\)

Furthermore, liability-avoiding strategies often incongruously entail strict enforcement of an indenture’s remedial provisions, even when inaction by the indenture

\(^{24}\) This emphasis on avoiding liability is perhaps also partially explained by the traditionally low compensation paid to indenture trustees. The low compensation itself may indicate a fundamental market defect, at least part of the explanation for which may be investors’ expectations that the bonds in which they invest will not default, thereby discounting any expected benefit of a highly skilled indenture trustee. For a valuable discussion of market failures in contract law due to cognitive limitations, see Melvin Aron Eisenberg, \textit{The Limits of Cognition and the Limits of Contract}, 47 \textit{STAN. L. REV.} 211, 216 (1995) (explaining, \textit{inter alia}, that people often fail to make rational choices in contracts because they “are unrealistically optimistic”).

\(^{25}\) \textit{Cf.} American Bankers Association, Corporate Trust Committee, \textit{The Trustee’s Role in Asset-Backed Securities}, at 4 (Mar. 12, 2003) (stating indenture “[t]rustees are usually named late in the preparation of a transaction (with accordingly limited ability to negotiate terms) and are paid relatively small fees to act as trustees in transaction involving large sums of money.”).

\(^{26}\) JAMES E. SPIOTTO, \textit{DEFAULTED SECURITIES: THE PRUDENT INDENTURE TRUSTEE’S GUIDE XI-9} (1990) (further explaining that “[m]istakes in administering a defaulted account can cost the corporate trust department its profits for years to come. Successful handling of a default might even be a profitable venture.”); \textit{see also To Provide for the Regulation of the Sale of Certain Securities in Interstate and Foreign Commerce and Through the Mails, and the Regulation of the Trust Indentures Under Which the Same Are Issued and For Other Purposes: Hearings Before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce, 75th Cong. 51 (1938) [hereinafter \textit{House 1938 TIA Hearings}]} (statement of Harold V. Amberg, Vice President and General Counsel of the First National Bank of Chicago) (testifying that “[t]he decisions that face an indenture trustee when a corporate debtor is in failing circumstances are extremely delicate and difficult.”).
trustee might be the optimal course for bondholders. For example, strict enforcement could unnecessarily force the issuer into bankruptcy, which might result in less recovery for bondholders than an out-of-court restructuring. If the indenture trustee does not act, however, “it will most likely be liable for negligence.” The indenture trustee therefore frequently finds itself between the proverbial Scylla and Charybdis—having to decide between forcing the issuer into bankruptcy on one side and facing potential liability for inaction on the other.

These deficiencies in the post-default governance of public bond issues by indenture trustees contrast unfavorably with the increasingly sophisticated post-default behavior of lenders on private debt. Although it is possible that these private-lender

27 See, e.g., Landau & Krueger, supra note 1, at 138 (observing that “the [T]rustee may logically be inclined to take immediate action under the remedial provisions [of the indenture] to avoid being subjected to substantial potential liability”).

28 See Spiotto, supra note 26, XII-14:

[T]he indenture trustee should be aware that, at times, it may be in the best interests of the holders to be patient and not to proceed immediately to litigation or other remedies. Complete liquidation or acceleration of debt may not always be in the best interest of the obligor and may adversely affect the obligor’s ability to resolve its problems. A forced sale or acceleration may actually impair the security of the holders and cause the bondholders to recover less.

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

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

31 See Baird & Rasmussen, supra note 13, at 1211-12 (explaining how private lenders play an increasingly important role in corporate governance matters when a borrower defaults).
actions may benefit public bondholders, the interests of private lenders are by no means perfectly aligned with the interests of bondholders. Frequently, private lenders and public bondholders are competing creditors, such as when the bonds are subordinate to the company’s other senior debt. Bondholders then especially need an effective indenture trustee to protect their rights.

This article explores how the standard of indenture-trustee responsibility should be modified to make indenture trustees more effective. Instead of looking to the duties of traditional trustees, the article shows that the post-default duty of an indenture trustee—to increase bondholder recovery—is functionally the same as the duty of corporate directors to increase shareholder return. In that context, courts have devised a “business judgment” rule to protect corporate directors from the same chilling effects of potential liability faced by indenture trustees. This article contends that a similar rule, superimposed on the indenture trustee’s prudent-man standard, would help to correct existing governance deficiencies and achieve some of the unrealized goals of the TIA, while lowering the cost of public debt and providing greater protection for bondholders.

The article proceeds by first explaining, in Part II, the statutory framework of the TIA and the post-default prudent-man standard applicable to indenture trustees. The article then examines, in Part III, the prudent-man standard in other contexts, including

32 See id. at 1246–47 (detailing some post-default actions by private creditors that should benefit junior lenders, such as bondholders).
33 See id. at 1245 (explaining that the private lenders “who wield control” over defaulted debtors are “typically also the most senior” creditors).
34 Cf. Stewart M. Robertson, Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise, 11 HARV. J. L. & PUB. POL’Y 461, 462 (1988) (arguing in the context of solvent enterprises for the creation of “a legal framework” for public bondholders that “replicates the contractual model that governs the relationship between a corporation and holders of is privately placed debt obligations.”)
35 See infra Part IV.A.
traditional trust law and corporation law. Part IV compares the role of indenture trustees to traditional trustees and corporate directors. It concludes that because the indenture trustee’s duty is to increase potential returns to bondholders rather than merely safeguard assets, the principal justifications behind the business judgment rule for corporate directors apply equally to indenture trustees. Finally, Part V discusses how this proposed solution compares to some other suggested reforms to the legal framework for indenture trustees.

II. THE DILEMMA OF THE INDENTURE TRUSTEE

A. The Trust Indenture Act

Prior to 1939, no law in the United States specifically protected public bondholders. As a result of the stock market crash of 1929, Congress investigated how to restore investor confidence in the public securities markets. Bond market investors lacked confidence due to a collective-action problem not dissimilar to that previously noted.36 Being widely dispersed, bondholders had difficulty coordinating concerted action37; and because they had relatively small individual claims, bondholders lacked the incentive to incur the costs to overcome the problems caused by dispersion. Furthermore, this lack of incentive also made individual action by bondholders

36 See supra note 1 and accompanying text (describing today’s bondholder collective-action problem).
37 See TIA § 302(a)(1) (“concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors.”).
“impracticable.”

For these reasons, bondholders were often “not in a position, realistically, to look after their own interests.”

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

38 See id (“individual action by . . . investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action”).


40 See TIA § 302(a).

41 See To Provide for the Regulation of the Sale of Certain Securities in Interstate and Foreign Commerce and Through the Mails, and the Regulation of the Trust Indentures Under Which the Same Are Issued and for Other Purposes, Hearings before a Subcomm. of the H. Comm. on Interstate and Foreign Commerce, House of Representatives, 76th Cong. 224-25 (1939) [hereinafter House 1939 TIA Hearings] (statement of Edmund Burke, Jr. Assistant Director, Reorganization Division of the Securities and Exchange Commission); Senate 1939 TIA Hearings, supra note 39, at 34–35 (statement of Edward C. Eicher, Commissioner, Securities and Exchange Commission).

42 Landau & Krueger, supra note 1, at 175.

43 Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and
The bill that finally became law, the TIA, reflects that suggestion, at least after a bond default occurs. An indenture trustee must be appointed for each public bond issue over $10 million. Prior to default, however, the trustee’s duties are entirely ministerial, limited to “such duties as are specifically set out in [the] indenture.” Typical duties include distributing interest and principal payments to investors, maintaining a list of registered bondholders, monitoring covenants and other indenture provisions, and, if the debt is secured, holding and managing the security. Courts generally refuse to infer any additional pre-default duties.

After default, the situation radically changes.

REORGANIZATION COMMITTEES PART VI – TRUSTEES UNDER INDENTURES, at 110 (1936). This SEC report further recommended transformation of the indenture trustee into “an active guardian of [bondholder] interests throughout the entire life of the security.” Id. at 112. See also Robertson, supra note 34, at 472-473 (discussing the goals of the TIA with regard to the indenture trustee’s role).

44 TIA § 304(9).
45 TIA § 315(a)(1).
46 ROBERT LANDAU, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT 43 (1985).
47 See supra note 45 and accompanying text; In re E.F. Hutton Southwest Properties II v. Union Planters, 953 F.2d 963 (5th Cir. 1992) (“the corporate trustee has very little in common with the ordinary trustee, as we generally understand the fiduciary relationship . . . The trustee under a corporate indenture . . . has his rights and duties defined, not by the fiduciary relationship, but exclusively by the terms of the agreement. His status is more that of a stakeholder than one of a trustee.”); Elliot Associates v. J. Henry Schroeder Bank & Trust, 838 F.2d 66, 71 (2d Cir. 1988); Meckel v. Continental Resources Co., 758 F.2d 811, 816 (2d Cir. 1985); Broad v. Rockwell International Corp., 614 F.2d 418, 432 (5th Cir. 1980). However, although the TIA does not create an implied pre-default fiduciary duty of the indenture trustee, a state law fiduciary duty may apply. See id. For an argument that full fiduciary duties should apply to the indenture trustee both pre- and post-default, see Martin D. Sklar, The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?, 106 BANKING L. J. 42 (1989) (arguing “the indenture trustee should, on grounds of sound precedent and public policy, be held to the standard of a genuine fiduciary both before and after an issuer’s default.”).
B. The Indenture Trustee’s Post-Default Duties

After default, the indenture trustee must “exercise . . . such of the rights and powers vested in it by such indenture, and [must] use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.” 48 As one judge has observed, an indenture trustee’s “post-default duties are . . . flexible and less easily defined” than pre-default, 49 and “more like the duties of a common law fiduciary.” 50 For these reasons, “[t]he administration of [an] indenture after default is the greatest test of the corporate trust officer’s skill and expertise [there often being] no applicable precedents to follow, and the trustee may find itself navigating in unchartered waters.” 51

Although a “default” is defined by the applicable indenture, it includes both technical defaults, such as covenant violations, or more serious defaults, such as failure to make a scheduled payment of principal or interest or the filing of bankruptcy. 52 The indenture trustee must notify bondholders of a payment default, but need not notify bondholders of lesser defaults if, in good faith, it determines that withholding such notice is in the interests of bondholders. 53

48 TIA § 315(c).
50 Id.
51 LANDAU & KRUEGER, supra note 1, at 171.
52 TIA section 315(c) defers the definition of “default” to that in the indenture: “[t]he indenture trustee shall exercise in case of default (as such term is defined in such indenture) . . . .” (emphasis added). [Model Indenture for additional cite]
53 See TIA § 315(b) (the “indenture shall automatically be deemed (unless it is expressly provided therein that such provision is excluded) to provide that, except in the case of default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the trustee shall be protected in withholding such notice if and so long as the board of directors, the executive committee, or a trust committee of directors and/or responsible officers, of the trustee in good faith determine that the withholding of such notice is in the interests of the indenture security
If the indenture trustee decides to take action against the issuer, it must determine whether, under the applicable indenture, it can act alone or whether the bondholders must be brought into the decision. For example, many significant actions, such as changing the amount or maturities of principal and interest payments, typically require bondholder consent (usually unanimous). Because of the collective-action problem, bondholder consent—much less unanimous consent—may be difficult to obtain.

For actions that do not require bondholder consent—and most actions do not require such consent—indenture trustees often seek to insulate themselves from potential liability by organizing bondholder meetings to solicit direction. The TIA itself provides a safe harbor for indenture trustees that act in good faith in accordance with the direction of a majority of bondholders. One informed commentator observes that a prudent indenture trustee will seek such direction from bondholders for any unilateral action by holders.

54 See TIA § 316; Marcel Kahan, The Qualified Case Against Mandatory Terms in Bonds, 89 NW. U. L. REV. 566, 569 (1995) (explaining how the practical effect of TIA section 316(2) is to require unanimous consent for changes of the indenture’s payment terms). Consent solicitations are sometimes used by issuers to amend the payment terms in an indenture. These solicitations are both time-consuming and extraordinarily expensive for an issuer.

55 Cf. Schwarcz, supra note 1, at 1003-04.

56 Section 315(d)(3) of the TIA states: the “indenture shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions protecting the indenture trustee with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of the indenture securities at the time outstanding . . . .”
the indenture trustee that entails a degree of risk. In practice though, obtaining direction from bondholders, especially in large public bond issues, is often impossible and, even where possible, entails significant expense.

In most cases, therefore, indenture trustees cannot rely on bondholders for direction. The indenture trustee then is faced with a myriad of difficult choices. For example, it may have to decide whether (and, if so, when) to try to obtain collateral from the issuer to secure unsecured bonds and what might be offered as a quid pro quo. The indenture trustee also may need to decide whether (and, if so, when) to enforce remedies contained in the indenture, such as accelerating maturities, demanding specific performance of covenants, or—in the case of a payment default—simply suing for any overdue principal or interest.

If the bonds are secured, the indenture trustee faces additional choices presented by the option of foreclosing on the collateral. Structured-finance and securitization transactions present further choices, such as deciding whether to exercise remedies (for

57 See SPIOITTO, supra note 26, XI-5 (advising “[b]efore exercising remedies or taking action against the obligor in a situation where the recovery is questionable and the source of the indenture trustee fees and expenses are not free from doubt, a wise trustee will seek to receive the written direction, instruction and indemnity of a majority of the holders.”).

58 See id. XII-13.

59 [cite]

60 See id. XII-1-5.

61 See id. XII-6.

62 The TIA applies to many structured finance products; however, because the TIA only applies to publicly issued debt securities, it does not apply to many common securitization transaction where the “SPV issues equity securities” or whenever the securities, regardless of whether they are debt or equity, are privately placed. See FRANKEL, supra note 7, § 12.26; American Bankers Association, Corporate Trust Committee, The Trustee’s Role in Asset-Backed Securities (Mar. 12, 2003) (“a significant portion of all asset-backed transaction documents are not [qualified under the TIA]; they do not impose upon the trustee after the occurrence of a default anything more than its pre-default ministerial duties.”).
example, notifying obligors or taking over servicing and collection activities) against the financial assets backing the securities. 63

Where bankruptcy is a possibility, the indenture trustee’s choices can further multiply. Most critically, an indenture trustee may have to decide whether to file an involuntary bankruptcy petition. 64 It may also need to decide, for example, when to join an involuntary bankruptcy petition against the issuer. Once an issuer is in bankruptcy, the indenture trustee may need to decide whether to join a creditors’ committee 65 or, especially where the bonds are subordinated, to attempt to form a separate creditors’ committee. The indenture trustee usually will not be able to vote on a bankruptcy reorganization plan but may have the opportunity to object to such a plan. 66 If the bonds are secured, the indenture trustee also may need to decide whether to make a motion to lift the automatic stay and when to request adequate protection. 67 Additionally, the

In many structured finance transactions that are not qualified under the TIA, an indenture trustee is included but it is required to take post-default actions only in “accordance with the transaction documents . . . in order to limit the trustee’s personal liability and reinforce the notion that the trustee is not responsible for taking any independent action.” Sheilah D. Gibson, The Case for the Expanded Role of Trustees in Securitizations, 121 Banking L.J. 387, 392 (2004).

63 See id. (describing an indenture trustee in a securitization deal “may be called upon in the event of default to “(i) increase[] monitoring and review of servicing and collections; (ii) provid[e] notice to investors; (iii) [consider] liquidation; (iv) review[ ] and enforce credit enhancement and (v) prepar[e] for negotiations and possible bankruptcy.”).

64 See United States Bankruptcy Code § 303(b)(1). Although the indenture trustee may file an involuntary bankruptcy petition, “[g]enerally, [bond]holders are not going to benefit from the bankruptcy experience, and, given the sensitive nature of the decision to initiate the bankruptcy proceedings, an indenture trustee should consider such filing a last resort.” See Spiotto, supra note 26, XIV-1.

65 See id. XIV-5 (citing In re Wickes Co., Case No. LA826658-WL (Bankr. C.D. Cal. May 13, 1982); In re Nucorp Energy, Case No. 82-03106-K11 (Bankr. S.D. Cal. Oct. 12, 1982)).

66 See id. XIV-13.

67 See e.g., LNC Investments v. First Fidelity Bank, 173 F.3d 454, 457 (2d Cir. 1999) (adjudicating a claim by bondholders that the indenture trustee breached TIA section
indenture trustee may need to decide whether to invest funds that it holds during a bankruptcy proceeding.  

In the event the company selling financial assets (the “originator”) in structured-finance and securitization transactions enters bankruptcy, the indenture trustee will have the primary responsibility to ensure “continued collection of proceeds of transferred receivables” and to protect investors from “attempts of the originating seller . . . to extend the terms of the securitization or to use the receivables as its cash collateral, or to secure new financing during the bankruptcy in part based upon the receivables transferred to the SPV.” The indenture trustee may also need to defend the “true sale” nature of the securitization to prevent the receivables from reverting back to the bankrupt originator.

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

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

As discussed, the TIA’s prudent-man standard requires the indenture trustee, after default, to use the same degree of care and skill in exercising rights and powers under the

315(c) for waiting too long to make a motion to lift the automatic stay in the bankruptcy of Eastern Airlines, as well as failure to take other measures to obtain additional security); Bluebird Partners v. First Fidelity Bank, 85 F.3d 970, 972 (2d Cir. 1996) (dismissing a claim, for lack of standing, by bondholders against their indenture trustees for not filing a motion to lift the automatic stay earlier in the bankruptcy of Continental Airlines). See generally Aaron R. Cahn & Jeremy B. Hirsch, Indenture Trustee’s Dilemma: When To Seek Adequate Protection, NEW YORK LAW JOURNAL (Oct. 18, 2002).


69 Gibson, supra note 62, at 392-93.

70 See id.
indenture “as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”71 The TIA’s legislative history indicates some intent to apply the same “prudent man” standard to trust indentures as used in traditional trust law.72 As an SEC Commissioner explained, “the primary purpose of the bill is to bring all indenture trustees . . . up to the high level of diligence and loyalty now maintained by the more conscientious trust institutions.”73 Indenture trustees, however, strongly advocated a more flexible standard. For example, one witness at the Senate’s TIA hearings argued that a trust-law prudent-man standard certainly will set a large red flag before [the indenture trustee], and indicate to him that in view of his obligations to depositors and stockholders he should lean over backward to carry out all the terms of the indenture to the letter. He will not be a man who can look at the situation clearly and intelligently and act in accordance with his judgment of what is in the best interests of all concerned.74

Another witness contended the trust-law prudent-man standard, if applied in a trust-indenture context, would “do more harm to the bondholders . . . than you would benefit them by all the rest of the bill.”75 These criticisms of the trust-law prudent-man standard often emphasized scenarios in which inaction by the indenture trustee was the course of

71 See supra note 48 and accompanying text.

72 “The standard provided for is substantially the same as that which is applicable in the field of personal trusts, with the addition of the provision which binds the trustee by its misrepresentations as to its skill.” Senate 1939 TIA Hearings, supra note 39, at 28 (statement of Edward C. Eicher, Commissioner, Securities and Exchange Commission). For a discussion of why the trust-law standard should not automatically be the basis for the TIA’s trust-indenture standard, see infra Part IV.


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

75 Id. at 169 (statement of G.S. Canright, Counsel for Corporate Trust Division, Continental Illinois National Bank & Trust).
action most beneficial to bondholders, whereas a trust-law prudent-man standard would require immediate enforcement of the exact remedial provisions of the indenture. 76

Courts have not clearly resolved these conflicting views, although one unreported decision, LNC Investments v. First Fidelity Bank, 77 relied on a leading treatise and the TIA’s legislative history to conclude that the prudent-man standard for indenture trustees should be interpreted by analogy to traditional trust law. 78 In general, though, not much has changed since one commentator remarked in 1971 that “the authorities are in disagreement even as to the basic nature of the corporate trust relationship,” 79 and indeed courts have not even settled such fundamental issues as the extent, if any, to which an indenture trustee’s post-default duty to bondholders is fiduciary in nature. 80

76 See id. at 119–20 (statement of John K. Starkweather, Chairman of the Federal Legislation Committee of the Investment Bankers’ Association of America) (describing default situations where inaction by the indenture trustee is preferable to strict enforcement of the indenture). Uncritically enforcing the exact remedial provisions of the indenture is not unlike the unfortunate situation that has come to pass. See supra notes 26-30 and accompanying text.


78 Id. *17 (citing 4 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1628 n.64 (1990) and H.R. Rep. No. 1016, 76th Cong., 1st Sess. 55 (1939)).

79 Johnson, supra note 53, at 203.

80 Although an initial draft of section 315(c) of the TIA used the term “fiduciary” (requiring the indenture trustee after default to “use the same degree of care and skill in [exercising rights and powers under the indenture] as a prudent man would exercise under the circumstances if he were a fiduciary”), that term was deleted from the final version. See Senate 1939 TIA Hearings, supra note 41, at 12. Recently, however, there appears to be a trend to view the indenture trustee as a “limited fiduciary” in the event of default. See E.F. Hutton Southwest Properties II v. Union Planters, 953 F.2d 963, 975 (5th Cir. 1992) (observing a judicial trend “to view the Indenture Trustee as a limited fiduciary” after default). Under this view, the limited fiduciary relationship reflects the delineation of indenture-trustee powers in the indenture. See U.S. Bank v. U.S. Timberlands Klamath Falls, 2004 WL 1699057 (Del. Ch. 2004) (not reported in A.2d) (holding that “the powers of the Trustee are defined by and limited by the terms of the indenture” except to the extent the indenture trustee’s actions help to implement “the express purpose of the trust once the issuer is in default of payment and after the trustee
This lack of settled case law should not be interpreted to mean that indenture trustees do not constantly face potential litigation resulting from their post-default actions. Many claims against indenture trustees have been brought before courts only to be later settled or dismissed on procedural grounds. And a consequence of the unsettled case law is ambiguity in the prudent-man standard, creating a chilling effect on indenture trustees and causing the myriad deficiencies in post-default governance of public bond issues described above. As a result, indenture trustees are generally viewed as ineffective and failing to meet the goals envisioned by the TIA, one Congressional witness testifying, for example, that “[n]ot only are trustees redundant, too often they are little more than functionaries, noted mainly for their passivity, inertia and indecision.”

81 See, e.g., Caplin v. Marine Midland Grace Trust Company of New York, 406 U.S. 416, 425 (1972) (dismissing for lack of standing a claim by the bankruptcy trustee on behalf of bondholders against the indenture trustee for failure to properly monitor and enforce a covenant); Bluebird Partners v. First Fidelity Bank, 85 F.3d 970 (2d Cir. 1996) (dismissing for lack of standing a claim by bondholders against the indenture trustees for breach of section 315(c)’s prudent man standard). [add cite regarding settlement]

82 See supra notes 23-34 and accompanying text.

83 See Baird & Rasmussen, supra note 13, at 1216 (arguing the “indenture trustee . . . can do no more than insist on rigid compliance with the bond covenants”); Amihud, Garbade, & Kahan, supra note 13, at 476 (describing the indenture trustee as “generally passive”); George G. Triantis & Ronald J. Daniel, The Role of Debt in Interactive Corporate Governance, 83 CAL. L. REV. 1073, 1089 (1995) (explaining “the passivity of [indenture] trustees is well known); Victor Brudney, Corporate Bondholders and Debtor Opportunism: In Bad Times and Good, 105 HARV. L. REV. 1821, 1831 n.23 (1991) (stating in regard to the problems of modifying the original indenture, “[t]he indenture trustee has little incentive, or indeed obligation, to bargain on behalf of the bondholders with respect to debt modification. In any event, the trustee lacks the incentives of the sole lender in the rebargaining process.”).

84 Deregulating Capital Markets, Hearings before H. Comm. on Commerce, Telecommunications, and Finance, 1995 WL 722275 (Dec. 5, 1995) (statement of Morey W. McDaniel). Furthermore, while there certainly exists a significant role for the indenture trustee in bankruptcy proceedings, in a number of recent cases the U.S. Trustee
To address these deficiencies, two opposing movements have arisen in recent years advocating reform of the indenture trustee’s role within the TIA framework. One movement argues for statutory changes to the TIA that would give indenture trustees enhanced and extraordinary powers to act on behalf of bondholders after default—creating a so-called “supertrustee.” The other movement proposes partial repeal of the TIA to eliminate the mandatory indenture trustee. No one, however, has yet systematically examined the prudent-man standard itself to determine whether its development in other contexts may provide useful insights to help resolve these deficiencies. That is what this article does next.

III. THE PRUDENT-MAN STANDARD IN OTHER CONTEXTS

The “prudent man” is a well-known standard in traditional trust law and corporation law. As a general proposition, courts often look to analogous areas of law as needed to assess fiduciary-like responsibilities. The application of analogical reasoning to fiduciary relationships is suspect, however, absent an explanation of “why some similarities . . . are relevant and others not.” Although at least one court has ruled that the prudent-man standard for indenture trustees should be interpreted by analogy to traditional trust law, any attempt to analogize an indenture trustee’s duties to those of a

challenged the payment of fees and expenses to the indenture trustee for failure to meet the “substantial contribution” test of section 503(b) of the Bankruptcy Code. See Nixon Peabody LLP, Corporate Trust Alert (July 25, 2003).

85 See infra Part V (discussing in greater detail these proposed reforms).
86 See Amihud, Garbade, & Kahan, supra note 13.
87 See Deregulating Capital Markets, supra note 84.
88 See Deborah A. Demott, Fiduciary Obligation, Agency and Partnership 3 (1991) (“[c]ourts . . . resort to analogy in order to determine the rules applicable to a fiduciary in a particular situation.”).
90 See supra note 78 and accompanying text.
traditional trustee should fail absent a rigorous examination of their similarities and differences. Indeed, “mechanical analogies to the features of prototypical fiduciary relations result in rules that are confusing and inappropriate.” In examining the prudent-man standard in potentially analogous legal contexts, this part focuses primarily on the underlying in-context rationale for that standard and its interpretations.

A. Traditional Trust Law

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

The standard of care applicable to a trustee under traditional trust law is the “prudent man,” and the duty of a trustee under that standard is “to use care and skill to preserve the trust property.” This is primarily a negative duty, meaning the trustee

91 Frankel, supra note 89, at 807.
92 See generally Schwarcz, Commercial Trusts, supra note 21, at 562–73 (explaining the principal features of gratuitous and commercial trusts).
93 [cite]
94 Schwarcz, Commercial Trusts, supra note 21, at 562.

This article discusses the common law of trusts, however, one could also look to the law developed for ERISA plans. The federal ERISA statute uses a similar prudent-man standard and courts rely heavily on traditional trust law to interpret the statute. See Gregg v. Transportation Workers of America International, 343 F.3d 833, n.3 (6th Cir. 2003) (stating, for the purpose of the ERISA statute, “[c]ourts define ‘prudent person’ as that term is employed in the common law of trusts.”).

96 Modern trust law remains closely tied to its “ancient use” when “[t]he use was a passive trust” merely designed to safeguard property—the duties of the feoffee, the predecessor of the trustee, “were almost entirely negative duties. . . . No active duties and no powers were implied merely because of the relationship.” Scott, supra note 95, § 164, at 251.
should refrain from exposing trust beneficiaries to unreasonable risks. Thus, the traditional trust law duty focuses more on preserving, rather than increasing, the value of the assets held in trust.  

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

---

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

98 *See* CHARLES E. ROUNDS, JR., LORING: A TRUSTEE’S HANDBOOK § 6.2.2. (2005).

99 *Id*.

100 *See id.* at 309 (defining a reasonable investment strategy for ordinary trustees as one that preserves the purchasing power of the principal).


102 Schwarcz, *Commercial Trusts, supra* note 21, at 581.

103 *See* ROUNDS, *supra* note 98, § 6.2.2 (stating “[t]he safe harbor [of this duty to invest] is . . . [a] trustee is held to a standard of conduct, not performance. Prudence is evaluated at the time of the investment and on an ongoing basis without the benefit of hindsight.”); *SCOTT, supra* note 95, §227, at 431-34. In the context of ERISA fiduciaries, the definition of the prudent man similarly focuses on the investigation leading to the investment, rather than the investment itself. For example, in defining the duty of care applicable to an ERISA fiduciary, the Fifth Circuit stated:
Application of traditional trust-law principles to the trust-indenture context is highly suspect. On a formalistic level, trust indentures are not even actual trusts because no property is held in trust for beneficiaries of trust indentures.\textsuperscript{104} More substantively, the trustee of a traditional trust has essentially ministerial duties whereas, as discussed in Part II.B, the post-default duties of an indenture trustee are intended to protect bondholders at a time of turmoil. Part IV of this article shows that bondholders expect, and the TIA attempts to create, a more active, risk-taking indenture trustee.

B. Corporation Law

The duty of corporate directors also relies on the prudent-man standard. An early Supreme Court case articulated this standard as taking into account how “ordinarily prudent and diligent men . . . under similar circumstances” should act.\textsuperscript{105} Similarly, the

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

\textit{Keating v. RJR Nabisco}, 223 F.3d 286, 299 (5th Cir. 2000).

\textsuperscript{104} Schwarcz, \textit{Commercial Trusts, supra} note 21, at 569 (arguing that a trust indenture might be viewed as a “hybrid form of a trust”) (citing \textit{Restatement (Third) of Trusts} § 2, cmt. f (Tentative Draft No. 1, 1996)).

\textsuperscript{105} Briggs v. Spaulding, 141 U.S. 132, 152 (1891).
Principles of Corporate Governance and the ABA’s Model Business Corporation Act have applied a prudent-man standard to the duty of care by corporate directors.\textsuperscript{106}

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

[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself.\textsuperscript{107}

Although many view this articulation of the corporate director’s duty as maximizing shareholder value,\textsuperscript{108} some courts have suggested broadening the duty to require

\begin{flushleft}
\textsuperscript{107} 204 Mich. 459, 507 (1919).
\textsuperscript{108} See Ian B. Lee, Corporate Law, Profit Maximization, and the “Responsible” Shareholder, 10 STAN. J.L. BUS. & FIN. 31, 32 (2005) (stating “[i]n the corporate law
\end{flushleft}
maximizing value of the entire “corporate enterprise.” For purposes of this article, it is sufficient to say the duty of corporate directors is to maximize the value of the corporation.

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

The business judgment rule, a judicial add-on to the prudent-man standard, is intended (among other things) to protect corporate directors who take calculated risks in attempt to maximize corporate value. Under the business judgment rule, courts

 academy today in the United States, the dominant view is that corporate law requires managers to pursue a single aim: the maximization of stockholder profits.”); Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 VAND. L. REV. 83, 85-86 (2004) (describing this approach as the shareholder primacy model of corporate governance, which “both as a normative and a positive matter, [posits] that corporate decision-making powers must be exercised so as to maximize shareholder wealth.”).


111 See Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (explaining the purpose of the business judgment rule is to “protect and promote the full and free exercise of the managerial power granted to Delaware directors”); see also infra notes 119–122 and accompanying text (describing the rationale supporting use of the business judgment rule).
examine a corporate director’s decision “only to the extent necessary to verify the
presence of a business decision, disinterestedness and independence, due care, good faith,
and the absence of an abuse of discretion.”\textsuperscript{112} In this sense, the business judgment rule
does not directly affect the standard of conduct but is more properly characterized as a
“tool of judicial review.”\textsuperscript{113}

The “due care” component of the business judgment rule relates to whether a
proper investigation was made prior to the decision.\textsuperscript{114} To that extent it is similar to the
“process” approach of traditional trust law.\textsuperscript{115} However it is significantly more difficult
for plaintiffs to demonstrate breach of due care under the business judgment rule because
of the presumption in favor of corporate directors.\textsuperscript{116} To overcome this presumption, “a
shareholder claiming a lack of due care must demonstrate that a majority of the directors
who made the challenged decision were uninformed” to the point of gross negligence.\textsuperscript{117}

\textsuperscript{112} DENNIS J. BLOCK, The BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE

\textsuperscript{113} Id. at 3; see also Melvin Aron Eisenberg, The Divergence of Standards of Conduct
(contrasting a “standard of conduct” with a “standard of review”).

\textsuperscript{114} See e.g., Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (explaining “[d]ue care in
the decision-making context is \textit{process} due care only”) (emphasis in original).

\textsuperscript{115} See supra note 103 and accompanying text (observing that, under traditional trust law,
courts focus on the process by which trustees make investment decisions).

\textsuperscript{116} BLOCK, supra note 112, at 12 (quoting Sinclair Oil Corp v. Levien, 280 A.2d 717
(Del. 1971) (“A board of directors enjoys a presumption of sound business judgment, and
its decisions will not be disturbed if they can be attributed to any rational business
purpose.”)); see also Bainbridge, supra note 108, at 87 (“[c]ourts . . . will abstain from
reviewing the substantive merits of the director’s conduct unless the plaintiff can carry
the heavy burden of rebutting that presumption.”).

\textsuperscript{117} BLOCK, supra note 112, at 32 (citing Stoner v. Walsh, 772 F. Supp. 790, 801 (S.D.N.Y
1991); Levine v. Smith, 59 1A.2d 194, 206 (Del. 1991)); see Citron v Fairchild Camera,
569 A.2d 53, 66 (stating “the standard for determining ‘whether a business judgment
reached by a board of directors was an informed one is gross negligence.’”); Melanie B.
Leslie, Trusting Trustees: Fiduciary Duties and the Limits of Default Rules, 94 Geo. L. J.
This presumption in favor of corporate directors is, in practice, one of the most critical aspects of the business judgment rule. 118

There are four reasons the business judgment rule is used to protect corporate-director performance under the prudent-man standard: (1) without such a rule, corporate directors would tend to be “unduly risk-averse” 119 and would fail to take expected-value maximizing actions 120; (2) it “encourage[s] competent individuals to assume directorships” 121; (3) it protects the principle of director management, since if

67, 95 (2005) (explaining a plaintiff overcomes the presumption created by the business judgments only by showing gross negligence).

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

119 See Eisenberg, supra note 113, at 445, stating one of the main reasons for the business judgment rule,

under an ordinary standard of care directors might tend to be unduly risk-averse, because if a highly risky decision had a positive outcome the corporation but not the directors would gain, which if it had a negative outcome the directors might be required to make up the corporate loss. The business-judgment rule helps to offset that tendency.

See also AMERICAN LAW INSTITUTE, supra note 106, § 4.01 cmt. d. (justifying the business judgment rule as necessary to avoid “the risk of stifling innovation and venturesome business activity.”).

120 See Eisenberg, supra note 113, at 444–45 (explaining how the business judgment rule encourages corporate directors to make decisions based on the highest expected value).

121 BLOCK, supra note 112, at 7; In re J.P. Stevens & Co., Inc. Shareholders Litigation, 542 A.2d 770, 780 (Del. Ch. 1988) (“Because businessmen and women are correctly
“shareholders are granted the right to demand frequent judicial review of board decisions, 
the result would be to transfer ultimate decision-making authority from the board to any 
shareholder who is willing to sign a complaint"122; and (4) without such a rule, courts 
would have to substantively review complex corporate decisions.123

The next part of this article examines whether something similar to a business 
judgment rule should be used to protect indenture-trustee performance under the prudent-
man standard of the TIA. Even though there are similarities between the business 
judgment rule and traditional trust law insofar as both look to “process” rather than 
outcome,124 traditional “[t]rustees and other pension fiduciaries lack the protection 

perceived as possessing skills, information and judgment not possessed by reviewing 
courts and because there is great social utility in encouraging the allocation of assets and 
the evaluation and assumption of economic risk by those with such skill and information, 
courts have long been reluctant to second-guess such decisions when they appear to have 
been made in good faith.”).

122 BLOCK, supra note 112, at 1 (quoting Dooley, Two Models of Corporate Governance, 
47 BUS. LAW. 461, 470 (1992)) (internal quotation marks omitted).
123 Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (“After-the-fact litigation is a most 
imperfect devise to evaluate corporate business decisions. The circumstances 
surrounding a corporate decision are not easily reconstructed in a courtroom years later, 
since business imperatives often call for quick decisions, inevitably based on less than 
perfect information. The entrepreneur’s function is to encounter risks and to confront 
uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed 
years later against a background of perfect knowledge.”).
124 BETTY LINN KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND 
MANAGEMENT 294 (date? [cite]) (noting that courts analyze “the same aspects of conduct 
to determine whether the fiduciaries acted prudently” in both the corporate and traditional 
trust contexts). See also id. at 289-90:

Notwithstanding the variations in legal standards set out by judges, 
fiduciary cases under state trust law, ERISA, and corporate law make very 
similar factual examination. They scrutinize the fiduciary’s information 
gathering and evaluation process to determine whether alternative courses 
of action were weighed and the effects of all possibilities projected; 
whether the fiduciaries sought a range of expert opinions, inquired into the 
grounds for those opinions, and made their own personal evaluation as 
well; whether the fiduciaries permitted themselves to be rushed into a
accorded corporate officers and directors by the business judgment rule,“ namely the extra insulation provided by the business judgment rule’s presumption in favor of corporate directors and the rule’s heightened standard of gross negligence.

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

The prudent-man standard determines how an actor should perform his or her duties. The first step of any analysis thus must focus on the duty to which the actor is subject. In the trust-indenture context, that duty—which falls on the indenture trustee—is at least to try to preserve the amount that bondholders could recover at the time of default. That duty also may, and perhaps should, extend to trying to increase that amount. In traditional trust law, that duty—which falls on the trustee—is to preserve the value of the trust’s assets for the trust’s beneficiaries. In corporation law, that
decision or demanded the time to make a reasonable inquire; whether the fiduciaries imposed conditions on the transaction to protect the beneficiary or shareholders; and whether the fiduciaries monitors the implementation of their decisions.

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

125 KRIKORIAN, supra note 124, at 290.

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

127 See Beck v. Manufacturers Hanover Trust, 632 N.Y.S.2d 520, 528 (1st Dep’t 1995) (stating the indenture trustee’s duty is to “exercise his contractually conferred rights and powers in order to secure the basic purpose of any trust indenture, the repayment of the underlying obligation.”) (emphasis added); SPIOTTO, supra note 26, XVIII-1 (stating the “indenture trustee’s role is to obtain the best recovery possible for the holders under the circumstances.”); LANDAU & KRUEGER, supra note 1, at 171 (stating “the trustee should see that the security holders realize their claims in full or to the greatest extent possible.”).

128 See infra Part III.A.
duty—which falls on corporate directors—is to take calculated risks in order to maximize corporate profitability. Once the applicable duty is properly defined, and assuming all else is equal, that duty should be a principal driver of how to apply the prudent-man standard.

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

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

There is a lack of specificity in existing law as to whether an indenture trustee’s duty, after default, is merely to safeguard existing value or to increase the potential return to bondholders to try to get them paid in full. The Second Circuit, for example, does not appear to distinguish between a duty “to safeguard the assets” and a duty to secure “repayment of the underlying obligation.” The distinction, however, is akin to the difference between the duty of a traditional trustee to preserve trust property and the duty of a corporate director to maximize corporate value.

129 See infra Part III.B.

130 LNC Investments v. First Fidelity Bank, 173 F.3d 454, 462 (2d Cir. 1999) (stating the indenture trustee’s duty is “to act prudently to safeguard the assets of the Trust,” but in making that statement relying on a New York Appellate Court’s statement that the indenture trustee’s duty is to “exercise his contractually conferred rights and powers in order to secure the basic purpose of any trust indenture, the repayment of the underlying obligation.”) (emphasis added).

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

If the trust-indenture duty is simply to try to preserve the amount that bondholders
could recover at the time of default, then it is like that of traditional trusts insofar as it
involves merely preserving value. To this extent, it should be a positive duty albeit one
that involves fairly ministerial efforts. One might even argue the required affirmative
efforts should be less under trust-indenture law than traditional trust law because
preserving value is more critical under traditional trust law since beneficiaries of
traditional trusts have no ability to diversify their ownership of trust assets. In contrast,
bondholders can choose, much like corporate shareholders, how much, if anything, to
invest in any given corporation and can easily re-sell publicly-issued bonds, enabling

133 In the pre-TIA era, publicly issued bonds were often fully secured. See Lev, supra
note 6, at 51-52. Thus, the indenture trustee’s duty was to safeguard the value of
bondholders’ security interest, which explains why a pre-TIA article stated the indenture
trustee’s post-default duty required “various affirmative courses of conduct . . . for the
preservation of the security.” Posner, supra note 3, at 204. Publicly issued bonds,
however, are rarely fully secured in modern times. [cite]
134 Cf. Robert Sitkoff, Trust Law, Corporate Law, and Capital Market Efficiency, 28 J.
CORP. L. 565 (2003) (arguing that corporation law imposes a less stringent standard on
directors than does trust law on trustees because shareholders can easily diversify but
trust beneficiaries may or may not be able to do so).
them to diversify their investments. The ability of bondholders to choose and to diversify investments therefore makes it less important that indenture trustees—just like the ability of corporate shareholders to choose and diversify their equity investments makes it less important that corporate directors—be constrained to make secure investments.

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

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

In traditional trust law, those parties could be anyone and often are individuals, even minors. When the TIA was enacted in 1939, most bondholders were also individuals and other small investors. It therefore would have been more reasonable at that time, based solely on the identity of the protected parties, to view the indenture trustee’s role as more akin to the role of trustees under traditional trust law. In recent

\[135\] The evidence from the legislative history of the TIA certainly supports the proposition that Congress intended the TIA’s prudent-man standard to be substantially the same as the prudent-man standard applied in the field of personal trusts. Then-SEC Commissioner William O. Douglas testified before Congress that the prudent-man standard of the TIA “is substantially the same standard as that required of trustees under the so-called personal trusts.” *House 1938 TIA Hearings, supra* note 26, at 40 (statement of William O. Douglas, Commissioner, Securities and Exchange Commission).
years, however, large institutional investors dominate the public bond market.\footnote{Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 566, 583-86 (1995) (analyzing the Flow of Funds Accounts prepared by the Federal Reserve Board to conclude “the market for corporate bonds is heavily dominated by institutional investors, and . . . individual investors play only a small role.”)} The nature of bondholders is virtually identical to, and indeed often the same entities as, the large institutions that control most of the public equity market.\footnote{For example, The Vanguard Group, Fidelity Investments, and American Funds dominate the lists of top twenty-five equity and bond funds (as measured by assets held). Out of the twenty-five largest equity funds, the Vanguard Group manages five, Fidelity Investments manages seven, and American Funds manages ten. See Wall Street Journal, Mutual Funds Quarterly Review, *Largest Stock Funds* (Jan. 4, 2007), available at http://online.wsj.com/documents/mfq06-4-stockfunds.htm. Out of the twenty-five largest bond funds, The Vanguard Group manages eight, Fidelity Investments manages six, and American Funds manages two. See Wall Street Journal, Mutual Funds Quarterly Review, *Largest Bond Funds* (July 10, 2006), available at http://interactive.wsj.com/documents/mfq06-2-bondfunds.htm.} Because the nature of the parties protected by the prudent-man standard of trust-indenture law is similar to that of the parties protected by the prudent-man standard under corporation law, the analogy remains sound.\footnote{If at any time the parties protected by the prudent-man standard in either of these contexts no longer typically consist of large institutional investors, the above analysis should be modified accordingly.} The article therefore next turns to the question posed earlier: whether indenture trustees have—or should have—a duty after default of increasing, as opposed to merely preserving, bondholder recovery.

It appears clear that indenture trustees may well have—and certainly should have—a duty after default of *increasing* bondholder recovery. The fundamental bondholder bargain is to receive “interest at the prescribed rate plus the eventual return of the principal.”\footnote{Metropolitan Life Insurance v. RJR Nabisco, 716 F. Supp. 1504, 1518 (S.D.N.Y. 1989) (quoting ABA, Commentaries on Indentures (1971)).} An issuer in default, however, will likely be unable to repay interest and principal in full. Therefore, to satisfy the bondholder bargain, indenture trustees

---

\footnote{Can we expand the normative argument about the bondholder “bargain”?}
should work with defaulting issuers to try to increase payment on the bonds, up to the level of full principal and interest. This parallels how private creditors generally behave after default.\textsuperscript{140}

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

\begin{quote}
\centering
it is the role of the indenture trustee to help \textit{maximize the return to holders}, once a default or troubled situation has occurred. The indenture trustee must insure compliance with the terms of the indenture and when compliance cannot be achieved, the indenture trustee’s role is to obtain the \textit{best recovery possible} for the holders under the circumstances.\textsuperscript{141}
\end{quote}

Similarly, Robert Landau and John Krueger in their treatise on corporate trust administration argue that “\textit{[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.}”\textsuperscript{142}

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

The article next tests this hypothesis.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{140} See Baird & Rasmussen, \textit{supra} note 13, at 1233-46 (illustrating how private creditors seek to maximize recovery of principal and interest on their loans).
\item \textsuperscript{141} SPIOTTO, \textit{supra} note 26, XVIII-1 (emphasis added).
\item \textsuperscript{142} LANDAU & KRUEGER, \textit{supra} note 1, at 171 (emphasis added).
\end{itemize}
\end{footnotesize}
B. The Business Judgment Rule Applied To the Indenture Trustee

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

Recall the reasons that justify the business judgment rule in corporation law. In that context, equity investors voluntarily put their money at risk and therefore expect a return on their investment. Because of this expectation, the business judgment rule attempts to grant corporate directors the flexibility necessary to fulfill their duty by engaging in “venturesome business activity.” Similarly, the indenture trustee’s duty to increase value, rather than merely preserve it, requires the freedom to take calculated risks. To the extent it can influence the amount of recovery, the indenture trustee should be able to choose courses of action that yield the highest expected value to bondholders (up to, of course, the value needed for full repayment) rather than those that preserve value with the least amount of risk. This same principle—maximizing expected value—also serves as a key justification for the business judgment rule.

In contrast, one reason why courts have refused to extend the full protection of the

\[143\text{ See supra notes 119–123 and accompanying text.}\]
\[144\text{ See AMERICAN LAW INSTITUTE, supra note 106, § 4.01, comment c. Corporate directors are given broad discretion to engage in risky actions because “shareholders to a very real degree voluntarily undertake the risk of bad business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers.” BLOCK, supra note 112, at 8 (quoting Frances T. v. Village Green Owners Ass’n, 42 Cal. 3d 490, 507 n.14 (1986)).}\]
\[145\text{ Cf. Baird & Rasmussen, supra note 13, at 1233-46 (discussing the calculated risks that creditors generally take after default to try to increase recovery on their claims).}\]
\[146\text{ See supra note 120 and accompanying text.}\]
business judgment rule to traditional trustees is because traditional trusts exist “to provide security for their beneficiaries—not to engage in venturesome business.”

The business judgment rule also exists to encourage highly-skilled professionals to accept positions on corporate boards. Although post-default situations require the “best and the brightest of the corporate trust area,” the market currently appears to face a lack of supply of indenture trustees capable of navigating the uncharted waters of post-default actions. This is certainly an unintended result of the TIA, which was designed to provide bondholders with a higher quality and “conscientious” representative. As it does in corporate law, application of the business judgment rule in the trust-indenture context should encourage a higher caliber of individuals to assume indenture trustee positions by allowing them the freedom to exercise their discretion—ultimately providing greater bondholder protection.

---

147 Cf. Howard v. Shay, 10 F.3d 1484, 1489 (9th Cir. 1995) (rejecting application of the business judgment rule to the investment decisions of a trustee of an ERISA plan). See also Leslie, supra note 117, at 96-107 (comparing the duty of care for corporate directors and ordinary trustees).

148 See KRIKORIAN, supra note 124, at 290-91 (describing why “pension and trust fiduciaries need not be given this dispensation from the strict standard of fiduciary law.”).

149 SPIOTTO, supra note 26, XI-9 (further explaining that “[m]istakes in administering a defaulted account can cost the corporate trust department its profits for years to come. Successful handling of a default might even be a profitable venture.”); see also House 1938 TIA Hearings, supra note 26 (statement of Harold V. Amberg, Vice President and General Counsel of the First National Bank of Chicago) (testifying that “[t]he decisions that face an indenture trustee when a corporate debtor is in failing circumstances are extremely delicate and difficult.”).

150 [cite] Furthermore, upon default, many indenture trustees immediately resign. Deregulating Capital Markets, supra note 84 (statement of Morey W. McDaniel).

151 Senate 1939 TIA Hearings, supra note 39, at 32 (statement of Edward C. Eicher, Commissioner, Securities and Exchange Commission); House 1938 TIA Hearings, supra note 26, at 45 (statement of Robert M. Hanes, Chairman of the Committee on Federal Legislation of the American Bankers’ Association and President of the Wachovia Bank & Trust Co. Of Winston-Salem, N.C.) (explaining one of the principle objectives of the TIA “was to bring the procedure of corporate trustees to the high standards by the best and most responsible persons in the profession.”).
In corporation law, the business judgment also serves to preserve the “ultimate decision-making authority” of the board. Although the TIA’s system of bondholder governance does not give the indenture trustee plenary power to make all decisions for bondholders, application of the business judgment rule should ultimately lead to a more efficient system of bondholder governance.\(^\text{152}\) To minimize the inefficiency caused by the collective-action problem, the TIA gives indenture trustees a variety of powers to act on behalf of bondholders in the event of default. The protection afforded by the business judgment rule should lead to indenture trustees more actively (and effectively) exercising these powers, mitigating the need for costly and less efficient decision-making actions (e.g., individual bondholders acting on their own\(^\text{153}\); the indenture trustee’s refusal to act until it receives direction from the bondholders\(^\text{154}\); or the indenture trustee’s refusal to exercise its discretion, opting instead to automatically enforce the indenture’s available remedies\(^\text{155}\)).

The need for a business judgment rule also rests on the impracticality of courts and juries having to evaluate the “prudence” of complex business decisions made by corporate directors. For a variety of professional services (e.g., medical doctors and traditional trustees), professionals will be able to “shield themselves from liability . . . by showing that they followed accepted protocols or practices.”\(^\text{156}\) Corporate directors often cannot benefit from this shield “because almost every business decision is unique.”\(^\text{157}\) Moreover, “[a]fter-the-fact litigation is a most imperfect device to evaluate corporate

\(^{152}\) The term “governance” is commonly used to describe an organization’s “system that facilitates efficient decisionmaking.” See Stephen M. Bainbridge, Corporation Law and Economics 192 (2002).

\(^{153}\) Spiotto, supra note 26, XII-14.

\(^{154}\) See supra notes 56–59 and accompanying text.

\(^{155}\) See supra notes 27–30 and accompanying text.

\(^{156}\) Eisenberg, supra note 113, at 444.

\(^{157}\) Id.
business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information.”

These same justifications apply to the post-default actions of indenture trustees, which often entail unique and complex considerations of the issuer’s potential future solvency compared to the immediately available remedies for bondholders. These decisions often must be made in the face of great uncertainty and extreme time pressure. In contrast, traditional trustees often have the luxury of time and nearly infinite options when considering possible investment options. Thus, “judges and juries are better equipped to determine whether a [traditional] trustee’s action, or lack of action, amount to negligence.”

In short, a business judgment rule would likely lower the cost of debt and provide greater protection for bondholders. With the protection afforded by such a rule, indenture trustees would demand less protection for potential liability. Bondholders would feel less compelled to take matters into their own hands, incurring substantial costs. Bondholders also might be willing to accept a lower rate of return with the protection afforded by a specialized professional willing and able to exercise its discretion in the event of default to increase the return to bondholders. Issuers would be more comfortable knowing that the indenture trustee would be acting on behalf of bondholders

158 Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982).
159 See supra Part II.B (describing the many complex post-default choices an indenture trustee must make in situations where the issuer may be confronting insolvency or already in bankruptcy proceedings).
160 [cite]
161 Leslie, supra note 117, at 99-100 (further explaining, “[u]nlike the corporate environment, where management must deal daily with a multitude of variables, and quick action on less than full information may be necessary, the business of trust management is comparatively straightforward. Trustees ordinarily need not make decision under time pressure, and investment decisions involve relatively clear consideration.”).
162 See supra note 153 and accompanying text.
rather than facing unpredictable actions by individual bondholders, and that the indenture trustee would not be uncritically enforcing the indenture’s available remedies.\footnote{As would occur if the prudent-man standard were governed by traditional trust law, or if such standard were (as presently) so ambiguous that indenture trustees so acted to avoid the potential for liability. \textit{Cf. supra} note 76 and accompanying text.} A business judgment rule also would free indenture trustees to exercise their specialized talent and experience for the benefit of bondholders, and would encourage more qualified parties to enter the market for indenture trustees.\footnote{The one aspect of applying the business judgment in the trust-indenture context that could raise the cost of debt is the entry of higher quality indenture trustees. However, considering the benefits that would be provided by higher quality indenture trustees, the net effect should be a lower cost of debt.}

It should be emphasized that the business judgment rule advocated by this article should include at least the presumption against liability as well as the gross-negligence threshold contemplated by the corporate business judgment rule, which many corporation law scholars argue are the real teeth of the rule.\footnote{\textit{See supra} note 118.} Section 315(d)(2) of the TIA already provides certain protections that might appear to loosely parallel a business judgment rule,\footnote{Section 315(d)(2) provides that each “indenture shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts.” William O. Douglas, then an SEC Commissioner, advocated including § 315(d)(2) in the TIA to try to ensure “a practicable, workable, and safe standard of care for the trust institutions.” \textit{House 1938 TIA Hearings, supra} note 26, at 40.} but in practice that Section has proved insufficient because it lacks a presumption against, and adequate threshold for, indenture-trustee liability.\footnote{Although, like the business judgment rule, § 315(d)(2) provides process-oriented protection, recall that traditional trust law is likewise process oriented, and that the effective difference between the business judgment rule and traditional trust law is the “extra insulation” provided by the business judgment rule’s presumption in favor of corporate directors and heightened standard of gross negligence. \textit{See supra} notes 124-125 and accompanying text.}
It therefore appears that the prudent-man standard for indenture trustees after default should be tempered by a business judgment rule that includes a presumption against liability as well as a gross-negligence liability threshold. As a final step in the analysis, however, it is appropriate to compare this approach with possible alternatives.

V. ALTERNATIVES

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

A. Eliminating the Mandatory Indenture Trustee

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

168 In the mid-90s, Congress considered further reforms to the TIA and heard testimony that advocated for at least partial repeal of the TIA. See H.R. REP. NO. 104-622 (1996) (“In the context of the Subcommittee hearings on . . . the Committee notes that three witnesses testified on the proposal to repeal the Trust Indenture Act. Morey W. McDaniel, Esq., an indenture practitioner, questioned the Act’s continued utility and supported its repeal, while SunTrust Capital Markets President and CEO R. Charles Shufeldt, testifying on behalf of the ABA Securities Association, argued that the Act still served a useful purpose and opposed repeal. Columbia University Professor of Law John C. Coffee, Jr. testified that there was a ‘plausible case for repealing much of the statute’ but cautioned Congress to retain necessary protections for bondholders in some form.”).

169 Deregulating Capital Markets, supra note 84 (statement of Morey W. McDaniel).
That proposal, however, is at least partially predicated on the existing deficiencies in indenture-trustee post-default governance. If those deficiencies are fixed, as this article suggests, the argument to eliminate the TIA’s mandatory trustee requirement becomes less compelling.

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

B. Enhancing the Indenture Trustee’s Statutory Powers

The call for greater indenture trustee power is best illustrated by the “supertrustee” proposal of Professors Yakov Amihud, Kenneth Garbade, and Marcel Kahan. Their central argument is that public bond indentures should contain more covenants, with the goal of lowering agency costs by increasing monitoring of the

\[\text{__________________________}\]

170 See id.

171 See supra notes 1-2 & 36-39 and accompanying text (indicating that the deficiencies in bondholder governance preceded the TIA’s mandatory-trustee requirement).

172 Many public bond issues would likely continue to rely on indenture trustees because a bond issue that starts out with specific institutional investors will eventually have different investors as the bonds are traded. Even if all the new investors are institutions, some may want the protection of an indenture trustee. A bond issue’s failure to have an indenture trustee thus is likely to reduce the trading value of the bonds. Furthermore, any initial belief by investors that they will work together in the event of a default is undermined by the fact that, under the indirect holding system for securities, the actual beneficial owners of publicly-traded bonds will be difficult, costly, and time-consuming to identify. See supra note 1.

173 Amihud, Garbade, & Kahan, supra note 13.
Private bank debt often includes a much more extensive package of covenants than in bond indentures because it is easier for a defaulting issuer to negotiate with private lenders than with public bondholders (since indenture trustees do not usually have authority to waive defaults in, or to amend, substantive covenants without bondholder consent). To induce issuers to agree to include more extensive covenants in public bond indentures, indenture trustees would be exclusively empowered to waive covenant defaults and renegotiate substantive terms of the indenture.

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

---

174 See id. at 470.
175 See id. at 465-66.
176 See id. at 474 & 474 n. 93.
177 See id. at 469–70.
178 See Lev, supra note 6, at 116.
180 Cf. Larry Light, Bondholder Beware: Value Subject to Change Without Notice, BUS. WK., at 34 (Mar. 29, 1993) (“[b]ondholders can – and will – fuss all they like. But the reality is, their options are limited: higher returns or better protection. Most investors will continue to go for the gold.”).
More significantly, though, the “supertrustee” proposal is not inconsistent with this article’s call for a business judgment rule. Indeed, the authors of the “supertrustee” proposal even briefly suggest that their “supertrustees” be protected “under a liability standard analogous to the ‘business judgment rule’.”

C. Preserving the Ambiguity of the Prudent-Man Standard

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

In this sense, the ambiguous prudent-man standard under the TIA theoretically may motivate the parties—the issuer, underwriters, indenture trustee, and bondholders—to devise efficient market-driven solutions. In the trust-indenture context, though, the very collective-action problem that undermines bondholder governance prevents the Ayres-Gertner theory from being fully realized. For example, it is often difficult, costly, and time-consuming to ascertain the identities of bondholders, and without that

181 Amihud, Garbade, & Kahan, supra note 13, at 478.
182 This argument was originally suggested to the authors by Richard Lasker, Senior Attorney, Cravath, Swaine & Moore LLP.
184 See supra note 1.
There therefore appear to be no viable alternatives to this article’s proposal to judge indenture trustee post-default performance by a business judgment rule.

VI. CONCLUSIONS

Instead of effectively representing public bondholders, indenture trustees are at best only marginal, and sometimes even counterproductive, participants in most post-default situations. This article has argued that such poor performance results from ambiguity over the “prudent man” standard imposed on indenture trustees under the Trust Indenture Act, as well as concern that an indenture trustee’s liability under that standard may be strictly judged by reference to traditional trust law.

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

185 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”); Robertson, supra note 34, at 464 (examining the contracting problems with indentures); 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 bondholders).
Some may counter, however, that although such a rule would go far to resolve the collective-action problem of bondholder governance, its flexibility might exacerbate the agency-cost problem (in that indenture trustees would be less closely subject to bondholder wishes). The net effect could be tested empirically, however, by comparing the prices of defaulted bonds before and after implementing such a business judgment rule. For the reasons discussed in this article, we believe that any such comparison will show that applying a business judgment rule to indenture trustees will lower the cost of public debt while, at the same time, providing public bondholders with greater, not less, protection.