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## Indenture Trustee Duties: The Pre-Default Puzzle

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## INDENTURE TRUSTEE DUTIES: THE PRE-DEFAULT PUZZLE

*Steven L. Schwarcz*<sup>1</sup>

*Abstract: This Article addresses a topic at the intersection of finance, agency, contract, and trust law: the pre-default duties of an indenture trustee for bondholders. The existing scholarship on indenture trustee duties focuses on the post-default scenario, when the indenture trustee is required to act as a prudent person in like circumstances on behalf of the bondholders. No prior scholarship addresses an indenture trustee’s pre-default duties. It is critical to try to define those duties because activist investors in the \$42-trillion-plus bond market increasingly are making pre-default demands on indenture trustees, requiring them to know how to respond.*

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### INTRODUCTION

This Article addresses a topic at the intersection of finance, agency, contract, and trust law: the pre-default duties of an indenture trustee. Indenture trustees act for the benefit of the investors in a company’s bonds, debentures, or other debt securities (collectively, “bonds”; investors in those bonds being “investors” or “bondholders”).<sup>2</sup> They

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1. Stanley A. Star Professor of Law & Business, Duke University School of Law; Senior Fellow, Centre for International Governance Innovation (CIGI); Founding Director, Duke Global Capital Markets Center. I thank Kris Liu, Tom Yu, Mark X. Hollwedel, Aleaha Jones, and Sean S. Bach for valuable research assistance, and Harold Kaplan, Samuel Robert Henninger, and participants in the University of Cincinnati College of Law 30th Corporate Law Symposium, on “The Business Uses of Trust,” for helpful comments. Although the author has been a consultant and expert witness in litigation involving some of the issues examined in this Article, the views expressed herein are entirely his own and intended to be impartial. Furthermore, whereas the author’s expert-witness testimony is based on his experience with trust indentures, indenture trustees, securitization, and market practice, this Article’s analysis is exclusively normative.

2. The contract under which the indenture trustee acts for the bondholders is usually called a “trust indenture.” RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 144–45, 154–56 (3d ed. 2000).

perform this role for virtually all companies (in this capacity, “issuers”) that issue bonds, whether in the United States or abroad.<sup>3</sup> This Article hereinafter refers to indenture trustees performing that role as “trustees,” without suggesting that they have, or should have, the fiduciary duties of a common law trustee.<sup>4</sup>

The existing scholarship on a trustee’s duties focuses on the post-default context. In many countries, including the United States, after an Event of Default has occurred the law requires the trustee to act on behalf of the bondholders as would a prudent person in similar circumstances regarding its own affairs.<sup>5</sup> The author previously has examined the duties of trustees in that post-default context, including how they should act when bondholders have conflicting interests.<sup>6</sup> However, this Article examines a trustee’s “pre-default” duties, which arise prior to the occurrence of an Event of Default (and continue after the Event of Default has been cured).

It is critical to define a trustee’s pre-default duties because activist investors, including hedge funds and so-called “vulture fund” investors that purchase defaulted bonds at deep discounts, increasingly are making

3. Cf. Steven L. Schwarcz, Commercial Trusts (Dec. 14, 2012) (unpublished manuscript), <http://ssrn.com/abstract=2182267> (discussing indenture trustees for bonds issued in China).

4. See, e.g., *Meckel v. Cont’l Res. Co.*, 758 F.2d 811, 816 (2d Cir. 1985) (“Unlike the ordinary trustee, who has historic common-law duties imposed beyond those in the trust agreement, an indenture trustee is more like a stakeholder whose duties and obligations are exclusively defined by the terms of the indenture agreement.”); Harold L. Kaplan & Mark F. Hebbeln, *Doing Well by Doing Right*, ABA TRUSTS & INVESTMENTS 34 (July/August 2008) (arguing that indenture trustees do not have “the generalized broad-based responsibilities of a common law trustee, or ‘fiduciary,’” because indenture trustees “purely administer[] and implement[] contractual obligations under the indenture.”). Cf. *In re E.F. Hutton Sw. Prop. II, Ltd. v. Union Planters Nat’l Bank*, 953 F.2d 963, 968 (5th Cir. 1992) (“There is no doubt . . . that if an indenture trustee owes any fiduciary duties to the beneficiary above and beyond those duties explicitly recited in the trust indenture, they are much more attenuated than those normally owed by trustees.”).

5. See, e.g., 15 U.S.C. § 7700o(c) (2010) (“The indenture trustee shall exercise in case of default . . . the same degree of care and skill . . . as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”); Solomon Y. Deku, Alper Kara, & David Marques-Ibanez, *Trustee Reputation in Securitization: When Does It Matter?* 5 (Feb. 26, 2018) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2869724](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2869724) (stating that the post-default prudent-person standard applies in the United Kingdom). Cf. Corporation Act, 2001, s 283DA para (c) (Austl.), [https://www.legislation.gov.au/Details/C2017C00328/Html/Volume\\_2](https://www.legislation.gov.au/Details/C2017C00328/Html/Volume_2) [<https://perma.cc/2APD-D47E>], (requiring a trustee to “do everything in its power to ensure that the [issuer] remedies any breach” unless the breach is immaterial).

6. Steven L. Schwarcz, *Fiduciaries With Conflicting Obligations*, 94 MINN. L. REV. 1867 (2010). Conflicting interests among bondholders are fundamentally different from the problem of conflicts between indenture trustees, on the one hand, and the interests of those bondholders, on the other; cf. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 808–16 (1983) (discussing that problem). The law does not clearly address bondholder conflicts. Although trust law addresses conflicts among beneficiaries by imposing a duty of impartiality on the trustee, that duty does not extend to commercial trusts. *Meckel v. Continental Resources Co.*, 758 F.2d 811, 816 (2d Cir. 1985) (indenture trustees, unlike ordinary trustees, are not subject to a duty of undivided loyalty).

pre-default demands on trustees.<sup>7</sup> Trustees must know how to respond. Also, the manner in which they respond can have widespread economic consequences because the bond market is huge. The total principal amount of bonds outstanding was approximately \$43 trillion in the United States, as of the fourth quarter of 2018,<sup>8</sup> and approximately \$103.25 trillion worldwide, as of the first quarter of 2018.<sup>9</sup>

Activist investors are also suing trustees for losses on their bonds, alleging the trustee should have taken pre-default actions to protect the bonds.<sup>10</sup> In part, this represents what the author has called a “protection gap.” When things go wrong, investors often blame parties with deep pockets, especially trustees, for failing to protect them.<sup>11</sup> To avoid the risk of liability, trustees should know how they should discharge their pre-default duties.

Part I of this Article provides a historical overview of a trustee’s pre-default duties. Part II then analyzes, more normatively, a trustee’s pre-default role. Thereafter, Part III applies that normative analysis to the types of pre-default issues that may arise in lawsuits against trustees. Finally, Part IV examines steps that trustees could take to help guide their decision making when investors make pre-default demands.

## I. HISTORICAL OVERVIEW

The history of the enactment in the United States of the Trust Indenture Act of 1939 (the “TIA”), which provides a statutory framework for the conduct of trustees under TIA-qualified indentures,<sup>12</sup> provides a valuable record of the original debate over the trustee’s pre-default responsibilities. Congress enacted the TIA in order to restore investor confidence in the bond markets following the stock-market crash of 1929 and the ensuing

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7. Creditors of distressed debtors now routinely sell their claims at discounted prices to “vulture” funds, which then try to recover more than they paid and also attempt to engage in strategic voting, etc., to maximize their return.

8. *Statistics*, SEC. INDUSTRY & FIN. MARKETS ASS’N, <https://www.sifma.org/resources/archive/research/statistics/>.

9. BANK FOR INT’L SETTLEMENTS, SUMMARY OF DEBT SECURITIES OUTSTANDING, (Sept. 23, 2018).

10. *Cf.* JAMES E. SPIOTTO, DEFAULTED SECURITIES, THE GUIDE FOR TRUSTEES AND BONDHOLDERS 31 (2018) (observing that “upon default, a trustee is judged by hindsight”). This law-firm self-published book includes a short chapter (Chapter III – “Post-Closing Considerations Prior to Default,”) that provides certain practical pre-default client guidance). *Id.* at 31-39.

11. Steven L. Schwarcz, *The Roberta Mitchell Lecture: Structuring Responsibility in Securitization Transactions*, 40 CAPITAL U. L. REV. 803, 804 (2012). Even traditional financing transactions can have protection gaps because it may be impossible to anticipate, and therefore contractually protect against, every possibility; the complexity of securitization transactions can exacerbate the protection gap. *Id.* at 810.

12. Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (1939) (codified as amended at 15 U.S.C. §§ 77aaa–77bbbb (2010)).

Great Depression.<sup>13</sup> The TIA currently requires the appointment of a trustee for bondholders in every public bond issuance over \$10 million.<sup>14</sup> The trustee's basic role, according to the TIA, is to help solve the collective action problem that individual bondholders may be unable to effectively coordinate their actions with other bondholders.<sup>15</sup>

The 1929 report of the Securities and Exchange Commission ("SEC") that led to enactment of the TIA criticized the passive, or "ministerial," pre-default role generally taken at that time by indenture trustees.<sup>16</sup> The SEC recommended that a post-default "prudent man" standard<sup>17</sup> should apply to trustee performance both prior to, and after, the occurrence of an Event of Default,<sup>18</sup> and that trustees should be required to actively monitor actions of an issuer.<sup>19</sup> Almost a decade later when the TIA was enacted, however, the pre-default ministerial role had become widely accepted in market practice.<sup>20</sup> That role—as well as the post-default prudent man standard—was codified into the TIA,<sup>21</sup> which in turn solidified the passive market practice.

The trustee's pre-default duties have not been seriously re-examined since 1929, although the bond market has changed dramatically since then. Banks, pension funds, hedge funds, and other institutional investors now dominate, and there are few individual retail investors. Indeed, institutional investors now hold the overwhelming majority of corporate and foreign bonds.<sup>22</sup> By virtue of their sophistication and the size of their

13. See 15 U.S.C. § 77bbb(b) (2010) ("[U]nless regulated, the public offering of notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, by the use of means and instruments of transportation and communication in interstate commerce and of the mails, is injurious to the capital markets, to investors, and to the general public.").

14. 15 U.S.C. § 77ddd(a)(9) (2010). Bonds issued or guaranteed by governments or banks are exempted from that requirement. 15 U.S.C. § 77c(a)(2), § 77ddd(a)(4)(A).

15. See 15 U.S.C. § 77bbb(a)(1) (2010) (stating that the TIA was enacted because "individual action by [investors] . . . is rendered impracticable by reason of the disproportionate expense," "concerted action by [investors] in their common interest . . . is impeded by reason of the wide dispersion of [investors] through many states," and relevant information may not be available to all investors).

16. SEC. AND EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Part VI—Trustees Under Indentures 110 (1936).

17. See *supra* note 5 and accompanying text.

18. Wilber G. Katz, *Responsibility of Trustees Under the Federal Trust Indenture Act of 1939*, 26 A.B.A. J. 290, 291 (1940).

19. Stewart M. Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J.L. & PUB. POL'Y 461, 472-3 (1988).

20. James G. Blaine, President of the Marine Midland Trust Company, testified in 1935 that trustees normally took no active steps, prior to default, to protect the interest of bondholders. See SEC. AND EXCH. COMM'N, *supra* note 16, at 23.

21. 15 U.S.C. § 77ooo(a)(1) (2010).

22. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNT OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS; SECOND

bondholding, institutional investors face less of a collective action problem than retail investors.<sup>23</sup> Moreover, certain institutional investors increasingly are actively engaging in high-risk strategic investing.<sup>24</sup>

Whether or not due to these market changes, today there are at least two views of the trustee's pre-default role. By far the dominant view—and the view that comports with existing law and the plain language of indentures—is that trustees have no fiduciary duties to investors prior to an Event of Default.<sup>25</sup> Rather, their duties are ministerial and limited to the specific terms of the indenture.<sup>26</sup> Such duties typically include administrative functions such as document custody, payment-priority (“waterfall”) analytics, and payment processing.<sup>27</sup>

Since the 2007-08 financial crisis (the “financial crisis”), however, some investors argue that trustees—especially trustees of securitized bond issues—should have some pre-default fiduciary duties. Understanding this requires an understanding of the categories of bond issues. In unsecured bond issues, which dominate bond issuances, the trustee acts for the benefit of investors whose right to payment is based on a contract claim against the issuer, little different from how an “agent bank” acts for a syndicate of unsecured bank lenders.<sup>28</sup> In secured bond issues, the trustee acts that same way and, usually, also as a collateral

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QUARTER 2015, at 118 (Sept 10, 2015), <https://www.federalreserve.gov/releases/z1/20150918/z1.pdf> [<https://perma.cc/32CX-W9A8>].

23. Cf. Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 462 (1986) (making that argument in the context of large shareholders).

24. See *supra* note 7 and accompanying text.

25. Even after its post-default duties are triggered, the trustee is not a traditional fiduciary-trustee. Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037, 1051-52, 1057-61 (2008).

26. See, e.g., Trust Indenture Act, 15 U.S.C. § 7700o(a)(1) (2010); *Elliott Assocs. v. J. Henry Schroder Bank & Trust Co.*, 838 F.2d 66, 68-71 (2d Cir. 1988) (holding that a trustee's pre-default duties are limited to those duties expressly provided in the indenture).

27. Although ministerial, performing these duties well can require substantial investment and operational expertise. For example, it can be difficult to execute payment-priority analytics when there are deviations between contractual requirements and computer programming. See Henry T.C. Hu, *Too Complex to Depict? Innovation, “Pure Information,” and the SEC Disclosure Program*, 90 TEX. L. REV. 1601, 1637-42 (2012). The SEC's requirement that documents be written in “plain English” (see 17 C.F.R. § 230.421(d)(2) (2010)) also can make it difficult to precisely describe the payment structure. Hu, *supra*. Furthermore, the trustee must perform even “basic, non-discretionary, ministerial tasks with due care.” *Ellington Credit Fund Ltd. v. Select Portfolio Servicing, Inc.*, 837 F. Supp.2d 162, 192 (S.D.N.Y. 2011).

28. Unsecured bond issues create, at most, a hybrid form of a trust because there is, technically, no trust corpus. See Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 569-70 (2003). Cf. RESTATEMENT (THIRD) OF TRUSTS § 2, cmt. f (Tentative Draft No. 1, 1996) (emphasis added): “A trust involves three elements: (1) a trustee, who holds the trust property and is subject to duties to deal with it for the benefit of one or more others; (2) one or more beneficiaries, to whom and for whose benefit the trustee owes the duties with respect to the trust property; and (3) *trust property, which is held by the trustee for the beneficiaries.*”

agent for the investors. In securitized bond issues,<sup>29</sup> however, the trustee acts for the benefit of investors whose right to payment is limited to collections on specified financial assets, such as mortgage loans, that have been purchased by a trust or other special purpose entity.<sup>30</sup>

Even prior to the financial crisis, certain credit-rating agencies had suggested that trustees of securitized bond issues may have greater duties than trustees of other categories of bond issues. Standard & Poor's ("S&P") stated, for example, that trustees of securitized bond issues consisting of mortgage-backed securities ("MBS") "act as fiduciaries that protect the interests of" investors.<sup>31</sup> Moody's Investors Service ("Moody's") stated that trustees in MBS transactions have an affirmative duty to investigate likely servicer defaults and to be proactive participants.<sup>32</sup> In contrast, however, Fitch Ratings stated that such "unrealistic reliance on trustees" in MBS and other securitization transactions not only "misses the mark" but also "increases the risk to investors by potentially masking other more important considerations" such as the quality of servicer performance.<sup>33</sup> An FDIC manual regarding MBS trusteeships suggests that trustees of securitized bond issues have

29. The indenture in a securitized bond issue is often designated a pooling and servicing agreement, or "PSA." In the author's experience, the relevant provisions concerning the trustee of a securitized bond issue are identical whether it uses an indenture or a PSA (and this Article generically will refer to both as an 'indenture'). Also, some securitized bond issues, even though involving a public offering, have been interpreted to be outside the scope of the TIA. *See* *Ret. Bd. of Policemen's Annuity & Benefit Fund of Chi. v. Bank of New York Mellon*, 775 F.3d 154, 164 (2d Cir., Dec. 23, 2014) (holding that certain pass-through mortgage-backed securities were exempt from the TIA under § 304(a)(2) because they were "'certificate[s] of interest or participation in two or more securities having substantially different rights and privileges,' namely, the numerous mortgage loans held by each trust"). This Article's normative analysis of securitized bond issues is not dependent on whether such bond issues are subject to the TIA.

30. *See, e.g.*, Steven L. Schwarcz, *What is Securitization? And for What Purpose?*, 85 S. CAL. L. REV. 1283, 1295-98 (2012) (observing that in a typical securitization transaction, a sponsor will purchase a pool of loans or other rights to payment ("financial assets") from firms, such as mortgage lenders, originating those assets ("originators") and sell them to a special purpose entity ("SPE", sometimes called a special purpose vehicle or SPV)). The SPE will issue securities to investors, repayable from the periodic financial asset payments. Securitization enables originators to multiply their available funding, such as by selling off their loans for cash from which they can make new loans.

31. STANDARD & POOR'S CORP., S&P'S STRUCTURED FINANCE CRITERIA 100 (1988) (also stating that the trustee has an obligation to oversee the servicer and to act as a back-up servicer if necessary).

32. Claire M. Robinson, *Moody's Re-examines Trustee's Roles in ABS and MBS*, MOODY'S RATING METHODOLOGY REPORT 3,4 (Feb. 4, 2003). That two rating agencies expressed these views about the trustee's duties does not create legal precedent. The function of rating agencies is to evaluate the "likelihood of timely payment of interest and return of principal to investors" on rated securities, not to describe how financial markets should operate. Schwarcz, *supra* note 11, at 811. Furthermore, rating agencies do not generally focus on trustee duties as part of their rating criteria. *See, e.g.*, STANDARD & POOR'S CORP., *supra* note 31, at 80 ("In analyzing [MBS], S&P focuses on the following key issues: the legal infrastructure; the credit quality of the collateral; the amount and quality of loss protection provided, and finally, the payment structure.").

33. *Seller/Servicer Risk Trumps Trustee's Role In U.S. ABS Transactions*, FITCH RATINGS (Feb. 24, 2003, 10:25 AM), <https://www.fitchratings.com/site/pr/82592> [<https://perma.cc/6M5N-UDC6>].

duties to ensure that the underlying loans are “properly serviced”<sup>34</sup>—although that manual states that it is intended to provide general guidance subject to the provisions of governing agreements and that “duties and actions are specified in the indenture and the corporate trustee/agent is limited to the provisions of the indenture.”<sup>35</sup> At least during the financial crisis, some practitioners have observed expectations that trustees of securitized bond issues may have higher pre-default duties than trustees of other bond issues.<sup>36</sup> Whether or not inspired by these precedents, the author has seen a number of complaints in recent lawsuits alleging that, pre-default, a trustee of a securitized bond issue should “police the deal” for or otherwise protect the investors.<sup>37</sup> To date, however, courts have not ruled that trustees have greater duties in securitized bond issues.

## II. ANALYZING PRE-DEFAULT DUTIES

To analyze what a trustee’s pre-default duties should be, this Article will start by considering the possible normative frameworks for legally imposing duties in a business context. There appear to be at least two potentially overlapping frameworks: to correct market failures, discussed in subpart A; and to maximize efficiency, discussed in subpart B. Subpart C also considers a formalistic rationale for imposing such duties. Based on that analysis, subpart D articulates a normative rule for determining a trustee’s pre-default duties.

### A. Correcting Market Failures.

The fundamental normative justification for financial regulation is to correct market failures.<sup>38</sup> The primary justification for regulating the

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34. TRUST EXAMINATION MANUAL, Section 6, Part B.10 (FDIC 2005), [https://www.fdic.gov/regulations/examinations/trustmanual/section\\_6/section\\_vi.html#b\\_5\\_mutual\\_fund\\_transfer\\_agent](https://www.fdic.gov/regulations/examinations/trustmanual/section_6/section_vi.html#b_5_mutual_fund_transfer_agent) [https://perma.cc/SRC3-85NP].

35. *Id.* at Part C.

36. *See, e.g.*, Christopher J. Brady, Marla Chernof Cohen, & Harold L. Kaplan, *The Role of the Trustee in Securitization Transactions*, in SECURITIZATION OF FINANCIAL ASSETS § 9.03 (2d ed., Jason H.P. Kravitt, ed., 2007 Supplement) (observing that “especially in securitization and other asset-backed transactions, expectations about [both pre- and post-default] trustee responsibilities have increased”).

37. *See, e.g.*, Complaint at 2, *Commerzbank AG v. Bank of New York Mellon*, No. 1:15-cv-10029 (S.D.N.Y. Dec. 23, 2015), (contending that prior to an Event of Default, a trustee for a securitized bond issue is required to police the deal for investors). *Cf.* Barry S. Fagan, *Commerzbank AG Has Sued Wells Fargo Bank For Over \$100 Million Dollars in Toxic Mortgage-Backed Securities Losses*, JD SUPRA BLOG (Jan. 10, 2016), <https://www.jdsupra.com/legalnews/commerzbank-ag-has-sued-wells-fargo-bank-00245/> (discussing complaints filed in the Southern District of New York in which plaintiff alleged that “Investors were dependent upon . . . Wells Fargo [Bank, as trustee.] to police the deal and to protect their contractual and other legal rights”).

38. *Cf.* PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 756 (15th ed. 1995)

duties of a trustee pre-default therefore should be to correct pre-default market failures.<sup>39</sup>

When the TIA originally was enacted in 1939, many of the bondholders for whom trustees acted were retail investors. They were unable to adequately protect themselves because of a collective action problem, a type of market failure.<sup>40</sup> In modern times, however, institutional investors dominate the bond markets,<sup>41</sup> greatly reducing the retail-investor collective action problem.<sup>42</sup> As a result, the role of trustees to protect bondholders by solving the collective action problem should be less urgent today than in 1939.

Even in 1939, however, trustees' pre-default duties were ministerial and limited to the specific terms of the indenture.<sup>43</sup> Therefore, other things being equal, trustees should not be held to higher pre-default duties today. Other things, however, may not be equal. The rise of activist investors and the advent of securitized bond issues have potentially created other market failures.<sup>44</sup> The rise of activist investors has created a possible agency failure: such investors do not necessarily act for the benefit of the other investors. The advent of securitized bond issues has also created a possible information failure: some securitized bond issues are so complex that investors do not always fully understand them.<sup>45</sup>

Activist investors, not trustees, are responsible for the agency failure.

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(observing that primary goal of financial regulation should be to correct market failures); DAVID GOWLAND, *THE REGULATION OF FINANCIAL MARKETS IN THE 1990S* 21 (1990) (characterizing regulating markets to correct market failures as the "public interest theory").

39. This Article uses the term "market failure" loosely because the economic literature defines the term loosely. Economists define market failure as a "situation" in which there is an economic inefficiency. Traditionally, market failures are often associated with imperfect information (such as information asymmetries), non-competitive factors (such as a monopoly), principal-agent conflicts, or externalities.

40. See *supra* note 15 and accompanying text.

41. See *supra* note 22 and accompanying text (finding that institutional investors now hold over eighty percent of corporate and foreign bonds).

42. See *supra* note 23 and accompanying text (finding that, by virtue of their sophistication and the size of their bondholding, institutional investors face less of a collective action problem than retail investors). *But cf. infra* notes 88-93 and accompanying text (discussing practical issues that might impair the ability of even an institutional investor to form a coalition of investors having the requisite voting rights to direct the trustee).

43. See *supra* note 26 and accompanying text.

44. This Article focuses on market failures that might affect the relationship between bondholders and the trustee. It does not focus, for example, on "securitization's abuses [that] contributed to the global financial crisis." Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 101 *CORNELL L. REV. ONLINE* 115, 117 (2015).

45. *Id.* at 131. The information failure is exacerbated by risk marginalization, which is not unique to securitized bond issues: investments can become so widely diversified that rational investors lack the incentive to monitor any of them individually. Steven L. Schwarcz, *Marginalizing Risk*, 89 *WASH. U. L. REV.* 487 (2012). This problem is not unlike the tragedy of the *anticommons* in property law; where too many owners have rights to exclude others from a scarce resource, no individual owner has an effective privilege of use and the resource becomes prone to underuse. See Michael Heller, *The Tragedy of the Anticommons*, 111 *HARV. L. REV.* 621 (1998).

Ideally, indentures should be drafted to limit the ability of investors to cause that failure. Nonetheless, so long as that failure could arise, trustees—as a matter of best practices, and to reduce risk<sup>46</sup>—should not want to exacerbate the failure. To that end, a trustee might wish to consider, when requested to take an action, whether that action could create or exacerbate a conflict of interest among investors. If it might, the trustee at least should have the right<sup>47</sup> to refuse to take that action—provided that refusal violates neither the indenture nor (as later discussed<sup>48</sup>) formal investor directions.<sup>49</sup>

Nor should trustees have a pre-default duty to protect bondholders by trying to correct the information failure.<sup>50</sup> This failure is certainly real; securitizations can be extremely complex.<sup>51</sup> A study of securitization deals from 2002 to 2007 found that, on average, it takes 38 pages to describe the underlying financial assets and 27 pages to describe the payment-priority “waterfall.”<sup>52</sup> Large securitizations may be especially complex, especially if they include multiple types of underlying financial assets and multiple classes (often called “tranches”) of bonds, complicating the relationship between asset performance and payment on the issued bonds.<sup>53</sup> As a result, some practitioners suggest that securitized bond issues “require a level of [trustee] sophistication and specialization

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46. Cf. SPIOTTO, *supra* note 10, at 32 (observing that “good practice[s] constitute evidence to demonstrate the reasonableness of the trustee’s actions”).

47. I am proposing a right, not a duty. A recent lawsuit questions more broadly whether trustees have the right to protect bondholders pre-default. My experience is that a trustee’s post-duties are not intended to preclude pre-default rights. Cf. SPIOTTO, *supra* note 10, at 36-37 (observing that “the implied power of a trustee would clearly authorize [a good faith] action” to “protect [bond] holders in a troubled situation prior to default,” even though the indenture “does not make that action] mandatory.”). I also observe that most indentures include a “Certain Rights of the Trustee” provision that allows the trustee to consult with counsel and to rely on counsel’s advice as authorization and protection for any action taken by the trustee, in good faith, in accordance with that advice. See *infra* note 132 and accompanying text.

48. See *infra* note 85 and accompanying text.

49. Cf. Kaplan & Hebbeln, *supra* note 4, at 4 (observing that “the indenture trustee’s role under the indenture still can be viewed as including facilitating a level playing field for all bondholders . . . [which entails] ever more difficult issues of balancing countervailing interests in doing what is right”); Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1336 (2002) (arguing that the trustee is the representative of the minority voice, which may be oppressed by competing interests).

50. See *supra* note 45 and accompanying text (observing that some securitized bond issues are so complex that investors do not always fully understand them).

51. Warren Buffet stated that an investor may have to read up to 750,000 pages to understand a securitization. Nicholas Varchaver, *What Warren Thinks*, FORTUNE (Apr. 14, 2008), [http://archive.fortune.com/2008/04/11/news/newsmakers/varchaver\\_buffett.fortune/index.htm?postversion=2008041410](http://archive.fortune.com/2008/04/11/news/newsmakers/varchaver_buffett.fortune/index.htm?postversion=2008041410) [<https://perma.cc/3NLX-RS4K>].

52. Andra C. Ghent et. al., *Complexity in Structured Finance* 14 (Nov. 2, 2017) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2325835](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325835).

53. Craig Furfine, *Complexity as a Means to Distract: Evidence From the Securitization of Commercial Mortgages* 7-8 (Sept. 2012) (unpublished manuscript), [https://www.kellogg.northwestern.edu/~media/Files/Faculty/Research/Furfine\\_Complexity.ash](https://www.kellogg.northwestern.edu/~media/Files/Faculty/Research/Furfine_Complexity.ash).

that is different from that of the traditional indenture trustee.”<sup>54</sup>

There is no evidence, however, that sophisticated or specialized trustees could correct the information failure. Trustees generally have no disclosure duties, nor is there a rationale that supports trustees having such duties. Nor do trustees have (nor should they have) a duty to recommend investments. Furthermore, even if trustees otherwise could help to correct the information failure, trustees for securitized bond issues are not—at least, currently—significantly more sophisticated or specialized than other trustees. Trustees receive relatively small fees,<sup>55</sup> and the trust departments of financial institutions normally contract only to engage in relatively ministerial tasks.<sup>56</sup> Trustees rarely negotiate the terms of the indentures. In fact, they usually are presented the transaction documents at the last minute and asked to sign, with little to no opportunity to make changes.<sup>57</sup>

In contrast, investors in securitized bond issues normally are highly sophisticated financial institutions, of which activist investors tend to be the most sophisticated.<sup>58</sup> In the Rule 144A exempt transactions that characterize many securitized bond issues, the investors must be qualified institutional buyers (“QIBs”), the highest SEC ranking of investor sophistication and size. It is unlikely that even sophisticated and specialized trustees would better understand complex securitized bond issues than those investors.<sup>59</sup>

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54. Brady, et al., *supra* note 36, at 9-6.

55. Cf. Hunton & Williams LLP, *Client Alert, Dealing With Bondholders In Troubled Times*, HUNTON ANDREWS KURTH LLP 1, 1 (Dec. 2008), <https://www.huntonak.com/images/content/1/6/v3/1601/dealing-with-bondholders-in-troubled-times.pdf> [<https://perma.cc/Z6TP-4JMF>] (“[T]he nominal annual fee paid for standard trust services provides little incentive for an indenture trustee to [represent the bondholders].”). See also AMERICAN BANKERS ASSOCIATION, CORPORATE TRUST COMMITTEE, *THE TRUSTEE’S ROLE IN ASSET-BACKED SECURITIES 4* (Mar. 12, 2003).

56. Cf. Hunton & Williams LLP, *Client Alert, Dealing With Bondholders In Troubled Times*, HUNTON ANDREWS KURTH LLP 1, 1 (Dec. 2008), <https://www.huntonak.com/images/content/1/6/v3/1601/dealing-with-bondholders-in-troubled-times.pdf> [<https://perma.cc/Z6TP-4JMF>] (“[T]he nominal annual fee paid for standard trust services provides little incentive for an indenture trustee to [represent the bondholders].”). See also AMERICAN BANKERS ASSOCIATION, CORPORATE TRUST COMMITTEE, *THE TRUSTEE’S ROLE IN ASSET-BACKED SECURITIES 4* (Mar. 12, 2003).

57. CORP. TR. COMM., AM. BANKERS ASS’N, *THE TRUSTEE’S ROLE IN ASSET-BACKED SECURITIES 4* (Nov. 9, 2010), <https://www.aba.com/aba/documents/press/RoleoftheTrusteeinAsset-BackedSecuritiesJuly2010.pdf> [<https://perma.cc/MP47-JBP7>] (observing that indenture trustees usually are asked to sign transaction documents that are pre-negotiated by other parties).

58. Cf. Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 193–94 (2015) (discussing how activist investors employ “expensive, time-consuming” tactics to achieve their goals).

59. *But cf. supra* note 45 and accompanying text, (discussing risk marginalization, which might reduce an investor’s incentive individually to try to understand).

*B. Maximizing Efficiency.*

Another normative justification for financial regulation is maximizing efficiency. In theory, correcting market failures should make private markets work most efficiently. Therefore, subpart A's analysis of correcting market failures should be sufficient, in principle, to maximize efficiency.

In particular, though, maximizing efficiency requires avoiding any duplication of efforts. In bond issues, including securitized bond issues, parties have specified roles. The pre-default duties of trustees are usually limited to administrative tasks such as mailing notices or selecting bonds for redemption,<sup>60</sup> or delivering certificates, preparing and transmitting reports, and forwarding notices.<sup>61</sup> As a condition to investing, investors that want the trustee to perform additional roles could demand the indenture to require that performance.<sup>62</sup> A trustee would then want to be compensated, however, for performing those additional roles. If those additional roles are substantive or expose the trustee to liability, that compensation might be substantial, especially compared to the relatively small fees that trustees are currently paid.<sup>63</sup> And that, in turn, would reduce the value of the trust estate. Perhaps for that reason, the author is unaware of bond indentures imposing additional roles on trustees.

Moreover, even if investors wanted parties to perform additional roles, trustees may not be the best choice of parties to perform substantive roles. As discussed, they may not be sufficiently sophisticated or specialized.<sup>64</sup> Officials of the federal government recently reached this same conclusion:

A number of prominent investors have told us over the past year that a trustee fiduciary duty is . . . the only way, of accounting for all of the failures of the legacy model. Based on all of our work and irrespective of legacy terms and contracts, even if we believed in imposing a fiduciary duty, we have concluded the trustee is the wrong party for that duty going forward. The core competency of trustees is in carrying out administrative functions, not in forensic activities that require subjectivity and judgment,

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60. *Cf. In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, Nos. MDL-1446, H-01-3624, 03-5808, 2008 WL 744823, at \*8 n.22 (S.D. Tex. Mar. 19, 2008) (explaining that until an Event of Default occurs, an indenture trustee performs certain administrative tasks such as mailing notices or selecting bonds for redemption).

61. *Cf. CFIP Master Fund, Ltd. v. Citibank, N.A.*, 738 F. Supp. 2d 450, 473 (S.D.N.Y. 2010) (listing some duties that the indenture trustee had, including "delivering certificates . . . preparing and transmitting reports . . . and forwarding notices . . .").

62. *Cf. John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 183 (1997) ("Trust fiduciary law is default law that the parties can alter to their needs.").

63. *See supra* note 55 and accompanying text.

64. *See supra* notes **Error! Bookmark not defined.**-56 and accompanying text.

which is ultimately what a fiduciary must exercise.<sup>65</sup>

The current equilibrium of small trustee fees and (except when the trustee is formally directed by investors, as later discussed<sup>66</sup>) ministerial pre-default duties appears to represent a market consensus, or at least the market practice, on balancing costs and benefits. Market practice, in turn, suggests a presumption of efficiency and indicates a sensible balance: post-default, investors rely on the trustee's expertise to address the default and maximize recovery on their claims—which requires taking calculated risks;<sup>67</sup> pre-default (absent the aforementioned formal investor directions), investors expect the trustee only to perform the duties expressly stated in the indenture, to preserve the trust estate.<sup>68</sup>

### C. Formalism

The author has encountered a formalistic rationale for imposing additional pre-default duties on trustees of securitized bond issues: because securitized bond issues involve purchased financial assets, they more closely resemble a traditional trust, and trustees of a traditional trust have fiduciary duties.<sup>69</sup> In a business context, however, that argument is not compelling.

In classic language, the Supreme Court has observed that saying “that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligation does he owe as a fiduciary?”<sup>70</sup> Although fiduciary law develops by drawing analogies with established prototypes, that method should not apply when cases are not analogous.<sup>71</sup>

The traditional fiduciary duty applicable to common law trustees serves to prevent them from taking advantage of beneficiaries.<sup>72</sup> Trustees in securitized bond issues, however, cannot take advantage of bondholders

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65. Dr. Michael Stegman, Remarks by Counselor to the Secretary for Housing Finance Policy Before the Structured Finance Industry Group 1st Annual Private Label Symposium (Nov. 12, 2014) <https://www.treasury.gov/press-center/press-releases/Pages/jl2694.aspx> [<https://perma.cc/U2HN-ZMN6>].

66. See *infra* notes 85-88 and accompanying text.

67. Cf. Schwarcz & Sergi, *supra* note 25, at 1068.

68. *Id.* at 1069.

69. Cf. Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 327 (1999) (arguing that because the equity holders of an SPV have only a nominal interest in the SPV's performance, the bondholders should be granted more fiduciary duty protection than holders of traditional bonds); Langbein, *supra* note 62, at 182 (discussing securitization and trust fiduciary law).

70. Sec. and Exch. Comm'n v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

71. Frankel, *supra* note 6, at 805-07.

72. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1408 (2002).

because, in the author's experience, their powers to deal with trust assets and to apply collections thereof are highly restricted. Typically, virtually all of their duties regarding the underlying financial assets are contractually specified.<sup>73</sup> Any formalistic argument for imposing fiduciary pre-default duties on trustees of securitized bond issues therefore appears weak.

*D. Articulating a Normative Rule.*

The above analysis of a trustee's pre-default duties suggests the normative rule that, pre-default, the trustee's only duties should be those specified in the indenture. A trustee also should have the right to refuse to take an action that could create or exacerbate a conflict of interest among investors, provided that refusal violates neither the indenture nor formal investor directions.

This normative rule sometimes could result in a pre-default protection gap<sup>74</sup> insofar as the indenture fails to assign any specific party to enforce pre-default remedies. For example, although some indentures require the servicer to enforce cure-or-repurchase remedies for breaches of representations and warranties regarding purchased financial assets and to resolve defects in the documents evidencing or relating to those financial assets,<sup>75</sup> others are silent. For indentures that are silent, the investors can protect themselves by marshaling the requisite voting rights (and providing adequate indemnification of costs) to contractually direct the trustee to enforce those remedies.<sup>76</sup>

Investors unable to marshal the requisite voting rights to direct the trustee would have little basis to argue that the trustee should have an implied duty to enforce those remedies. This is because, as discussed, most indentures are explicit that the trustee's duties are ministerial and limited to the specific terms of the indenture and many further clarify that the trustee is not subject to any implied duties.<sup>77</sup> These limitations on trustee pre-default duties also will be shown to be economically efficient.<sup>78</sup> Sophisticated investors should be responsible for the rights and obligations they contractually agree to; it is not the job of courts to

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73. See *infra* Section II.C, (examining additional duties that arise in securitized bond issues).

74. Cf. Schwarcz, *supra* note 11, and accompanying text (observing that when things go wrong, investors often blame parties with deep pockets, especially trustees, for failing to protect them).

75. Cf. *infra* notes **Error! Bookmark not defined.**-125 and accompanying text (discussing resolving document defects).

76. See *infra* notes 87-88 and accompanying text.

77. See *supra* note 26 and accompanying text.

78. Cf. *infra* note 110 and accompanying text (explaining why imposing a pre-default monitoring duty on the trustee would be inefficient).

create implied protections.<sup>79</sup>

### III. APPLYING THE PROPOSED PRE-DEFAULT NORMATIVE RULE

This part applies the foregoing normative rule for determining a trustee's pre-default duties to the types of issues that may arise in lawsuits against trustees.

#### A. *Taking enforcement and other remedial actions.*

A problem can arise in a bond issue even prior to a formal Event of Default.<sup>80</sup> One or more investors may then demand that the trustee take some enforcement or other remedial action to try to correct the problem. Compliance with that demand could be expensive; trustees normally are entitled to reimbursement of their enforcement costs from the trust estate, which would reduce the value of that estate for investors generally. Taking remedial action could therefore create a conflict if it would disproportionately benefit only certain investors.<sup>81</sup>

For example, activist investors may purchase subordinated (junior) bonds of a barely solvent issuer at pennies on the dollar. Those investors may then demand that the trustee take an expensive enforcement action, with relatively little chance of success but a high upside if successful.<sup>82</sup> Taking that action would be unlikely to have a positive expected value for the investors generally.<sup>83</sup>

To illustrate this, assume that activist investors purchase all \$100 of subordinated bonds of an issuer for their current trading value of \$1, and that other investors hold all \$500 of the issuer's senior bonds, which are trading at par. The activist investors then demand that the trustee take an enforcement action likely to cost \$300, which has a 90% chance of recovering nothing and a 10% chance of recovering \$400. The expected

79. *Cf.* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (refusing to find an implied covenant protecting investors where the bond indenture lacked that protection).

80. *Cf. infra* note 82 and accompanying text (discussing such problems).

81. A decade ago, Professors Kahan and Rock suggested this conflict was more theoretical than real. *See* Kahan & Rock, *supra* note 99, at 306-07. They cautioned, however, that hedge funds "could, through their ownership of other securities or derivatives, benefit from activism even if the activism harms other bondholders." *Id.* at 307.

82. Longstanding investors in those subordinated bonds might, of course, have a similar incentive. The above expected value analysis should apply regardless of who holds the subordinated bonds.

83. Expected value is a statistical methodology to help predict whether an action is likely to be beneficial or harmful or to compare the value of alternative proposed actions. Calculating an expected value involves identifying each possible outcome and its probability of occurring, then multiplying each such outcome by its probability, and finally summing all of those values. *See, e.g.*, Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1, 33 (2016).

value of taking that enforcement action would be calculated as follows:

Expected value = (10% chance of enforcement action being successful) × (\$400 recovery from that success - \$300 cost of taking the action) + (90% chance of enforcement action being unsuccessful) × (\$0 recovery from that failure - \$300 cost of taking the action) = negative \$260.

From the standpoint of the investors, taking the action would be expected to be harmful, significantly reducing recovery on the senior bonds without increasing recovery on the subordinated bonds. The activist investors nonetheless would want the trustee to take that action because, absent that action, their \$100 face-amount of subordinated bonds are worth only \$1, which is the most they would lose if the action fails; whereas taking the action gives them a small chance of being paid in full if it is successful, yielding a \$100 recovery on their \$1 investment.

Absent formal investor directions discussed below, a trustee should have the right to refuse to take that action. Similarly, absent formal investor directions, a trustee should have the right to refuse to take any action not specifically required by the indenture.<sup>84</sup> In case of doubt, a trustee could seek—or could request the investor(s) demanding the action to arrange for—formal investor directions.<sup>85</sup> An indenture typically allows investors with at least 25-50 percent of voting rights to direct the trustee to act, and to indemnify the trustee<sup>86</sup> for the cost of taking the action.<sup>87</sup> Investors with the requisite voting rights may seek to direct the trustee to commence a lawsuit, for example.<sup>88</sup> Provisions authorizing

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84. A trustee especially should want to avoid taking an action if a rough cost-benefit balancing suggests that its costs might exceed the benefits. *Cf. infra* Section IV.D, (arguing that, lacking other guidance, a trustee should be able to fall back on basic common sense, including a rough cost-benefit balancing).

85. Should—and under the model debenture indenture, does—the right of the trustee to request investor directions apply pre-default? The author has reviewed an indenture raising that question. Sections 7.01(c)(3) of the indenture gives the trustee the right to request direction from the relevant number of investors; but that section refers to section 6.05, which is part of the “Defaults and Remedies” article. Section 7.01(c)(3) provides that “The Trustee shall not be liable to Holders of Securities of a series with respect to action it takes or omits to take in good faith in accordance with a direction received by it from Holders of Securities of such series pursuant to Section 6.05, and the Trustee shall be entitled from time to time to request such a direction.”

86. Although indentures usually indemnify the trustee, this specific indemnification requirement appears to be intended to shift risk onto the investors requesting the action.

87. *See, e.g.*, Adam Levitin, *The Paper Clause: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L. J. 637, 709 (2013) (observing that a typical indenture allows holders of more than 25% principal amount of bonds to control trustee actions). The TIA requires indentures to authorize at least majority bondholders to direct the trustee’s exercise of power. 15 U.S.C. § 77ppp(a)(1) (2010).

88. *See, e.g.*, Complaint at 1, *Bear Stearns Mortg. Fund Tr. 2006-SL1 v. EMC Mortg. and JP Morgan Chase Bank*, No. 7701-CL (Del. Ch., Jul. 16, 2012), 2012 WL 3041067, (pleading that the trustee filed the lawsuit “acting at the direction of certain holders of Certificates issued by the Trust”); Complaint at 1, *HSBC as trustee of Merrill Lynch Alternative Note Asset Trust, Ser. 2007-OAR5 v. Merrill Lynch*

formal investor directions can increase efficiency by leveraging the expertise of sophisticated investors.

Practical issues may sometimes impair the formation of a coalition of investors having sufficient voting rights to direct the trustee to act. For example, although the trustee often controls the investor list, the indenture might restrict turning it over unless some minimum number of investors (e.g., three) request it—thus creating a potential “catch-22.” It is more typical in the author’s experience, however, for indentures to authorize trustees to provide information to any investor seeking to assemble an investor group for directing trustee action. The TIA provides, and even indentures not governed by the TIA sometimes similarly provide, that investors may communicate with other investors with respect to their rights under the indenture.<sup>89</sup> The fact that bonds are traded under a worldwide indirect holding system<sup>90</sup> creates another practical issue: the trustee might only have a list showing a securities depository or clearinghouse—such as the Depository Trust Company (“DTC,” or its nominee Cede & Co.) in the United States or Euroclear in Europe—as the holder of a single “global” certificate.<sup>91</sup> That could require a concerned investor to examine the chain of transfers of the bonds to ascertain their owners.<sup>92</sup>

Even if investors are unable to direct trustee actions, they may be able individually to pursue their claims in appropriate cases.<sup>93</sup> They also can

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Mortgage Lending, Index No. 652793/2016 (N.Y. County filed May 25, 2016) (pleading that the trustee filed the lawsuit “at the direction of a certain holder of residential mortgage-back securities issued by the Trust”).

89. Trust Indenture Act, ch. 38 § 312(b) (codified as amended 15 U.S.C. §§ 77aa – 77bb (2010)).

90. Cf. Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 DUKE L. J. 1541, 1547-49 (2001) (describing the indirect holding system for securities).

91. *Id.* at 1547.

92. See, e.g., Thomas G. Ward & Daniel M. Dockery, *How the Indirect Holding System Affects Investor Suits*, LAW360 (Sept. 29, 2015), <https://www.law360.com/articles/708861/how-the-indirect-holding-system-affects-investor-suits>. I have observed efforts by investors and other industry participants to resolve these practical issues. These include, for example, investors taking out newspaper advertisements listing the securitization trusts in which they invested and soliciting the participation of other investors of those trusts to help investigate possible trust breaches; lawyers inviting large institutional investors to register information about their bond holdings; and plaintiff law firms sending proposed dispute-settlement agreements to trustees for their consideration.

93. See, e.g., *New Jersey Carpenters Health Fund v. NovaStar Mortgage Funding Trust*, Series 2006-3 et al, filed in N.Y. County on May 21, 2008 (Index. No. 601563/08), subsequently removed to S.D.N.Y.; Press Release, Federal Housing Finance Agency, FHFA Announces \$5.5 Billion Settlement with Royal Bank of Scotland (July 12, 2017), <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-%245pt5-Billion-Settlement-with-Royal-Bank-of-Scotland.aspx> [<https://perma.cc/CC4T-UP46>] (announcing settlement by FHFA as conservator of Fannie Mae and Freddie Mac of the 17th case of the 18 cases filed by FHFA against participants in the mortgage finance sector and that FHFA received a favorable verdict in the 18th case). Cf. Mark Adelson, *Representations and Warranties in Mortgage-Backed Securities*, *The Journal of Structured Finance*, 98, 101 (Spring 2017) (observing that, in “many cases, investors sued under federal or state securities laws. Those laws can provide favorable remedies and usually are the preferred method for suing on defective” mortgage-backed securities.).

ask regulators to address their grievances. In response to the financial crisis, for example, the U.S. Department of Justice, the U.S. Securities and Exchange Commission, and other regulators have filed numerous cases and regulatory actions against securitization parties and recovered billions of dollars.<sup>94</sup>

*B. Investigating “red flags” and other suspicious occurrences.*

Investors may become aware of so-called red flags and other suspicious occurrences in a bond issue even prior to a formal Event of Default. One or more investors may then demand that the trustee investigate the event. Compliance with that demand could be costly, and trustees normally are entitled to reimbursement of their enforcement costs from the trust estate, which could reduce the value of that estate for investors generally. The trustee’s engaging in an investigation could therefore create a conflict if it would disproportionately benefit only certain investors. For example, an investor in subordinated bonds who might benefit from an expensive investigation would have an incentive to direct the trustee to make that investigation if the costs of an unsuccessful investigation are disproportionately borne by investors in more senior bonds.<sup>95</sup>

Although the requested investigation might create or exacerbate a conflict of interest among investors, many indentures have language specifically addressing the right of investors to direct the trustee to take an action, which should include making an investigation.<sup>96</sup> In that case, the same analysis of whether investors may direct the trustee to take a specific remedial action should apply to the question of whether investors may direct the trustee to make a specific investigation.<sup>97</sup>

Even absent an investor demand, investors sometimes use the trustee’s failure to investigate a red flag or other suspicious occurrence as a basis for a later claim against the trustee, as a deep pocket. Although indentures typically absolve trustees from liability unless they act negligently or with willful misconduct, investors who suffer losses<sup>98</sup> sometimes argue that a trustee’s failure to make the investigation would be negligent, if not also

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94. See, e.g., News Release, Dep’t of Justice, Bank of America to Pay \$16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading Up to and During the Financial Crisis (Aug. 21, 2014).

95. Cf. *supra* notes 82-85 and accompanying text (illustrating this type of a conflict).

96. See *supra* notes 87-92 and accompanying text.

97. Cf. *Bear Stearns Mortg. Funding Tr. 2006-SL1 v. EMC Morg. LLC*, No. CV 7701-VCL, 2015 WL 139731, at \*5 (Del. Ch. Jan. 12, 2015) (discussing that certain investors directed the trustee to “ask[] EMC for loan origination files, servicing records, and other loan documentation for the Mortgage Loans”).

98. These investors sometimes can include activist investors who purchase bonds at pennies on the dollar and fail to obtain payment of the full face value of those bonds. See *supra* text accompanying note 82.

evidence of willful misconduct. Reading an indenture as a consistent whole, however, the more specific governing text would appear to be the standard provision that the trustee “undertakes to perform . . . only such duties as are specifically set forth” in the indenture and has no duty to investigate any “facts or matters” unless appropriately requested by investors to do so.<sup>99</sup> If there is no duty to act, the trustee’s inaction cannot constitute negligence.

*C. Monitoring and supervising servicers (and other parties).*

In securitized bond issues, the bondholders are dependent on collections on the purchased financial assets.<sup>100</sup> Invariably, therefore, these transactions require a party, usually called a servicer (or sometimes collection agent), to service those financial assets and collect payment thereon.<sup>101</sup> In litigation filed following the financial crisis, which caused widespread defaults on residential mortgage loans, some investors have argued that trustees in MBS transactions should have monitored or supervised the performance of the mortgage-loan servicer.<sup>102</sup>

An indenture could specifically require the trustee to supervise the servicer or assure that the servicer complies with the indenture.<sup>103</sup> However, more typically in the author’s experience, indentures provide that the trustee has no duty to monitor or supervise the servicer. Instead,

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99. I am not claiming that the investors themselves are better situated to perform investigations. Cf. Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281, 297-98 (2009) (discussing impediments to investigations by investors).

100. See *supra* note 30 and accompanying text.

101. The servicer normally is required to act in the “best interests” of the investors. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 391-92 (2008).

102. See, e.g., *Ellington Credit Fund Ltd. v. Select Portfolio Servicing, Inc.*, 837 F. Supp.2d 162, 172 (S.D.N.Y. 2011) (alleging that trustee of securitization breached its duty for insufficient supervision of servicer); David Dayen, *How Mortgage Companies Might Finally Be Held Liable*, THE NATION (Mar. 14, 2018), <https://www.thenation.com/article/how-mortgage-companies-might-finally-be-held-accountable/> [<https://perma.cc/XSV2-TD7U>] (stating that trustees are responsible for monitoring servicers). Compare CORP. TR. COMM., AM. BANKERS ASS’N, *supra* note 57, at 7 (stating that a trustee is not required to monitor the actions of the servicers) with Robinson, *supra* note 32, at 4 (suggesting that relying solely on servicer self-reporting is inadequate, and calling for a more active role of the trustee). Professor Levitin argues that trustees should engage in meaningful monitoring of servicers, but they are often unlikely to do so because of the close relationship between trustees and servicers. *Problems in Mortgage Servicing from Modification to Foreclosure: Hearing before the Subcomm. On Banking, Housing, & Urban Affairs*, 111th Cong. 10 (2010) (statement of Associate Professor Adam J. Levitin, Geo. U.L. Center), <https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1111&context=cong> [<https://perma.cc/CFD9-UUVY>].

103. See, e.g., Michael J. Canning, et al., Am. Bankr. Inst., *Committee Educational Session: Real Estate Tranche Warfare: Real Estate Restructurings: Issues Raised By Complex, Multi-Tranche Financial Structures*, 120910 ABI-CLE 573 (2010).

the servicer itself typically attests periodically to its own compliance, and the trustee is entitled to rely on the truth and accuracy of that attestation.<sup>104</sup>

Absent clear indenture language, should the trustee have a pre-default duty to monitor or supervise the servicer? Notwithstanding the claim that trustees have duties to ensure that mortgage loans in MBS transactions are “properly serviced,”<sup>105</sup> imposing a monitoring or servicing requirement would be duplicative and expensive—and thus inefficient. Servicers provide a wide array of services, including collecting principal and interest payments, communicating with borrowers, addressing borrower delinquencies and bankruptcies, working out loan modifications or other borrower difficulties, foreclosing on properties, maintaining foreclosed homes, and selling real-estate-owned properties after foreclosure. They charge arm’s length fees for performing these services.<sup>106</sup> Most trustees are not equipped or compensated to monitor or supervise that performance.<sup>107</sup> Trustees, therefore, should not have that pre-default duty.<sup>108</sup>

#### D. Monitoring for Events of Default.

Investors sometimes claim that a trustee should have a pre-default duty to monitor for the existence of an Event of Default. Some practitioners have likewise suggested that trustees for securitized bond issues might have this duty.<sup>109</sup> Indentures normally provide, however, that notwithstanding the actual existence of an Event of Default, the trustee’s post-default heightened duty is not triggered until a responsible officer of the trustee has “actual knowledge” or, if the indenture provides, written notice of the Event of Default.

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104. Sometimes an experienced master servicer may be appointed to supervise the servicer’s performance.

105. See *supra* note 34 and accompanying text.

106. See, e.g., Residential Capital LLC, Annual Report (Form 10-K) 9 (Feb. 27, 2009), <http://www.secinfo.com/d14D5a.s16Ca.htm#1stPage> [<https://perma.cc/Q8SK-A5NQ>] (reporting that Residential Capital, LLC, a mortgage loan servicer, charged approximately 15 basis points (0.15%) for servicing insured mortgage loans and 25 basis points (0.25%) for servicing uninsured mortgage loans). Cf. Laurie Goodman et al., *The Mortgage Servicing Collaborative: Setting the Stage for Servicing Reforms*, URBAN INSTITUTE 6 (2018). [https://www.urban.org/sites/default/files/publication/95666/the-mortgage-servicing-collaborative\\_1.pdf](https://www.urban.org/sites/default/files/publication/95666/the-mortgage-servicing-collaborative_1.pdf) [<https://perma.cc/5E3S-42L8>] (finding that the average servicing cost per loan as of 2016 was \$163 for performing loans and \$2,113 for non-performing loans).

107. See *infra* note 124 and accompanying text.

108. Also, for these same reasons, a trustee that allegedly is aware of a servicing failure should not have a pre-default duty to correct the failure absent indenture language requiring it to do so.

109. Brady et al., *supra* note 36, at 9-6 (discussing the additional sophistication and specialization needed for such a trustee “to achieve an appropriate awareness of possible weakening financial condition of an issuer or servicer or to determine early amortization events”). Cf. *id.* at 9-16 (stating that a “diligent and competent trustee [for a securitized bond issue] will be able to recognize certain warning signals that may precipitate a trigger event in the documents”).

Even absent that language in an indenture, a trustee should not have such a pre-default monitoring duty. Requiring such a duty would require the trustee to constantly investigate all events that might trigger an Event of Default. That would be expensive and time consuming—and thus, inefficient—with investors bearing the cost.<sup>110</sup> It also could expose the trustee to indeterminate liability if it failed, even for reasons beyond its control, to become aware of an Event of Default. Uncertainty of the standard—one that is merely ministerial, or one requiring prudence and judgment—by which their performance would be judged would discourage financial institutions from acting as trustees or at least motivate them to charge higher fees to compensate for the risk.<sup>111</sup>

Sometimes, one or more investors may notify the trustee that an Event of Default has occurred but the notification lacks specific, actionable information clearly showing the existence of the Event of Default. What then should be the duty of a trustee regarding an alleged but unproved (or disputed) Event of Default? The answer should take into account and balance practical considerations—which could include seeking, or requesting that those investors obtain, formal investor directions.<sup>112</sup> Otherwise, investors who cannot muster the requisite number to direct the trustee to make an investigation could repackage their demands by alleging that an Event of Default requires the trustee to act. If the trustee were then required to expend trust assets to investigate the Event of Default, those investors could achieve indirectly what they could not do directly.

In one case that the author is aware of, for example, the “complaining investor” sent a notice to the trustee describing improper servicing by the servicer and alleging that constituted an Event of Default. The complaining investor’s information was based on publicly available statements about, and regulatory investigations and proceedings pertaining to, the servicer’s servicing practices, as well as rating-agency downgrades of the servicer’s servicing ratings. Responding to the trustee’s inquiry, the servicer said it was properly performing its servicing duties. The trustee then sent the investors a notice describing the complaining investor’s arguments and the servicer’s response, stating that it had not formed any view as to whether an Event of Default had occurred, and requesting direction by a requisite number of investors. Not

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110. Cf. Louis Loss, *Introduction to AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE WITH REPORTER’S COMMENTARY VOL. I, PARTS I-XIII*, xl (1980) (“It has been persuasively urged that extension of the ‘prudent man’ test for purposes of ascertaining the occurrence of a default . . . would be impracticable and prohibitively expensive in terms of increased trustees’ fees.”).

111. Cf. *Dabney v. Chase Nat’l Bank*, 196 F.2d 668, 675 (2d Cir. 1952) (in which Judge Learned Hand observed that the “law ought not make trusteeship so hazardous that responsible individuals and corporations will shy away from it.”).

112. See *supra* notes 85-88 and accompanying text.

receiving such direction, the trustee concluded that no further action was warranted in the absence of additional information. That conclusion appears reasonable under the circumstances.

*E. Agreeing to settlements (and making other decisions that could affect investor recovery).*

Questions sometimes arise about a trustee's pre-default duty when making decisions that could affect investor recovery, such as deciding whether a trustee should settle a lawsuit or other claims against third parties or accept a debt restructuring on the bonds to avoid a default.<sup>113</sup> For example, shortly after The Bank of New York Mellon, as a trustee, entered into a settlement agreement with Bank of America to settle Countrywide's repurchase liability for \$8.5 billion, investors accused the trustee of having a conflict of interest, acting in bad faith, and breaching fiduciary duties in the course of administering the trusts and/or concluding the settlement.<sup>114</sup>

Indentures sometimes contain collective action clauses ("CACs") that allow a supermajority of investors to make these types of decisions, binding on all investors.<sup>115</sup> In those cases, the trustee could seek to obtain supermajority investor consent to the decision. In the United States, however, the TIA prohibits changing core payment terms of corporate bonds—their principal amount, interest rate, or maturity<sup>116</sup>—without unanimous bondholder consent.<sup>117</sup> Therefore, relatively few indentures in the United States contain CACs.<sup>118</sup> This can lead to otherwise favorable

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113. Such a debt restructuring, for example, might involve reducing principal or interest on the bonds or extending their payment terms (i.e., their amortization or maturity). Decisions affecting investor recovery sometimes concern provisions that entitle the issuer to redeem (i.e., prepay) the bonds prior to their stated maturity. Because early redemption would deprive the investors of contractually expected future interest payments, indentures often require issuers to also pay a call premium or make-whole payment. Questions sometimes arise, in the author's experience, as to whether the issuer has the right to prepay its bonds without also making those additional payments. (A call premium represents the difference between the price at which the issuer can redeem the bond issue and the issue price. A make-whole payment is a lump sum payment based on the net present value of all future coupon payments that will not be paid to bondholders after the early redemption.)

114. *Bank of New York Mellon v. Walnut Place, LLC*, No. 11-cv-5988 (S.D.N.Y. Aug. 26, 2011) (removing action entitled *In re the Bank of New York Mellon*, Index No. 651786/2011 (N.Y. Sup. Ct.)). Regulators also moved to join the suit. Memorandum and Order denying 17 Motion to Intervene, Filed by Attorney Generals of Delaware and New York, *id.* at Dkt. No. 140 (Nov. 18, 2011).

115. W. Mark C. Weidemaier & Mitu Gulati, *A People's History of Collective Action Clauses*, 54 VA. J. INT'L L. 51, 53 (2013).

116. *Cf. supra* note 113 (observing that a debt restructuring might involve changing one or more of such core payment terms).

117. 15 U.S.C.A. § 77ppp. *See also* *Marblegate Asset Mgmt., et al. v. Educ. Mgmt. Corp., et al.*, 846 F.3d 1, 11 (2d Cir. 2017).

118. CACs are more commonly found in sovereign bond indentures. Buchheit & Gulati, *supra* note 49, at 1330.

debt restructurings being “held hostage” by one or more bondholders, acting as holdouts in the hope they will receive special premiums for consenting.<sup>119</sup> Resolution of that holdout behavior is beyond the scope of this Article.<sup>120</sup>

#### F. Resolving document defects.

Securitized bond issues sometimes require the trustee to hold documents evidencing the underlying financial assets. For example, indentures in MBS transactions often require the trustee (or a custodian acting on the trustee’s behalf) to hold certain mortgage-loan documents such as the mortgage note, the mortgage with evidence of recording, an assignment of mortgage, and the original title policy. What should be the pre-default duty of a trustee to try to obtain documents that it fails to receive or to correct documents that are defective on their face?

Because the trustee’s performance costs typically would be paid from the estate, such a duty should not be triggered, if at all, unless the failure to receive a document or defect would actually harm investors.<sup>121</sup> That, in turn, should be judged in light of the purpose of document-delivery requirements—normally, to enable the servicer to service the loans properly and to enforce those loans and mortgages against defaulting borrowers.<sup>122</sup> If a missing or defective document is unnecessary for such servicing and enforcement, its absence or defect would lack harmful consequences.

The party best able to assess whether or not a missing or defective document would be needed for such servicing and enforcement—and the party most often assigned that responsibility, in practice—is the servicer, who actually services and enforces the loans.<sup>123</sup> Trustees are not ordinarily equipped to assess those consequences.<sup>124</sup> Furthermore,

119. Andrew G Haldane et al., *Optimal collective action clause thresholds* 9 (Bank of Eng. Working Paper no. 249, 2005), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=724002](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=724002).

120. The author separately has examined this type of holdout behavior and, at least in the sovereign debt context, its resolution. See, e.g., Steven L. Schwarcz, *Sovereign Debt Restructuring Options: An Analytical Comparison*, 2 HARVARD BUS. L. REV. 95 (2012).

121. Cf. *In re Bankers Trust Co.*, 450 F.3d 121,127-29 (2d Cir. 2006) (even though a trustee breached its pre-default duty of inspecting certain issuer certificates and providing notice to bondholders, the court awarded bondholders only nominal damages because, even if the trustee “had been punctilious in its inspection of the certificates,” that “would not have prevented the [bondholders’] losses”).

122. Patrick E. Mears & Mark R. Owens, *Representing Special Servicers in “Cleaning Up” Defaulted CMBS Loans*, PROBATE & PROPERTY 21, 23 (May/June 2011), [https://www.americanbar.org/content/dam/aba/publications/probate\\_property\\_magazine/v25/03/2011\\_a\\_ba\\_rpte\\_pp\\_v25\\_3\\_may\\_june\\_mears\\_owens.pdf](https://www.americanbar.org/content/dam/aba/publications/probate_property_magazine/v25/03/2011_a_ba_rpte_pp_v25_3_may_june_mears_owens.pdf) [<https://perma.cc/6U8S-7JNJ>].

123. See Mears & Owens, *supra* note Error! Bookmark not defined. and accompanying text.

124. In considering why trustees are not ordinarily equipped to assess those consequences, it may

assessing those consequences would require the exercise of judgment and, absent an Event of Default, trustees are not, and should not be, required to exercise judgment.<sup>125</sup> Ideally, indentures should therefore require servicers to assess those consequences and provide a procedure whereby the trustee could make that inquiry of the servicer.

### G. Disclosing problems.

Investors sometimes claim that a trustee should have a pre-default duty to disclose problems of which it becomes aware, such as documents that the trustee is required to hold being missing or defective.<sup>126</sup> Trustees, however, have no general disclosure duties, and there is no rationale that they should have such duties.<sup>127</sup> As a matter of best practices and to reduce risk, however, trustees may wish to disclose material problems of which they become aware. Investors then could consider whether to direct the trustee to act on those problems.<sup>128</sup>

Their ability to disclose material problems turns on trustees becoming aware of such problems, which cannot always be presumed. The author's experience in numerous securitization transactions, for example, is that many of the documents evidencing the underlying financial assets are missing or defective. Absent a procedure enabling the trustee to inquire about materiality with the servicer,<sup>129</sup> the trustee may be unable to assess the materiality of those missing and defective documents.<sup>130</sup> Future indentures ideally should provide such a procedure.

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be useful to compare the obligation of an issuer of a letter of credit. Such an issuer (usually a bank) is not responsible for the underlying commercial transaction. U.C.C. § 5-108(f), § 5-109(1) (AM. LAW INST. & LAW COMM'N). Rather, the issuer's "role in the transaction [is] ministerial." *United Commodities-Greece v. Fidelity Int'l Bank*, 478 N.E.2d 172, 174 (N.Y. 1985). A letter-of-credit issuer has no obligation to determine whether a submitted document is fraudulent. U.C.C. § 5-108(a), (e). If a submitted document "appears on its face strictly [to comply] with the terms and conditions of the letter of credit," the issuer must honor the letter of credit. U.C.C. § 5-108(a). Applying the same rationale, "require[ing] [the indenture trustee] to determine the substantiality of discrepancies [of documents] would be inconsistent with its function." *United Commodities*, 478 N.E.2d at 174.

125. Nothing in this Article suggests that an Event of Default unrelated to missing documents should require a trustee to exercise judgment about the consequences, and hence the materiality, of missing documents.

126. See *supra* notes **Error! Bookmark not defined.**-124 and accompanying text.

127. See Brady, et al., *supra* note 36; *supra* note 55 and accompanying text.

128. See Brady, et al., *supra* note 36; *supra* note 55 and accompanying text.

129. Cf. *supra* notes 124-125 and accompanying text (advocating such a procedure).

130. See *supra* notes 124-125 and accompanying text. Plaintiffs sometimes also claim, in the author's experience, that a trustee has a pre-default duty under Regulation AB to disclose problems. Adopted by the Securities and Exchange Commission ("SEC"), Regulation AB requires certain disclosure and periodic reporting about securitized bond issues, including requiring the servicer to deliver to the trustee annual assessments of compliance with servicing standards. See 17 C.F.R. §§ 229.1100 to 229.1123. Regulation AB is beyond the scope of this Article, which is normative.

## IV. RESOLVING AMBIGUITIES

Any normative rule for determining a trustee's pre-default duties, including the rule proposed by this Article, inevitably will face ambiguities. This Part examines how a trustee could try to resolve those ambiguities.

*A. Seek Legal Opinion.*

A trustee could seek a legal opinion to try to resolve ambiguities. Section 8.01 of most indentures, entitled "Duties and Responsibility of the Trustee," usually allows trustees acting in good faith to "conclusively rely" on opinions that conform to the indenture's requirements.<sup>131</sup> Furthermore, § 8.02 of most indentures, entitled "Certain Rights of the Trustee," usually allows trustees to consult with counsel and to rely on "the written advice" or "an opinion" of counsel" as "full and complete authorization and protection for any action taken, suffered or omitted by it in good faith and in accordance with such advice or opinion."<sup>132</sup>

Sometimes, however, a lawyer may be unable to clearly resolve the ambiguity, perhaps because its resolution transcends legal considerations or the law itself is unclear. In those cases, the trustee may wish to seek investor instructions (discussed below in subpart B) or even judicial guidance (discussed below in subpart C).

*B. Seek Investor Instructions.*

As discussed, indentures typically authorize a requisite number of investors to instruct the trustee.<sup>133</sup> In appropriate cases, the trustee could seek such instructions. If it then receives instructions, the trustee should be justified in following them. Absent instructions, the trustee should be justified in not taking further steps.

*C. Seek Judicial Guidance.*

In more difficult or sensitive cases, a trustee could seek judicial guidance. Two basic types of judicial procedures—interpleader and declaratory judgment actions—may be appropriate.<sup>134</sup> Interpleader,

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131. See, e.g., National Association of Bond Lawyers, *Model Form of Trust Indenture*, § 8.01(a)(2), at 37, <https://www.nabl.org/portals/0/documents/nablformreportsmodeldocs-nablformtrustindenture.pdf> [<https://perma.cc/B4U4-9SFJ>].

132. *Id.*, § 8.02(d), at 38.

133. See *supra* notes 87-92 and accompanying text.

134. See generally Robert J. Coughlin et al., *Rule 22 to Resolve a Catch-22: Defensive Maneuvers*

which is available under both federal and state law, is a procedure whereby a party with property subject to competing claims may compel the parties asserting those claims to litigate their dispute in a single proceeding.<sup>135</sup> Federal law provides two broadly similar types of interpleader, rule interpleader and statutory interpleader,<sup>136</sup> with statutory interpleader having more lenient jurisdictional requirements.<sup>137</sup> State law, including New York law, is similar to federal interpleader with one exception: it does not require the disputed property to be placed under the court's control (whereas federal interpleader does).<sup>138</sup>

A trustee also could request a declaratory judgment to have a court determine its rights, prior to taking action that may expose it to liability.<sup>139</sup> Unlike interpleader, a declaratory judgment action requires the existence of an "actual controversy."<sup>140</sup> The federal declaratory judgment procedure allows the court to order a speedy hearing of the controversy.<sup>141</sup> That could be valuable because attempts to seek judicial guidance often can involve lengthy delays.<sup>142</sup> Choosing between a federal or a state declaratory judgment procedure may also be influenced by jurisdictional requirements or strategic concerns.<sup>143</sup>

Some states provide even more targeted statutory procedures for trustees to obtain judicial directions.<sup>144</sup> Because these procedures are usually designed to apply only to gratuitous trusts, it is uncertain whether they could be applied to indenture trustees<sup>145</sup> or used in a

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for *Corporate Trustees Faced with Conflicting Claims*, in *NEW DEVELOPMENTS IN SECURITIZATION* 2008, at 771, 777 (PLI Com. L. & Prac. Course Handbook Series No. 14108, 2008), WL 908 PLI/COMM. 771.

135. CYCLOPEDIA OF FEDERAL PROCEDURE § 22.1 (3d ed. 2005).

136. Rule interpleader arises under FED. R. CIV. P. 22; statutory interpleader arises under 28 U.S.C. § 1335 (2006).

137. CYCLOPEDIA OF FEDERAL PROCEDURE, *supra* note 135, § 22.5.

138. See N.Y. C.P.L.R. 1006 (McKinney 2009); see also Coughlin et al., *supra* note 134, at 778–79 (noting this distinction between federal and New York interpleader laws).

139. Coughlin et al., *supra* note 134, at 782–83 (quoting *Banos v. Winkelstein*, 78 N.Y.S.2d 832, 834 (1948)).

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

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

142. Cf. *Fiduciaries With Conflicting Obligations*, *supra* note 6, at 1901–07 (discussing how using interpleader to try to resolve fiduciary conflicts can involve lengthy litigation, and comparing that with the much speedier English judicial procedures to resolve those types of conflicts).

143. See Coughlin et al., *supra* note 134, at 784–85.

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

145. Cf. *supra* note 28 (discussing the hybrid nature of a trustee on an indenture).

commercial context.<sup>146</sup>

#### *D. Exercise Common Sense*

Lacking other guidance, a trustee ultimately should be able to fall back on basic common sense, including a rough cost-benefit balancing. For example, regardless of what the trustee's duty otherwise should be, the occurrence of a suspicious event should not trigger a duty to investigate occurrences and events that are unrelated to that event. Such an extraneous investigation could significantly reduce trust assets without commensurately benefitting the investors. Similarly, absent formal investor directions,<sup>147</sup> a trustee should not generally take an action that would be expensive but unlikely to lead to a net favorable outcome—such as investigating whether a bankrupt or clearly insolvent party had breached one or more of its representations and warranties.<sup>148</sup> Even if the trustee could prove such a breach, a damage claim against that party may be unrecoverable.

#### CONCLUSIONS

This Article has examined the pre-default duties of indenture trustees. Whereas outstanding scholarship focuses on post-default duties, investors increasingly are making pre-default demands on trustees in the multi-trillion dollar bond market, requiring them to know how to respond.

The Article shows that, pre-default, the trustee should only have the duties specifically set forth in the bond indenture. It then applies that analysis to the types of issues that typically arise in lawsuits against trustees. Finally, the Article examines how trustees could try to resolve any ambiguities relating to those duties.

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146. See Coughlin et al., *supra* note 134, at 779. N.Y. C.P.L.R. 7701 provides, for example, that a “special proceeding may be brought to determine a matter relating to any express trust except a voting trust, a mortgage, [or] a trust for the benefit of creditors . . . .” N.Y. C.P.L.R. 7701.

147. See *supra* note 85 and accompanying text.

148. Originators and sometimes sponsors of securitization transactions make representations and warranties about the quality of the financial assets being sold, for which they are liable for breach. See *supra* note 30.