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Keynote Address: The Conflicted Trustee Dilemma

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I. INTRODUCTION

Financial market failures can be attributed in large part to three causes: conflicts, complacency, and complexity. An important subset of that first cause—conflicts—is the conflicted trustee. Investment securities are almost always held by multiple investors. Even if investors have voting power to make decisions, the practical difficulty of soliciting investor votes or sorting out sometimes-conflicting investor directions means, in reality, that many important decisions are inevitably made by a trustee or other agent (collectively, a "trustee") acting for the investors. This essay outlines the problem and concludes by asking a number of questions about the proper role of a trustee that require further attention in order to address financial crises.

A trustee acting for multiple investors can face difficult challenges even where the investors are of a single, non-conflicting class. If the securities are in default and the trustee is a deep pocket, investors may try to impose liability on the trustee for decisions that, viewed in retrospect, can arguably be deemed questionable or ill-advised. This poses a dilemma: after default, many decisions, such as whether to accelerate debt or liquidate collateral, require exquisite judgment calls, and, ex-ante, no given decision may be clearly right. Indenture trustees representing public bondholders often face this type of dilemma.[1]

The dilemma rises to a much higher order of magnitude, though, where investors themselves have conflicting interests, such as divergent priorities or disparate sources of payment. Then, the trustee is not only second-guessed for decisions that are essentially judgment calls, but also faces the difficult task of understanding and balancing the interests of conflicting classes, sometimes called "tranches," of investors. By vastly increasing the volume of debt securities in default, the financial crisis has brought this "conflicted trustee" dilemma to the fore. The dilemma has also been magnified by the numerous conflicting classes of securities that have become typical in mortgage-backed and other types of securitization. For example, so-called collateralized-debt-obligation transactions customarily involve a dozen or more conflicting classes of securities, all backed by the same pools of underlying mortgage loans and other financial assets.

To understand the conflicted trustee dilemma, consider actual scenarios in which the conflict arises. One such scenario involves the dilemma of realizing value on the financial assets underlying the securities. A trustee, usually referred to in this context as a servicer, is customarily employed to perform this role for the investors, agreeing to act in their "best interests." This standard gives little guidance, though, when, as commonly occurs, cash flows deriving from principal and interest on the underlying assets are separately allocated to different investor classes. Say, for example, the underlying assets are mortgage loans, and the servicer needs to restructure one or more defaulted loans to maximize overall recovery to investors. A decision by the servicer to restructure the loans by reducing the interest rate would adversely affect investors in the interest-only class; conversely, a decision by the servicer to restructure

1. *See* Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 Ala. L. Rev. 1037 (2008) (focusing on the trustee's collective-action problem).

the loans by reducing principal would adversely affect investors in the principal-only class. In either case, a restructuring is likely to spark what some have called "tranche warfare."[2] As a result, servicers are not restructuring mortgages but, instead, are simply foreclosing on homes, making people destitute and creating the blight of abandoned homes that is feeding the current financial crisis.[3]

The conflicted trustee dilemma also can arise when investors have conflicting views on how the trustee, after default, should exercise remedies against collateral. Consider a relatively simple case, where a class of senior investors and a class of subordinated investors are secured by the same collateral. In deciding whether and how to exercise remedies, the collateral trustee should attempt to balance the interests of the senior and subordinated investors. There is little guidance, though, on how that balancing should occur.

The English High Court of Justice recently was faced with such a conflict in *Bank of New York v. Montana Board of Investments*, in which Orion Finance Corporation, a huge structured investment vehicle, defaulted on its payment obligations to senior investors.[4] With billions of dollars at stake, the senior investors wanted the trustee to foreclose on the collateral (consisting of financial assets), which at the then-collapsed market prices would have yielded barely enough money to repay the senior investors, leaving nothing for subordinated investors. Such action could have severely compromised the financial condition, and possibly the ultimate viability, of the two large (and, in the interest of not harming their reputations, unnamed) financial institutions that held the subordinated securities. The subordinated investors, instead, wanted the trustee to delay foreclosure, hoping to be repaid (or at least to receive some recovery) from a subsequent rise in prices of the underlying financial assets or from collections on those assets. Neither the applicable collateral documents (in this case, a security agreement governed by New York law) nor the applicable foreclosure law (the New York Uniform Commercial Code) provided the trustee with clear answers.

Similar types of conflicts can arise in any default scenario involving a trustee acting for classes of securities that have differing priorities or sources of payment. Furthermore, as I'll show, the rise of hedge funds and distressed-debt investing can, de facto, cause a dilemma even where the trustee acts for a single class of *pari passu* securities.

II. ANALYSIS

Let's consider two scenarios: one where the conflicted trustee receives no directions from investors and the other where directions are in fact received. Let's also focus on the simple example of two classes of conflicting investors: one senior and the other subordinated. Although the existence of additional classes of investors with conflicting priorities would exacerbate the conflict, it should not fundamentally change the nature of the conflicted trustee's duties.

2. *E.g.*, Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503, 562–63 (2002).

3. *See, e.g.*, Gretchen Morgenson, *So Many Foreclosures, So Little Logic*, N.Y. Times, Jul. 5, 2009, at BU1.

4. [2008] EWHC (Ch) 1594. I was an expert in this case as to matters of New York trust and commercial law.

A. The Conflicted Trustee Without Investor Directions

In general, once the security is in default, the Trust Indenture Act, New York trust law, and the Restatement of Trusts require the trustee to act as a "prudent man" in like circumstances.[5] Presumably, because the trustee acts for both classes of investors, it will have to balance their interests. But how should a prudent man accomplish such balancing? The answer is not obvious.

In similar circumstances, the law governing gratuitous trusts imposes a duty of impartiality on a trustee acting for beneficiaries who, as among themselves, have conflicting interests.[6] The trustee then must "deal impartially" with the beneficiaries.[7] A duty of impartiality can work for gratuitous trusts because the trustee can resolve conflicts by reference to the intentions of the settlor of the trust. It is much less obvious, though, that such a duty makes sense in a commercial context where there is no settlor and the conflicting beneficiaries are aggressively seeking repayment.

In this context, we might examine the somewhat analogous duties of a corporation's board of directors to shareholders and creditors. If the corporation is solvent, the board's duty is solely to maximize shareholders' value because a solvent company is able to pay its creditors. However, when the corporation is insolvent—and possibly also when it is near insolvency—that duty may shift to balance shareholder and creditor interests. To what extent, if any, should a conflicted trustee's duty after default similarly shift? And what would that shift mean in practice? However one answers these questions, complying with the prudent-man standard requires judgment calls that can potentially expose the conflicted trustee to liability. Such a threat might influence a trustee to act in a manner that minimizes its liability, as opposed to acting in the best interests of the investors—as evidenced by the tendency (discussed above) of servicers to foreclose on, rather than to restructure, defaulted mortgages. It also might deter competent institutions from acting as trustees.

What can the trustee do to minimize its exposure? Some trustees are seeking opinions of counsel affirming that the action to be taken is authorized and permitted *notwithstanding* any harm to junior investors. These opinions, though, are not always forthcoming from counsel.[8] Furthermore, even where they are forthcoming, it is incongruous, if not questionable, that a purely legal opinion would satisfy a decision that involves mixed business and legal considerations. Some trustees are seeking additional indemnification, though that might not be enforceable and would not

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5. Trust Indenture Act, 15 U.S.C. § 77ooo (2006); Restatement (Third) of Trusts: Duty of Prudence § 77(1) (2007); N.Y. Est. Powers & Trusts § 126(1) (McKinney 2009).

6. Restatement (Third) of Trusts: Duty of Impartiality; Income Productivity § 79 (2007) (discussing this rule in the context of the conflicting interests of an income beneficiary and a remainder beneficiary).

7. Restatement (Third) of Trusts: Duty of Impartiality; Income Productivity § 79 (2007) ("A trustee has a duty to administer the trust in a manner that is impartial with respect to the various beneficiaries of the trust . . . .").

8. Doneene Damon, Statement at the Meeting of the Comm. on Trust Indentures & Indenture Trustees, Annual Meeting of the Am. Bar Ass'n Bus. Law Section (Apr. 18, 2009).

address reputational considerations.[9] Others are seeking declaratory judgments, though U.S. courts are often reluctant to grant them and, in any event, the declaratory judgment process can be expensive and time consuming.[10]

Should more be done to limit liability for conflicted trustees who attempt in good faith to comply with the prudent-man standard? In the context of trustees acting for non-conflicting classes of investors, I have argued that limiting trustee liability through a business-judgment-type rule would actually improve trustee performance under the prudent-man standard because trustees would then be more likely to exercise independent judgment.[11] It is worth examining whether a similar limitation on liability would improve the performance of conflicted trustees.

Next consider the more dramatic dilemma of a trustee who is conflicted by directions from a senior class to act in a way that will harm a subordinated class.

B. The Conflicted Trustee with Investor Directions

In some cases, the agreement governing the trustee will purport to empower a class of investors, typically the senior class, to direct the trustee after a default occurs. In the *Bank of New York* case, for example, the senior class claimed that it had the post-default power to direct the collateral trustee to foreclose on the collateral.[12] This can create a conflict between the interests of the class giving directions and other classes.

A similar conflict can arise even where the trustee acts for a single class of *pari passu* securities. With the rise of hedge funds as distressed-debt investors, one or more such funds may become majority investors in a particular class of securities. In some cases, these funds have attempted to privately negotiate exchange offers with the issuer of the securities, intending to gain an advantage over other investors in their class. Regardless of how the conflict between investors arises, the fundamental issues concerning the trustee are the same. Therefore, for purposes of analysis, let us again assume two classes—one senior, the other subordinated—but now with the senior class having post-default power to direct the trustee.

The law regarding the enforceability of a contractual right to direct a trustee has developed almost exclusively with gratuitous trusts. In this context, the Restatement of Trusts provides that if the terms of a trust

> confer upon [someone other than the trustee] a power to direct or otherwise control conduct of the trustee, the trustee has a duty to . . . comply with any exercise of that power, unless . . . the trustee knows or has reason to believe

9. Harold L. Kaplan & Mark F. Hebbeln, *Keeping a Level Playing Field: The Evolution of Discriminatory Consent Solicitations and Exchange Offers*, Am. Bankers Assoc. Tr. & Investments, Mar.–Apr. 2008, at 44, 50–52.

10. *Id.*

11. Schwarcz & Sergi, *supra* note 1, at 1073 ("[A]pplying a business judgment rule to indenture trustees will lower the cost of public debt while, at the same time, provide public bondholders with greater, not less, protection.").

12. *See Bank of N.Y.*, [2008] EWHC (Ch) 1594 at ¶¶ 41, 44.

> that the attempted exercise violates a fiduciary duty that the *power holder* owes to the beneficiaries.[13]

The power holder may itself be a beneficiary, as in the case of the senior class directing the trustee.

One would think that senior investors do not generally have fiduciary duties to subordinated investors. If so, it would appear that a conflicted trustee would be required to comply with otherwise contractually valid directions of the senior investors. The Restatement of Trusts, however, makes the answer more complex (and somewhat circular) by providing that, except as discussed below, the power holder (in our case, the senior class) is subject to the same fiduciary duty to other beneficiaries as is the trustee—and the trustee, of course, has a fiduciary duty to the subordinated class.[14] A power holder is not, however, subject to the trustee's fiduciary duty to other beneficiaries if the "power [is] granted for the sole benefit of a designated power holder[.]"[15] Whether that is the case will "depend upon trust language and all relevant circumstances," and "no precise rules on the matter can be stated."[16]

As a practical matter, the power given to a senior class after default to direct the trustee could well be granted for the sole benefit of the senior investors. Comment *d* of the Restatement provides that "[a] power that is for the sole benefit of the person holding the power is not a fiduciary power."[17] Nonetheless, "the power holder must not abuse the power by exercising it in a manner that is harmful or indifferent to the interests of the other beneficiaries *when such exercise is not reasonably related to the benefit intended for the power holder*."[18] In most cases, however, a senior class directing the trustee, after default, to protect its interests would appear to be exercising its power in a manner reasonably related to the benefit intended for that class.

Under the Restatement of Trusts, therefore, a conflicted trustee may well be required to comply with post-default power given to a senior class to direct the trustee. That is not the whole answer, though, because the Restatement of Trusts does not by its terms apply to commercial trusts. Part 1, Chapter 1 (Definitions and Distinctions) of the Restatement states, for example, that "[t]he Restatement of Trusts does not deal with such devices as . . . trusts used for purposes of security."[19] Section 1, Comment *b*, of the Restatement reiterates that the "law relating to the use of a trust as a security device . . . is not within the scope of this Restatement."[20]

13. Restatement (Third) of Trusts: Effect of Power to Control Acts of Trustee § 75 (2007) (emphasis added).

14. *See id*. cmt. e.

15. *Id.* cmt. c.

16. *Id*.

17. *Id*. cmt. d.

18. *Id*. (emphasis added).

19. Restatement (Third) of Trusts pt. 1, ch. 1, introductory note (2003).

20. Restatement (Third) of Trusts: Scope of This Restatement § 1, cmt. b (2003).

Although "many" of the rules of the Restatement do apply, "different rules are often applicable."[21]

There is limited commercial trust case law on whether a conflicted trustee must comply with power given to a senior class after default to direct the trustee. In the leading case, *Beck v. Manufacturers Hanover Trust Co.*, Manufacturers Hanover Trust Co. was a successor collateral trustee for holders of defaulted bonds issued by a railway company.[22] Mexico "for decades had had designs upon obtaining the collateral[.]"[23] Mexico therefore "systematically purchased in excess of ninety-five percent of the bonds" and, as dominant bondholder, "had called for an auction" of the collateral.[24] It was clear that Mexico, directly or indirectly, would purchase the collateral at the auction, and that given the absence of other bidders, the purchase price would plainly be the "upset," or minimum, sale price set by the trustee. At the contractual direction of Mexico, the trustee set a very low minimum sale price for the collateral, without arranging for a fair third-party valuation. The court held that, "[g]iven this state of affairs, it was absolutely crucial to the interests of the trust beneficiaries as beneficiaries, as opposed to the interests of Mexico as a beneficiary/prospective purchaser, that the collateral be fairly valued by a disinterested party."[25]

After *Beck*, a conflicted trustee thus appeared only to be required to comply with contractual directions if the trustee's resulting actions would be fair to all investors for which the trustee acts. The recently decided *Bank of New York* case, in which the English High Court of Justice applied New York law, upheld the principles of the *Beck* case.[26] In another case, *Fifth Ave. Bank v. Nunan*, the court held that New York trust law exempts a directed trustee of a gratuitous trust from fiduciary responsibility only if the direction is "express and unambiguous; it cannot be implied."[27] A conflicted trustee therefore would appear to be required to comply with post-default power given to a senior class to direct the trustee if valuation and other matters affecting the recovery of subordinated investors are fair *and* the senior class's power to direct the trustee is express and unambiguous.

Assuming these should be the rules, how should a trustee make these determinations? As before, some trustees are seeking opinions of counsel, which are not always forthcoming. Some are seeking additional indemnification, which might not be enforceable and would not address reputational considerations. And some are

21. *Id.*

22. 632 N.Y.S.2d 520, 522 (1st Dep't 1995).

23. *Id.* at 529.

24. *Id.*

25. *Id.* at 529–30.

26. *See Bank of N.Y.*, [2008] EWHC (Ch) 1594 at ¶¶ 59, 62.

27. 59 F. Supp. 753, 757 (E.D.N.Y. 1945) (applying New York law). In *Bank of New York* I gave evidence, based on *Fifth Ave. Bank*, that even if the applicable security agreement could be read to give the senior noteholders the contractual right to direct the collateral trustee with respect to foreclosure, such a reading would, at best, be implied.

seeking declaratory judgments, which are hard to obtain and can be expensive and time consuming. These are not efficient solutions.

III. CONCLUSION

The conflicted trustee dilemma is susceptible to legal solutions. To that end, besides the issues previously raised (including the very fundamental issue of how a conflicted trustee should attempt to balance its obligations to investors with conflicting interests),[28] there are several overarching issues that should be considered:

1. Should there be different trustees for each class of securities? Requiring that would be very expensive, at least prior to default. It also begs the question of how different trustees should work together to make decisions affecting multiple classes. Furthermore, multiple trustees do not appear to make sense for a single collateral pool.

2. To what extent should financing transactions be regulated to reduce conflicts, such as prohibiting interest-only and principal-only tranches or restricting senior-subordinated investment structures? The downside of regulation is that it would artificially restrict financing flexibility, potentially causing unintended consequences. For example, the senior-subordinate structure is universally recognized and, among other benefits, enables companies and investors to more precisely allocate risks to investment preferences. It also represents an effective substitute for third-party guaranties at a time when few third parties are of sufficient creditworthiness for their guaranties to be commercially meaningful.

3. To what extent can trustee provisions be crafted to provide algorithmic or otherwise easy-to-follow rules to address conflicts? The problem here is that one can never predict all possible conflict issues and their permutations.

4. To what extent would a Trust Indenture Act-type framework, requiring trustees to resign to avoid conflicts after default, balance norms and practicality? And, as a practical matter, can successor trustees always be found on reasonable terms and conditions (e.g., fees, indemnities)?

5. Should the U.S. have a practical, declaratory judgment-type of judicial procedure to enable conflicted trustees to obtain needed directions? In the *Bank of New York* case, the trustee took its

28. *See supra* text accompanying notes 6–11 (asking whether a duty of impartiality would be sufficient, or whether there should be more of a commercial balancing, such as that undertaken by directors of a corporation regarding the conflicting interests of shareholders and creditors).

dilemma to the English High Court of Justice, Chancery Division, precisely because it offered such a procedure.

These are all unanswered questions; but answers are worth pursuing to help overcome the current financial crisis and to prevent future crises.