New California Decision Puts Bank Trustees at Risk for Attorney Fees

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An important California Court of Appeal decision that reversed a $5 million award to an individual trustee for legal fees and costs incurred successfully defending surcharge claims may have far-reaching consequences for bank trustees. This article discusses the decision and the specific questions it raises under both California law and the law of other states. This article also provides tips and strategies for the bank trustee when retaining and supervising outside counsel to defend litigation brought by beneficiaries.

The recent case of *Donahue v. Donahue*[1] has raised the eyebrows of most trust lawyers in California. The decision will affect banks who are considering serving as trustees of trusts with potentially litigious beneficiaries, and banks already appointed as trustee who must defend malfeasance claims by beneficiaries.

In *Donahue*, the California Court of Appeal reversed an attorney fee award of approximately $5,000,000 to an individual trustee for legal fees and costs incurred successfully defending surcharge claims. The court remanded the case to the trial court to reconsider the attorney fee award in light of several unusual factors, including expert testimony on the reasonableness of the fees, and the amount of the beneficiary's fees as a benchmark in determining the reasonableness of those claimed by the trustee.

Most troublesome, however, was the court's ruling that the trial court should have considered not only whether the fees were reasonable in amount,

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but whether they "were reasonably incurred *for the benefit of the trust*."[2] The court provided no guidance as to what type of "benefit" the trust must have received to justify the trustee's fees. This decision tips the scales significantly in favor of beneficiaries and against the trustee. Because California is often the bellwether of legal trends, bank trustees need to take stock of this decision and act accordingly.

In some theoretical sense, a trust benefits from having the accounts of its trustee settled. But the fact is that a trustee who defends surcharge claims is acting primarily to protect the trustee's own pecuniary interests. That was certainly the case in *Donahue*, in which the former trustee faced claims that his sales of trust assets caused the trust to lose $20,000,000 in potential appreciation. The *Donahue* trust received no pecuniary benefit from the trustee's successful defense of the surcharge claims. It was the trustee who benefitted by obtaining a judgment that the trustee had no liability to reimburse the trust for malfeasance. The trust would have benefitted financially only if the trustee had *lost*, and the trustee had been ordered to reimburse the trust the millions of dollars of damages claimed by the beneficiary.

Donahue contains language harshly critical of the trustee that seems to reflect the Court of Appeal's reaction that the $5,000,000 fee award was grossly excessive. The court pointedly questioned, for example, whether the trustee had "demand[ed] a Rolls Royce defense when a prudent trustee could have arrived at the same destination in a Buick…."[3]

There is nothing new about the notion that fees incurred by a trustee should be reasonable in amount. *Donahue* is nonetheless a reminder that a trustee should be cautious when using trust funds to pay legal fees. In particular, trustees should carefully supervise counsel to avoid duplication of effort and unproductive or extravagant litigation tactics, and take steps to ensure that the expenses incurred bear a reasonable relationship to what is at stake.

But if *Donahue* requires a trustee to show some tangible benefit to the trust as a condition to recovering fees, trustees and beneficiaries alike should both hope that the decision is an aberration. It is hard to conceive how a trust will secure any tangible benefit when a trustee successfully defends a surcharge action, as the goal of the beneficiary's claim is typically to require the trustee to reimburse money *to* the trust. It is questionable whether such

a rule would be favorable even to beneficiaries. Responsible trustees will be reluctant to serve if there is doubt as to their right to recover reasonable fees incurred defending surcharge claims.

This article discusses the *Donahue* decision and the specific questions it raises under both California law and the law of other states. This article also provides tips and strategies for the bank trustee when retaining and supervising outside counsel to defend litigation brought by beneficiaries.

THE *DONAHUE* RULINGS

The *Donahue* action was brought by the income beneficiary of a family trust who objected to a former trustee's accounting on the ground that he had imprudently sold off millions of dollars of interest in a REIT. These sales resulted in the trust's loss of some $20 million in subsequent appreciation. The beneficiary also alleged that the trustee, who was himself an officer and shareholder of the REIT, was tainted by a conflict of interest.

The former trustee aggressively defended the claims, and after a 14-day trial, the court approved his accounting. In a separate unpublished opinion, the Court of Appeal affirmed, in all respects, the trial court's approval of the accounting, finding that the trustee's sales were a reasonable exercise of his discretion, were consistent with the trustee's duty to diversify trust assets, and that the trust had received "fair value" for the assets the trustee sold.[4]

But in its published opinion reversing the fee award, the Court of Appeal found that the trustee had followed a "spare no expense strategy" by which he incurred more than $5,000,000 in fees and costs. Among the facts cited by the Court of Appeal in questioning the trustee's "Rolls Royce defense" were:

- His use of a 45 member legal team from three separate law firms, some charging as much as $690 per hour;
- The presence at trial of some attorneys who "appeared to do nothing," but who were said to have been ready to cross-examine witnesses who were never called;
- Billings of $1,500,000 for one associate alone;
- Billings of $366,000 for an 80-page chronology and "case administration;"

- More than $184,000 in charges to prepare the trustee's fee petitions; and
- $150,000 in audio-visual expenses.

The beneficiary, by contrast, was represented by just two attorneys, who charged $375 per hour.

The trustee tried to justify his fees by arguing that it was a "bet the farm" case in which he faced potential personal liability of $20 to $25 million. The Court of Appeal turned this point against the trustee, sharply commenting that "[i]t was [the trustee's] 'farm' that was at stake, not the trust's," and suggesting that the trustee "may have decided to leave no field unfurrowed and to act without regard to cost in protecting his own personal interests."[5]

The Court of Appeal remanded the case for a redetermination of the amount of recoverable attorney's fees consistent with two main principles: (i) the fees must be reasonable in amount and reasonably necessary to the conduct of the litigation; and (ii) the fees "must be reasonable and appropriate for the benefit of the trust."[6]

The Court of Appeal also instructed the trial court to permit the beneficiary to use several fee measurement tools courts had previously disallowed. First, in light of the "size and complexity" of the trustee's fee requests, the court directed that the beneficiary be allowed to engage in limited discovery in support of the beneficiary's objections. Second, the court directed the trial court to permit the use of expert testimony on the reasonableness of the fees. The Court of Appeal found that expert testimony could be helpful on such issues as whether time devoted to preparing bills and fee requests should have been absorbed by the law firms as part of their overhead, and what steps the trustee should have taken to avoid duplicative or excessive charges when employing multiple firms. Finally, the court directed the trial court to engage in a "comparative analysis" of the trustee's fees and those incurred by the beneficiary, noting that such a comparison could provide a useful check on the reasonableness of the fees claimed by the trustee.

The court also strongly suggested that the trustee was not entitled to recover the fees he incurred litigating his fee requests. In doing so, the court commented that the trustee "has consistently pursued his own interests, to the potential detriment of the trust corpus,"[7] and then cited a federal securities case for the proposition that fees incurred litigating the recovery of fees

in common fund cases "should 'rarely, if ever, be bestowed' because the fee award runs counter to the interests of the fund."[8]

DONAHUE IS CONTRARY TO ESTABLISHED TRUST LAW

It is a basic rule of trust law, as reflected in the Uniform Trust Code,[9] that a trustee has a duty to administer the trust solely in the interest of the beneficiaries.[10] This rule, if taken to the extreme, might support an argument that a trustee should be precluded from recovering attorneys' fees if the trustee's actions do not protect or enhance the trust corpus.

But it has also long been the rule in California, and elsewhere, that if a "trustee is successful in defending against charges of misconduct, the trustee is normally entitled to indemnification for reasonable attorneys' fees and other costs…."[11]

Surprisingly, the court in *Donahue* failed to consider the California Supreme Court's own 1989 decision in *Estate of Trynin*.[12] *Donahue* is inconsistent with *Trynin* in two important respects. First, in contrast to *Donahue*'s holding that the trustee was not entitled to recover fees incurred litigating his fee requests, *Trynin* held that an attorney for a decedent's estate generally *is* entitled to recover fees incurred establishing and defending fee requests, subject to the court's discretion to consider whether amounts previously awarded adequately compensate the attorney.[13] In reaching this result in *Trynin*, the court cited with approval a case holding that a trustee is entitled to fees incurred successfully defending objections to an accounting,[14] and rejected the analogy to common fund cases relied upon by the court in *Donahue*.[15] Second, the court held that services by an attorney "that do not directly benefit the estate in the sense of increasing, protecting, or preserving it are nonetheless compensable" if the estate's representatives or attorneys were acting in accord with their established fiduciary duties.[16]

Donahue is likewise inconsistent with established trust law throughout the nation. Some cases have justified such awards in part on the theory that the successful trustee benefits the trust by establishing the propriety of his or administration of the trust.[17] Most decisions allow the recovery of reasonable fees and costs without any showing of benefit to the trust.[18] Others give lip service to the "benefit the corpus" rule and adopt an equitable rule.[19] More

often than not, the award of fees is result oriented,[20] with the fees allowed if the trustee was exonerated[21] and disallowed if malfeasance is found.[22]

Delaware has codified the rule in a statute that expressly authorizes a trustee to pay from the trust legal fees to defend itself against claims by beneficiaries, while giving the court discretion to disallow some or all of the fees if the trustee is found to have breached its fiduciary duties.[23]

To the extent that *Donahue* holds that fees claimed by the trustee must have been incurred "for the benefit of the trust," it creates confusion and uncertainty in what most practitioners thought to be an established area of trust law. This confusion arises from the court's failure to analyze what *kind* of benefit the trustee must show. The *Donahue* opinion does not provide a standard that may usefully be employed by other courts because the court failed to distinguish between fees incurred by a trustee defending itself against personal liability, and fees incurred to preserve the trust corpus or to recover property for the trust.

When a trustee incurs legal fees to protect or augment the trust corpus, consideration of whether the litigation benefited the trust is an appropriate factor in determining the reasonableness of those fees. Although a trustee is not the guarantor of litigation results, it is fair to require the trustee to show that it made a prudent and reasonable expenditure of trust funds, whatever the outcome of the case. If, for example, a trustee incurs $200,000 in fees to collect a $50,000 debt, the court might deny most of the fees because of the lack of benefit to the trust.

But requiring a trustee to show a benefit to the trust when the trustee defends surcharge claims by beneficiaries may impose an impossible burden. In such cases the trustee will not be able to show that the trust received any financial or other tangible benefit from its successful defense of the claims. The trustee is instead attempting to meet its burden of showing the propriety of its acts as trustee, and thereby defeat the beneficiary's claim that the trustee is liable to the trust.

LESSONS FROM *DONAHUE*

Donahue may be best explained by the old adage, "Bad facts make bad law." It is hard to imagine a court not being skeptical of a $5 million fee re-

quest from a trustee who employed dozens of lawyers to implement a "bet the farm" defense. The court's understandable concerns about the reasonableness of the trustee's fee request was a more than sufficient basis for reversing it. Going beyond that, and suggesting that trustees must also show that the fees incurred benefited the trust, imposes an inappropriate, if not impossible, burden. Hopefully, most courts will continue to take the realistic approach that trustees are entitled to recover reasonable fees incurred successfully defending claims by beneficiaries, without requiring a showing of any specific benefit.

Whether or not *Donahue* remains good law in California, there are lessons to be learned from it. Some of the key arguments and issues that bank trustees will undoubtedly face in other cases include:

- Trustees must be prepared for second-guessing of their staffing of large surcharge cases.
- Trustees should anticipate arguments that their fees are excessive if they substantially exceed the beneficiary's own fees. [24] Using the beneficiary's legal effort as a measuring stick, given that the beneficiary has no fiduciary duties and in some cases lacks the means to properly fund a civil trial, is at best risky and removes the statutory and trust instrument discretion vested in the trustee to make staffing decisions independently.[25]
- Trustees should be prepared to justify any decision to use multiple law firms to defend it.
- Trustees should anticipate that beneficiaries may offer expert testimony as to the reasonableness of the fees claimed and the trustee's staffing decisions.[26] No other case that allowed expert testimony on a trustee's fee request could be found, but a Missouri case ruled that the trial court acts an expert if it receives information as to billing rates in the geographic area.[27]
- Trustees should be cognizant of whether local law permits a trustee to recover attorneys' fees incurred in making a fee request and defending that fee request against objections by beneficiaries.

Donahue still leaves bank trustees free to manage and staff cases.[28] But the bank trustee should not do so on the assumption that the courts will

unquestioningly award them all of their fees and costs. Bank trustees should require their counsel to justify litigation strategies and tactics on a cost-benefit basis. Of course, a bank trustee may request a "Rolls Royce defense" if the importance of the case to the bank's reputation transcends the potential that the bank itself may be called upon to bear some of its fees from its own pocket.

Other actions that bank trustees may wish to consider include:

- Trustees need to consider the potential for litigation with beneficiaries and fee disputes before agreeing to serve as a trustee.
- Trustees should also review the trust instrument's provisions concerning reimbursement of fees and costs incurred by the trustee.
- A trustee may wish to file a petition to approve the retention of the law firm and obtain prospective approval of the firm's hourly rates. While most courts will not approve in advance the actual payments, many courts might approve the trustee's retention of a particular law firm and its hourly rates.
- Bank trustees might try to negotiate with their counsel to share some of the risk of being denied reimbursement of some or all of the attorney fees. A law firm might be willing to hold a percentage of the fees in its trust account pending ultimate court approval. The trustee in *Donahue* waited until the end of the litigation to request court approval of its fees. In the appropriate case, a bank trustee could seek interim approval of its fees.
- During the course of litigation, the bank trustee should be an active participant in development of litigation strategy, including development of a reasonable budget to support that strategy.

CONCLUSION

The *Donahue* decision may have achieved the right result, overturning a $5 million attorney fee award, for the wrong reasons. That being said, the court's gratuitous instructions to the trial court, to justify a trustee defense case on the basis of a benefit to the trust and using beneficiaries' attorney

fees as a benchmark, seem to present a dangerous precedent and may dissuade banks from acting as trustees where litigation is likely. But the bottom line for banks operating in a post-*Donahue* world is that the trustee may no longer outsource decisions regarding litigation budgets, staffing, and strategy, because *Donahue* makes it crystal clear that the bank which makes the wrong budget, staffing, and strategy decisions will be playing with its own chips.

NOTES

[1] *Donahue v. Donahue*, 182 Cal. App. 4th 259 (2010).
[2] *Id.* at 264.
[3] *Id.* at 268.
[4] *Donahue v. Donahue*, 2010 Cal.App.Unpub. Lexis 1053 (Cal. App. 4th Dist. Feb. 11, 2010).
[5] *Donahue v. Donahue*, *supra* note 1 at 268.
[6] *Id*. at 269.
[7] *Id*. at 271.
[8] *Id.* at 271, citing to *In re Fidelity Micron Securities Litigation,* 167 F.3d 735, 738 (1st Cir. 1999).
[9] The Uniform Trust Code is a model code for states to use to create a uniform, comprehensive body of trust law. It has been adopted in 29 states.
[10] Uniform Trust Code § 802(a); California Probate Code § 16002(a); *In re Hubbell's Will*, 302 N.Y. 246, 259, 97 N.E. 2d 888 (N.Y. 1951); *Sherman v. Sherman*, 16 Neb. App. 766, 751 N.W.2d 168, 173 (2008).
[11] *Restatement of the Law Third, Trusts* § 88 Comment d (2005); *see* Uniform Trust Code § 802(a); 3 Scott and Ascher on Trusts § 18.1.2.4 (4th ed. 2007); *Estate of Beach*, 15 Cal.3d 623, 644 (1975); *Matter of Bishop*, 98 N.Y.S.2d 69 (App. Div. 1950).
[12] *Estate of Trynin*, 49 Cal.3d 868, 874 (1989).
[13] *Id.* at 879.
[14] *Id.* at 874, citing *Estate of Cassity*, 106 Cal.App.3d 569, 574 (1980).
[15] *Id.* at 876-877.
[16] *Id.* at 874.
[17] *E.g., Holloway v. Edwards*, 68 Cal.App.4th 94, 99-100 (1998).
[18] *In re Trusteeship of Williams*, 591 N.W. 2d 743 (Minn.App.,1999); *Marshall v. First Nat'l Bank*, 622 S.W. 2d 558, 560 (Tenn.App.1981); *In re Temple Martial Trust*, 278 Mich.App.122, 748 N.W.2d 265 (2008); *Rapp. v. Rapp*. 252 Neb. 341, 562 N.W.2d 359 (1997).

[19] *Atwood v. Atwood*, 25 P.3d 936, 952 (Okla.App.2001) (Remand for finding whether allocation of attorney fees was "just, equitable and reasonable.").

[20] *See* generally, Robert L. Rossi, *Attorney Fees* § 11:58 (3rd Ed. 2009).

[21] *Matter of Estricher*, 202 Misc. 431, 111 N.Y.S.2d 295 aff'd mem., 281 App. Div. 828, 118 N.Y.S.2d 922 (1953) (Although trustee exonerated, his conduct was dubious, therefore defense fees disallowed); In *Jacob v. Davis*, 128 Md.App.433, 738 A.2d 904 (1999) (Allocation of defense fees in defense of trustee action depended on result).

[22] *Buck v. Cavett*, 353 P.2d 475, 477 (Okla. 1960) (Where action was personal action for breach of trust, attorney fees disallowed); *In re Kline's Estate*, 280 Pa. 41, 124 A. 280 (Pa. 1924) (Trustee fees disallowed where trustee was found partially negligent).

[23] 12 Del. C. § 3333.

[24] *Ramos v. Lamm*, 713 F.2d 546, 544 (10th Cir. 1983) (Attorney fee claim on civil rights action, "The court can look to how many lawyers the other side utilized in similar situations as an indication of the effort required.").

[25] *See* generally *Restatement of Trusts* 3rd § 71 (2009).

[26] *Donahue v. Donahue*, *Donahue v. Donahue*, *supra* at 270.

[27] *Klinkerfuss v. Cronin*, 289 S.W.3d 607, 613 (Mo.App.2009) ("The trial court is considered an expert on attorney's fees, including fees for services on appeal, and the court has discretion in determining the fee award.").

[28] *Donahue v. Donahue*, *supra* note 1 at 267.