

Theories of Liability of Corporate Trustees; Standard of Care; Negligence versus Gross Negligence

by

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Introduction

Bond counsel regularly mediate the basis for the trustee's liability between the bond issuer and the corporate trustee. Despite significant curtailment of the corporate trustee's "discretionary" responsibilities under most municipal bond indentures, drafters still tend to employ the customary fiduciary standards of care.

Acceptance of trusteeship usually implies acceptance of a fiduciary role, more than a mere agency, an agreement to apply a standard of care at least equal to that one would apply in the management of one's own affairs. Recent amendments to Pennsylvania's fiduciary code employ and impose this duty upon trustees in the absence of language to the contrary. [\[1\]](#)

The new statutory formulation continues prior law, imposing in the absence of contrary language a "prudent person standard." [\[2\]](#) If a trustee such as a bank has greater skill than an ordinary person, it will be bound to act according to its higher skill. [\[3\]](#) One might expect a bank trustee to have greater skill in selecting investments, managing money, evaluating property for sale, *et cetera*. In fact, corporate trustees have been held to such a higher standard even though they may not have represented that they have such expertise. [\[4\]](#)

All this, however, is subject to the widely accepted rule that the settlor's intent governs the standard of care to be employed. [\[5\]](#) This intent will be ascertained from the trust instrument. Courts and legislatures generally permit the settlor to establish the standard of care to be exercised even though this may diminish the likelihood that the trust terms will be carried out and the estate transferred to the intended beneficiary. [\[6\]](#)

Under this rule, a provision that a corporate trustee will be liable only for "gross negligence or willful misconduct" is valid and enforceable. [\[7\]](#)

Corporate trustees are employed today for many functions. These may include services as paying agent, bond registrar, funds custodian, construction monitor, project administrator, continuing disclosure agent, and bond holder representative. Governing indentures of the past often conferred significant discretion upon the trustee in carrying out these functions. As a matter of self protection trustees now require that indentures provide objective standards or further direction for any choices they are required to make.

Despite this change in the scope of duties and expectations, indentures continue to reflect their ancestry in the general fiduciary law and its negligence standard. At least for trustee behavior prior to events of default and enforcement actions, it may be time to address liabilities for some of these functions by employing principles of contracts, agency law, or other theories that more closely align with the parties' real expectations.

Litigation against corporate trustees during this century has focused on whether the basis for trustee liability is to be implied by law or derived from the terms of the indenture. [\[8\]](#) Assuming the majority view, that the language of the indenture controls, what standard of care should prevail? Should the trustee's immunity from liability end upon its "negligence" or only upon its

“gross negligence?”

Bond Industry Standards

The Trust Indenture Act of 1939 follows the common law liability standard of most jurisdictions by permitting distinctions to be made between pre- and post-default situations. After default, the trustee must protect bondholder interests using the “prudent man” standard. Pre-default liability may be defined by the terms of the indenture.

The Trust Indenture Act does provide that no provision of a qualified indenture may be construed to relieve the trustee from liability for its own negligent action or willful misconduct. Most municipal bond indentures, however, are exempt from the provisions of this Act.

Lack of consensus on a preferred standard for trustee liability in the municipal bond industry is evident in the National Association of Bond Lawyers’ draft Model Indenture. It provides that the trustee is liable only “for its own [gross] negligence or willful misconduct,” leaving the drafter to make the choice.

Mere Negligence versus Gross Negligence

Dim memory informs me that “gross” negligence is defined more by motive more than action; a state of mind that transforms an innocent accident into a virtual civil crime that warrants redress even though the actor is otherwise immune from his carelessness.

Modern courts struggle to find meaningful words to distinguish “gross” from “mere” negligence. Some say it involves “willfulness, or recklessness, or their equivalent” when applied to trusts. [\[9\]](#) The United States District Court for the Eastern District of Pennsylvania has said gross negligence “signifies more than ordinary inadvertence or inattention but less perhaps than conscious indifference to the consequences.” [\[10\]](#)

Bond Trustee’s Gross Negligence in Pennsylvania

Although sparse, there is some long standing guidance for Pennsylvania practitioners. Consider the following:

Gouley v. Land Title Bank:

It is not gross negligence or willful misconduct to fail to give bondholders notice of default by the primary obligor to make monthly sinking fund deposits on balloon debt where notice has been given to the guarantor in accordance with indenture. [\[11\]](#)

This holding may seem fair on its face since the guarantor has assumed credit risk. However, the facts disclose that the guarantor was cast in the documents as the putative “sole agent for bondholders,” the guarantor was insolvent, and the trustee bank and guarantor had many common directors and officers.

Browning v. Fidelity Trust:

It is not “bad faith” (the standard expressed in the indenture) or “gross negligence” (the court-imposed, minimum standard of

care) for the trustee to release the lien of a mortgage securing bonds while interest payments are in default. [\[12\]](#)

The court found that, while the bank's tellers had actual knowledge of missed bond interest payments, the corporate trust officers who acted on written direction of the mortgagor to release the mortgage lien securing the bonds did not have imputed knowledge of such defaults. Thus, the court reasoned, they lacked "a state of mind affirmatively operating with a furtive design or some motive of interest or ill will."

The Court concluded: "While they [the corporate trust officers] were not justified in relying upon the lack of information contained in the letters . . . their act, though technically negligent, was not characterized by recklessness, indifference, willfulness, or ulterior design and did not amount to gross negligence."

Harvey v. Guaranty Trust:

On the other hand, it may be gross negligence for a trustee to defease the lien of an indenture while some bonds are outstanding with no provision to pay them. [\[13\]](#)

The indenture protected the trustee "except in its own fraud or willful misconduct" and permitted the trustee to rely conclusively on a "certificate of the mortgagor under its corporate seal attested by the signature of its president and the affidavit of one or more directors" for action taken.

The trustee originally authenticated \$500,000 of bonds. In anticipation of refunding the issue, the mortgagor gave a letter to the trustee, signed by its president and bearing the corporate seal, requesting authentication of a \$20,000 temporary bond "in place of lost bonds as per the enclosed resolution." The accompanying corporate resolution recited that the original \$20,000 in bonds had been authenticated, but had never been sold and had been lost by the mortgagor. Diligent but unsuccessful search could not find them. An affidavit of the mortgagor's treasurer averred that the company had used these bonds as collateral for another loan that had been paid.

Presumably, the trustee felt it had the required assurances to proceed to issue the new bonds and then accept them in lieu of payment in consideration for the release of the indenture lien. Of this the court said: "A mere letter which requested authentication of a duplicate bond . . . cannot be regarded as a proper certificate by the company . . . Nor was the affidavit . . . to the effect that [the treasurer] was informed and believed that the missing bonds had been pledged . . . a sufficient affidavit to justify the trustee's reliance thereon as conclusive evidence that the mortgagor had received the return of the bonds and had lost them." [\[14\]](#)

Caldwell v. Hicks:

It is gross negligence for a trustee to leave trust funds on deposit in a bank after the bank closed. [\[15\]](#)

This case is a good example of "self-dealing" or personal benefit tipping the scale. Here the trustee was the president of the failing bank into which he deposited trust funds and was deemed to know that the funds might be lost during the closing of the bank.

Conclusion

If the indenture specifies a gross negligence standard, courts will attempt to give some meaning to it. In the absence of clear bad faith or intentional misconduct, the gross negligence standard may relieve a trustee from liability for significant breach of conduct.

To the extent the trustee is applying its own judgement in the absence of clear direction such relief may be appropriate

protection. To the extent the trustee's actions may be characterized as ministerial, as is more and more the case for pre-default functions, this standard of care may be but an unwarranted refuge.

Relief for the trustee is not relief for everyone. While the issuer of bonds may confer this special immunity upon its selected trustee, the issuer may not enjoy such immunity. Under the standards of these cases a trustee's failure to perform functions such as timely payment of debt service, proper notice of redemption or an event of default might well be excused if its is liable only for "gross negligence." The issuer, however, remains liable for the timely payments of debt service and redemption price and the bond holders may lose substantial benefits without remedy if the trustee is not liable for performing its contractual obligations.

The concept of negligence establishes a standard for behavior where contract or rule does not supply one. Where one is called upon to exercise judgment on another's behalf under circumstances that are difficult to predict, it may be fair to excuse poor judgement so long as it is made in good faith, not "grossly" negligent.

Conduct that is clearly defined by agreement or rule, however, should be enforceable without regard to the motive or mental state of the actor. This argues for the application of the "duty, breach, damages, liability" approach of contract law. This is essentially a "mere" negligence approach.

A common justification for the trustee's "gross" negligence standard is avoidance of "vexatious" or "frivolous" bondholder suits against the bank with the deep pockets. The problem is that may leave this issuer defending the "vexatious" bondholder suit over a duty that it has clearly contracted with, and paid, the trustee to perform.

Perhaps a better approach to avoiding "vexatious" or "frivolous" suits is to limit the damages that bondholders can recover. Assuming that both issuer and trustee intend to perform their respective obligations and be held liable for failing, damages should be paid for breach of duty but should be limited to direct, economic losses. These might be capped, for example at the principal loss plus interest at some specified rate during the period between loss and recovery. Full and fair disclosure of such limits in bond documents and offering materials should help to limit legal actions to only those necessary to hold each party to the bargain accountable for its own promises.

[1] 20 Pa. C.S. §7201 *et seq.*, as amended by the Prudent Investor Act. If you learn nothing more from this article, be sure to review that statute before agreeing to be named a guardian, custodian, or trustee for anyone!

[2] These statutes are essentially restatements of case law. See Shepard v. K.B. Fruit & Vegetable, Inc., 868 F. Supp. 703 (E.D. Pa. 1994), and In re Ellis' Estate, 460 Pa. 281 (1975).

[3] In re Mendenhall, 484 Pa. 77 (1979).

[4] In re Killey's Estate, 457 Pa. 474 (1974).

[5] In re Niessen's Estate, 489 Pa. 135 (1980).

[6] Id.

[7] Gouley v. Land Title Bank and Title Company, 329 Pa. 465, 470 (1938). Principle applied in Fidelity Bank v. Com. Marine and General Assurance Co., Ltd., 592 F. Supp. 513 (1984).

[8] See, Lorenz v. CSX Corp., 1 F. 3rd 1406 (3rd Cir. 1993), *aff'g.*, 736 F. Supp. 650 (W.D. Pa. 1990), and cases cited therein.

[9] [Hazzard v. Chase National Bank](#), 287 NYS 541 556 (1936), aff'd ,14 NYS2d 147, aff'd, 2828 NY 652, reh den, 283 NY 682, cert den, 311 U.S. 708 (1940)

[10] [Fidelity Leasing v. Dun & Bradstreet](#), 494 F. Supp. 786 (E.D. Pa. 1980).

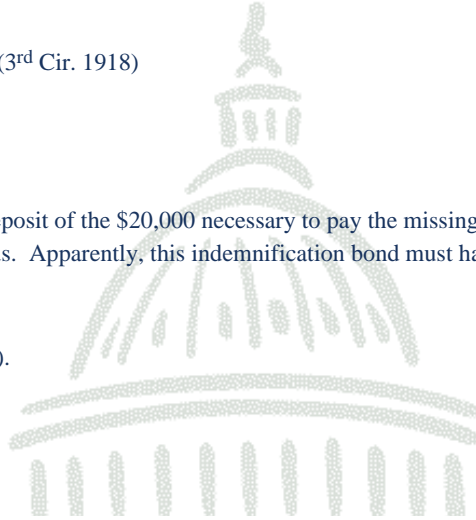
[11] [Gouley v. Land Title Bank and Trust Company](#), 329 Pa. 465 (1938).

[12] [Browning v. Fidelity Trust Co.](#), 250 F. Supp. 321 (3rd Cir. 1918)

[13] [Harvey v. Guaranty Trust](#), 236 N.Y.S. 37 (1929).

[14] Part of the solution would have been to require a deposit of the \$20,000 necessary to pay the missing bonds. The trustee was given an indemnity bond of \$61,000 as an inducement to issue the replacement bonds. Apparently, this indemnification bond must have expired upon defeasance of the indenture so that it was not available for the protection of the bondholder.

[15] [Caldwell v. Hicks](#), 15 F. Supp. 46 (D.Ct Ga. 1936).



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