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TRUSTS - EFFECT OF EXCULPATORY CLAUSES ON THE LIABILITY OF CORPORATE TRUSTEES

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TRUSTS — EFFECT OF EXCULPATORY CLAUSES ON THE LIABILITY OF CORPORATE TRUSTEES — The average investor doubtlessly relies upon the fact that some banking institution is a trustee for the bond issue in which he places his savings, and expects a degree of care com-

mensurate with the confidence he has in that institution.[1] The fact is, however, because of innumerable exculpatory clauses found in the corporate mortgage, the trustee's duties in regard to the protection of the bondholders' interests are practically negligible.[2] But before proceeding further with the subject, it is necessary to distinguish two situations: first, a case where the trustee has no duty whatsoever to act; and secondly, where a duty does exist but yet the performance is excused because of exculpatory provisions. The two circumstances involve essentially different problems. In regard to the first situation, although there is authority supporting the view that the trustee's duties are solely contractual,[3] the better opinion is that the position of the corporate trustee is somewhere between that of a mere stakeholder and that of a personal trustee.[4] From this fiduciary relationship, courts imply duties independently of the terms of the trust instrument.[5] Recognizing, then, that the duties of a trustee are both express and implied, the difficult problem confronting the courts is to what extent exculpatory clauses shall be given effect to relieve the trustee of liability for non-performance of acts which would otherwise be required.[6]

It is, of course, generally agreed that trustees cannot contract to

[1] Starr v. First Nat. Bank, (N. Y. S. Ct.) 96 N. Y. L. J. 771 (Sept. 21, 1936), noted 37 COL. L. REV. 130 (1937).

[2] Hazzard v. First Nat. Bank, 159 Misc. 57, 287 N. Y. S. 541 (1936).

[3] Hunsberger v. Guaranty Trust Co., 164 App. Div. 740, 150 N. Y. S. 190 (1914); affd. 218 N. Y. 742, 113 N. E. 1058 (1916); Nat. Water Works Co. v. Kansas City, (C. C. Mo. 1896) 78 F. 428; Baker v. Central Trust Co., (C. C. A. 6th, 1916) 235 F. 17; Colorado & So. Ry. v. Blair, 214 N. Y. 497, 108 N. E. 840 (1915); Meisal v. Central Trust Co., 179 App. Div. 795, 167 N. Y. S. 143 (1917), affd. 223 N. Y. 589, 119 N. E. 1059 (1918); Fleisher v. Farmers' Loan & Trust, 58 App. Div. 473, 69 N. Y. S. 437 (1901); Benton v. Safe Deposit Bk. of Pottsville, 255 N. Y. 260, 174 N. E. 648 (1931). But notice dictum, to the effect that a duty to record will be implied, in Chicago Title & Trust Co. v. Robin, 361 Ill. 261, 198 N. E. 4 (1935).

[4] Marshall v. Ilsley Bank & Guaranty Inv. Co., 213 Wis. 415, 250 N. W. 862 (1933).

[5] Hazzard v. First Nat. Bank, 159 Misc. 57, 287 N. Y. S. 541 (1936); Harvey v. Guaranty Trust Co., 134 Misc. 417, 236 N. Y. S. 37 (1929), affd. 256 N. Y. 526, 177 N. E. 125 (1931); Starr v. First Nat. Bank, (N. Y. S. Ct.) 96 N. Y. L. J. 771 (Sept. 21, 1936); Patterson v. Guardian Trust Co., 144 App. Div. 863, 129 N. Y. S. 807 (1911); Seelig v. First Nat. Bank, (D. C. Ill. 1937) 20 F. Supp. 61; Rhinelander v. Farmers' Loan & Trust Co., 172 N. Y. 519, 65 N. E. 499 (1902); Frishmuth v. Farmers' Loan & Trust Co., (C. C. N. Y. 1899) 95 F. 5, affd. (C. C. A. 2d, 1901) 107 F. 169; Drueding v. Tradesmen Nat. Bank & Trust Co., 319 Pa. 144, 179 A. 229 (1935); and generally see 57 A. L. R. 468 (1928).

[6] It has been suggested that exculpatory clauses are more likely to control where the duties are implied from the relationship rather than being expressly stated. Posner, "Liability of the Trustee under the Corporate Indenture," 42 HARV. L. REV. 198 at 204 (1928).

limit themselves against liability for acts committed in bad faith, or for gross negligence.[7] But there is serious difficulty in determining the type of conduct which can be described as grossly negligent.[8] The most accepted definition is "an intentional failure to perform a manifest duty in reckless disregard of the consequences."[9] Yet as was pointed out by one writer,[10] this definition is based upon personal injury cases, whereas a more proper derivation would be from bailment law. Accordingly, in this more analogous field, gross negligence would be the "want of ordinary care a prudent man would use in taking care of his own property." The latter definition is especially justifiable in the common circumstance wherein the trustee has interests which conflict with those of the bondholders.[11]

Can a trustee contract against a failure to exercise ordinary care? At present the answer appears to be "yes." The most liberal authority upholding this view is the *Browning* case,[12] wherein the trustee was found technically negligent, but the broad terms of the immunity clause relieving him from liability were upheld.[13] Likewise in *Hazzard v. Chase Nat. Bank of New York*[14] the court expressly found the trustee guilty of ordinary negligence but reluctantly held the exculpatory clause applicable to relieve him from liability. This result might have been avoided by finding that the trustee went beyond the scope of his authority,[15] hence the exculpatory clause did not apply, or by going

[7] Browning v. Fidelity Trust Co., (C. C. A. 3d, 1918) 250 F. 321, cert. den. 248 U. S. 564, 39 S. Ct. 9 (1918).

[8] Hazzard v. Chase Nat. Bank, 159 Misc. 57, 287 N. Y. S. 541 (1936); some of the various attempts to define gross negligence include "recklessness," "indifference," "reckless indifference," "supine negligence," "wilful neglect," and "wilful passivity."

[9] Browning v. Fidelity Trust Co., (C. C. A. 3d, 1918) 250 F. 321 at 325, citing McDonald v. International & G. N. R. R., (Tex. Civ. App. 1893) 21 S. W. 774 at 776.

[10] 31 ILL. L. REV. 1060 (1937).

[11] An inherent conflict is always existent because the trustees are financially interested in acceding to the wishes of the issuer. "If they [trustees] insist that the indentures contain provisions for the protection of the bondholders, it may be guessed that the business which they obtain from bankers and issuers would decline. Others less sensitive to the requirements of public interest and of investors would get the business." REPORT OF THE SECURITIES & EXCHANGE COMMISSION, Part VI, "Trustees under Indentures," p. 9 (June 18, 1936).

[12] Browning v. Fidelity Trust Co., (C. C. A. 3d, 1918) 250 F. 321, cert. den. 248 U. S. 564, 39 S. Ct. 9 (1918).

[13] The breach of duty involved was an express violation of the terms of the trust indenture.

[14] 159 Misc. 57, 287 N. Y. S. 541 (1936).

[15] Doyle v. Chatham & Phoenix Nat. Bank, 253 N. Y. 369, 171 N. E. 574 (1930); Conover v. Guarantee Trust Co., 88 N. J. Eq. 450, 102 A. 844 (1917), affd. 89 N. J. Eq. 584, 106 A. 890 (1918); Richardson v. Union Mortgage Co.,

unduly far in characterizing the trustee's acts as wilful.[16]

The recent decisions of the courts, nevertheless, indicate that legal opinion tends strongly against relieving the trustee from liability for even ordinary negligence.[17] Justice Frankenthaler in *Harvey v. Guaranty Trust Co.*[18] stated, "the tendency of our courts appears to be in the direction of refusing to permit such exculpatory provisions to prevail where the misconduct of the trustee is so repugnant to the trust as to defeat its very purpose." Although this remark was based upon the dictum in *Greene v. Title Guarantee Co.*,[19] its purport was followed by the Wisconsin court[20] in a recent decision which advanced the theory that a trustee is "under an obligation to exercise good faith as well as ordinary vigilance and intelligence." This view has again been advocated in the late case of *Starr v. Chase Nat. Bank*,[21] but that decision was probably based on a finding of bad faith. The result of these cases is that although the courts evince a strong desire to hold the trustee for liability due to ordinary negligence which impairs the security, nevertheless, because of the present development of the law, they are constrained to give legal effect to the exonerating provisions of the contract. However, viewing the tremendous recent growth of the use of this means of investment,[22] the writer submits that the public interest, which although insignificant before has now reached vast proportions, would justify a court in holding a trustee liable for even ordinary negligence regardless of the provisions of the instrument to the contrary.

A significant inroad has been made upon the effectiveness of exculpatory clauses by the federal court in *Seelig v. First National Bank*,[23] wherein the court clearly disregarded a provision in the mortgage that the trustee may assume there has been no default until notified in writing by one or more of the bondholders, in a situation where the trustee

210 Iowa 346, 228 N. W. 103 (1929).

[16] Harvey v. Guaranty Trust Co., 134 Misc. 417, 236 N. Y. S. 37 (1929), affd. 256 N. Y. 526, 177 N. E. 125 (1931).

[17] BAGWELL, VALIDITY OF EXCULPATORY CLAUSES IN CORPORATE MORTGAGES 24 (1933) [thesis presented to University of Michigan Law School]: "Such decisions by the courts may be justified on the ground of policy. After all, if the trustee fails to see after the interests of the bondholders, no one will."

[18] 134 Misc. 417 at 425, 236 N. Y. S. 37 (1929).

[19] 223 App. Div. 12, 227 N. Y. S. 252 (1928), affd. 248 N. Y. 627, 162 N. E. 552 (1928).

[20] Marshall v. Ilsley Bank & Guaranty Inv. Co., 213 Wis. 415 at 423, 250 N. W. 862 (1933).

[21] (N. Y. S. Ct.) 96 N. Y. L. J. 771 (Sept. 21, 1936).

[22] MOODY, MANUAL OF INVESTMENTS [PUBLIC UTILITIES] a9 (1936), estimates the debts of railroads, utilities and industrials under trust indentures at $33,390,000,000 at the end of 1935. This did not include financial and real estate corporate bonds.

[23] (D. C. Ill. 1937) 20 F. Supp. 61.

knew all the facts and the bondholders did not. The New York court, in an earlier case, *Fay v. New York Trust Co.*,[24] implied that it would likewise adopt the same view if a proper case were before it.

Obviously the courts are loathe to enforce exculpatory clauses against the interests of the bondholders, who, having no part in framing the instrument, are induced to believe that the financial institutions which hold themselves out as "trustees" will afford some protection to their investments. The greatest difficulty arises from the fact that frequently the trustee occupies a position where his own interests as a creditor or promoter of the mortgagor company may be contrary to the best interests of the bondholders. Nevertheless, it may be inexpedient to deny the trustee the opportunity to assist the obligor company, in so far as credit is not always easily obtainable from other institutions.[25] However, if the trustee is permitted to maintain conflicting interests, at least the courts ought to bind him to observe the same duties an impartial trustee would be held to perform. The *Trusts Restatement*[26] adopts the view that exculpatory provisions shall be given effect except where the conduct of the trustee indicates bad faith, or gross negligence, or in a situation where the trustee has profited by his breach of duty. Apparently, in the absence of statutes, the courts refuse to go beyond this extent in nullifying immunity clauses. Justice Rosenman suggested in the *Hazzard* case, "The entire system, however, should be changed by legislation, so as to provide more adequate compensation to the trustee, and the imposition of a duty of active vigilance akin to that placed upon ordinary fiduciaries."[27] A proposed bill[28] was introduced into the Seventy-fifth Congress (May 6, 1937) by Mr. Barkley, which in part seeks to regulate the liabilities of a corporate trustee. Among other provisions, the bill proposes that the trustee shall exercise the same degree of care which it expressly or impliedly represents itself as having, that the trustee shall not

[24] (N. Y. S. Ct.) 96 N. Y. L. J. 1455 (Oct. 30, 1936).

[25] Posner, "The Trustee and the Trust Indenture: A Further Study," 46 YALE L. J. 737 at 793 (1937): "If such institutions were disenabled from lending to enterprises for which they acted as indenture trustees, many would be immediately excluded from this capacity by foresighted management which anticipated late application to them for monetary needs. It is not likely, moreover, that trusteeships would be accepted by responsible banks, if the resulting penalty was the prohibition of loans to the obligor."

[26] TRUSTS RESTATEMENT, § 222 (1935).

[27] Hazzard v. First Nat. Bank, 159 Misc. 57 at 85, 287 N. Y. S. 541 (1936). Posner, "The Trustee and the Trust Indenture: A Further Study," 46 YALE L. J. 737 at 795 (1937), indicates that legislation should not only attempt to regulate the trustee's duties, but should equally as well govern the duties of the issuer and underwriter.

[28] S. Bill 2344, 75th Cong., 1st sess. (1937).

have any conflicting interests, and that the indenture shall not contain any provisions relieving it from liability for its own negligent action. Although this bill purports to protect the bondholders in every possible manner, if it is passed in its present form, it will necessitate extremely attractive compensation to induce institutions to act as trustees for corporate bond issues in the future.[29]

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[29] For a complete collection of all the literature on this subject, see McClelland and Fisher, Law of Corporate Mortgage Bond Issues 794, note 56 (1937).