

PRESENTATION TO STATE BAR OF CALIFORNIA - TRUST AND ESTATES SECTION - 1996

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TRUST LITIGATION: RECENT DECISIONS, CURRENT TECHNIQUES,
RECURRING PROBLEMS, A FEW SOLUTIONS

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I. Introduction

For better or worse, trust litigation is a growing field. This is due to a number of related factors. These include our growing affluence, a dislike of probate proceedings and the popularity of living trusts, the proliferation of unsophisticated trustees, and the prevalence of second marriages.

II. Creation and Modification

- A. What happens when a living trust document declares that real property is transferred to the trustee, but there is no formal conveyance to the trust? According to Estate of Heggstad, (1993) 16 Cal.App.4th 943, 20 Cal.Rptr.2d 433, the written declaration is sufficient, and a deed conveying the property is not required.

Here, the decedent created a trust, and identified in Schedule A all property to be placed in trust, including the subject property, married a month later, and died 17 months afterward. The trust declared that the property was transferred. The settlor did not execute a grant deed reconveying the property to himself as trustee. The decedent's son, the successor trustee, claimed that the trust language was sufficient to create a valid trust. The widow argued that the property was not in trust, and that she was entitled to an intestate share of the probate estate.

The court rejected the widow's claim, noting that section 15200 provides two methods for creating a

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trust: "(a) A declaration by the owner of property that the owner holds the property as trustee," and "(b) a transfer of property by the owner during the owner's lifetime to another person as trustee." The court also acknowledged that, where the trust property is real estate, the statute of frauds requires that the declaration of trust must be in writing signed by the trustee (section 15206). In sum, the trust document declared a trust in the property listed in Schedule A, was signed by the decedent, and was a proper and effective manifestation of his intent to create a trust.

- B. What happens when one settlor wants to revoke a trust created by many settlors? According to Estate of Wernicke, (1993) 16 Cal.App.4th 1069, 20 Cal.Rptr.2d 481, a trust that is not declared to be irrevocable cannot be unilaterally revoked; in the absence of a revocation provision, it requires joint action of all settlors.

In Wernicke, originally, there was a family trust that the beneficiaries persuaded the trustee to terminate in 1982. In 1985, the beneficiaries essentially reestablished the trust. Seven years later, one beneficiary learned that he was dying and wanted to revoke the 1985 trust in order to provide for his wife.

The court held that mutual revocation is required - one cotrustor cannot unilaterally revoke a presumptively revocable trust as to the portion of the corpus he contributed.

Regarding married settlors, Family Code section 761(b) provides that a trust can be revoked as to community property by either spouse acting alone, unless the instrument specifies otherwise.

III. Trustee's Duty of Loyalty

- A. What happens when a trustee mismanages the principal income generating asset of a trust, doesn't attempt to remedy its wrongdoing until the court's intended decision, and then fails to disclose and attempts to conceal its earlier maladministration? Matter of Estate of Gump (1991) 1 Cal.App.4th 582, 2 Cal.Rptr.2d 269, held that such conduct constituted knowing, wilful and intentional breach of trust and denied large amounts of trustee compensation and reimbursement for the trustee's attorney fees.

This was the fourth appeal in a court battle between Wells Fargo and the beneficiaries over Wells' management of the Gump trusts and particularly "a 60.41% interest in real property at 250 Post Street leased to the venerable San Francisco business firm known as Gump's retail store."

The trial court found that Wells failed to properly administer and enforce the Post Street lease, that Wells' failure to disclose and attempted concealment of prior maladministration constituted knowing, wilful and intentional breach of trust, that Wells had fraudulently misrepresented its competence, and Wells' threat to charge the beneficiaries for the cost of an audit constituted fraud and breach of trust. The audit threat was intended to intimidate and to pressure them to abandon their litigation.

Negligence is a breach of trust under Probate Code section 16400. Wells' misconduct was knowing and intentional, and also a breach of the duty of loyalty.

Wells' request for trustee compensation, attorneys' fees and costs in connection with Wells' services administering the lease were appropriately denied. However, since there was no fraud, the trial court abused its discretion in denying compensation for services unconnected with the lease property.

Attorney's fees and litigation costs incurred in a successful defense of an action brought by the beneficiary are recoverable. On the other hand, a trustee is not entitled to attorneys' fees and expenses of litigation where it is determined that the trustee breached the trust. Thus, the trial court abused its discretion in totally denying ordinary trustee's and attorneys' fees for services unconnected with the administration of the lease property.

- B. A State Bar disciplinary case shows that even some attorneys fail to understand a fiduciary's duty of loyalty.

In In re Hultman, 95 Daily Journal DAR 6066, filed April 28, 1995, attorney Hultman was appointed trustee of a client's testamentary trust, which was funded with \$32,000 cash. The attorney loaned \$25,000 to himself and his spouse in August 1990; the loan was secured by a note and a deed of trust. In September 1990, the attorney loaned another \$5,000 to himself and his spouse; this note was unsecured and was repaid in May 1992. The attorney and spouse had the ability to repay

the loans.

The attorney did not intend to deceive in filing a false pleading with a court, but the Review Department found the attorney to be grossly negligent, and thus "culpable of an act of moral turpitude." The attorney violated Rule 3-110(A) because the attorney's entire course of conduct was reckless failure to perform competently, which inevitably lead to filing a false accounting. The attorney also violated Rule 3-300 which prohibits an attorney from knowingly acquiring an interest adverse to a client.

The attorney was suspended from the practice of law for 3 years, but the suspension was stayed for all but 60 days.

- C. Conflicts of interest have caused problems for attorneys in the trust arena, and according to Pierce v Lyman, (1991) 1 Cal.App.4th 1093, 3 Cal.Rptr.2d 236, an attorney who participates in a trustee's misconduct can incur tort liability.

The complaint in Pierce sought over \$2 million in damages in an action against the former trustees of a testamentary trust, and their attorneys, investment advisors, and stockbrokers, for the alleged dissipation of trust assets due to improper investment activity. Examples of improper investment activity included the purchase of volatile and risky stock, short sales and investment in limited partnerships with little or no opportunity for return on investment.

The complaint alleged that attorney Lyman knew or should have known of the breaches of fiduciary duty, and that Lyman purposefully drafted and filed annual accountings with the probate court in order to conceal those breaches from the court. Lyman also used his authority over Trust assets and knowledge of Trust affairs to "gain access to investments on a preferential basis" and placed his own interest over the Trust's interest. He concealed his self-dealing from the court. Thus, although no attorney-client relationship was alleged between the attorneys and the beneficiaries, a valid cause of action for breach of fiduciary duty was stated because the attorneys had actively participated in the misconduct for their own financial gain.

The cause of action alleging that the attorneys conspired with the former trustees was remanded to the trial court because it was based on a civil conspiracy

between an attorney and his client within the meaning of Civil Code section 1714.10. That section requires the plaintiff first to show a reasonable probability of prevailing, before the case goes forward.

IV. Trustee's Standard of Care

- A. A dissatisfied and unhappy beneficiary does not always mean that the trustee has not administered the trust with care, skill, prudence, and diligence. There are times when the trustee, using its best judgment, makes unpopular decisions.

In Pillsbury v Karmgard, (1994) 22 Cal.App.4th 743, 27 Cal.Rptr.2d 491, the beneficiary Pillsbury filed a malicious prosecution suit against the low bidder for a parcel of real property. For over a year, trustee Wells Fargo considered filing suit, but concluded that a malicious prosecution suit was not in the trust's best interests. The scenario arose because Wells Fargo had decided to sell a parcel of real property and both potential buyers claimed they had binding contracts to buy the land. Closing was delayed due to suit for specific performance by the low bidder Karmgard. Page 10

Defendant's motion for nonsuit was granted because Pillsbury failed to prove that Wells "negligently or wrongfully declined to bring this malicious prosecution action." In sum, the beneficiary lacked standing to bring the suit unless the trustee had engaged in improper conduct.

- B. What happens when a beneficiary frivolously and in bad faith contests a trustee's account? According to Estate of Ivey v DiLeonardo, (1994) 22 Cal.App.4th 873, 28 Cal.Rptr.2d 16, fee and expense awards can be charged to the beneficiary's share of trust income.

The objector's (a 1/6 beneficiary) main point was that the trustee should have opposed a homestead petition. The objection was late and the objector claimed that extrinsic fraud excused her. The objector refused to comply with discovery.

Upon trial of the motions for sanctions under Code of Civil Procedure section 128.5, the trial court found that the objector's bad faith objections were made 1) for the sole purpose of harassing opposing parties 2) willfully and maliciously to injure the trustee or other beneficiaries and 3) with the intention that her objections were to punish and be vindictive. Lastly, the beneficiary willfully suppressed material evidence.

The trial court validly exercised its discretion in finding the objector's claims to be without merit.

The court instructed the trustee to pay \$147,041 to the trustee and \$203,475 to the other beneficiaries from future distributions of the 1/6 beneficiary. The trust had a spendthrift provision, which generally limits judgment creditors to 25 percent of the amount payable to the beneficiary. However, California law allows the court to use its equitable power to charge a beneficiary's share of a trust for a trustee's expenses and attorney's fees incurred in defending a frivolous claim, in spite of a spendthrift provision.

V. Judicial Proceedings Concerning Trusts

- A. In suits against trustees, it's important to know when the three year statute of limitations under Probate Code section 16460 for claims against a trustee applies. According to DeGrazia v Anderlini, (1994) 22 Cal.App.4th 1337, 28 Cal.Rptr.2d 37, the three year statute of limitations does not apply unless the beneficiary has received "an interim or final account or other report" from the trustee. Such an account or report must contain information about the assets, liabilities, receipts, and disbursements of the trust, acts of the trustee, and administration particulars relating to the beneficiary's interest.

Anderlini, the trustee of a testamentary trust, appealed from a judgment holding him liable to the beneficiary, DiGrazia, for breaching his duty as trustee to manage the trust property so as to ensure the beneficiary's income.

The trustee contended that an account or report was submitted when the spouse received an income and expense statement from the restaurant's accountant. The court determined that the accountant's statement was not the required type of an "account or report" that triggered the three year statutory period.

The trustee's alternate claim that the four-year statute of limitations under Code of Civil Procedure section 343 barred the beneficiary's action against him also failed. The statute does not begin to run without a clear repudiation of the trust by the trustee, or a known breach of the trustee's duty. The court concluded that the four-year limitation period had not run when the beneficiary filed her action because she did not know the facts which would have lead her to act until six years after she filed her action.

- B. What action must beneficiaries take before suing the trust's attorney and real estate broker? Saks v Damon Raike & Co, (1992) 7 Cal.App.4th 419, 8 Cal.Rptr.2d 869, held that the beneficiaries' only proper course was to proceed against the trustee - seeking either to compel the trustee to proceed against the attorney and broker, or to remove trustee and to appoint a trustee ad litem to sue the third parties.

Saks and King, beneficiaries, sought over \$2M in damages, alleging negligence, breach of contract and breach of fiduciary duty by both the attorney and broker employed by the trustee. The beneficiaries claimed that the assets were depleted through imprudent transactions. The primary transaction at issue was the purchase of property at which toxic waste was discovered after the purchase, and the property's sole tenant and guarantor went bankrupt.

Thus, the beneficiaries lacked standing to bring their claims.

- C. What happens when trustors do not expressly follow trust provisions that require the trustor to notify the trustee regarding an amendment? According to Estate of Irvine v Children's Hospital Foundation, 95 Daily Journal DAR 16407, filed November 21, 1995, such provisions bind the trustor to follow these provisions in order to make amendments to the trust.

The trustor did not notify the trustee of the amendment, as required by the trust provision. Therefore, the amendment was not effective. Additionally, the trustee obtained an order which showed that the trustor did not have sufficient mental capacity to understand the nature of the proposed amendment.

Notably, the court reasoned that the clear legislative intent behind Probate Code section 17200 was to authorize the probate court to hear and decide any petition for instructions filed by trustee regarding the internal affairs of trust even, as here, where the trust was revocable.

VI. Personal Liability of Trustee

- A. Are California trustees always subject to personal liability on account of actions they take in discharging their fiduciary responsibilities? No - at least not when it's an ERISA trust. In General American Life Ins. Co. v Castonguay, 984 F.2d 1518,

(9th Cir. 1993), ERISA's broad preemption clause preempted California's statute. ERISA plan trustees cannot be held personally liable for trust's contracts.

An ERISA trust (an employee benefit plan trust) was three million dollars short to reimburse General American. Probate Code section 18000 subjects trustees to personal liability on account of things they do in discharge of their responsibility to a trust. ERISA also regulates the trust - trustee relationship.

Since state law attempted to regulate a relationship already controlled by ERISA, ERISA's broad preemption clause took effect. Therefore, the trustees were not personally liable for the deficit.

VII. Protection and Rights of Third Parties Dealing with Trustee

- A. Are third parties dealing in good faith bound to inquire into a trustee's powers? Can third parties assume without inquiry that the trustee has authority to act as it does? According to Adler v Manor Healthcare Corp. (1992) 7 Cal.App.4th 1110, 9 Cal.Rptr.2d 732, and Probate Code section 18100, persons purchasing trust property from a trustee have protected bona fide status except where such persons have actual knowledge of a breach of trust.

Rossmoor is a privately owned and operated retirement community in Walnut Creek. The Golden Rain Foundation is trustee and holds all commonly owned Rossmoor properties. The Rossmoor developer (UDC), agreed to sell an unimproved parcel of land to Manor. Golden Rain conveyed an easement to UDC. Appellants sued Golden Rain alleging that the easement violated the trust, and that Golden Rain exceeded its powers as trustee, and that the title company's actual or constructive knowledge that Golden Rain exceeded its powers was imputed to Manor.

The court held that a third person, acting in good faith and without actual knowledge that a trustee is exceeding its power, is fully protected in dealing with a trustee. The Law Revision Commission expressly intended to give greater protection to the rights of third party purchasers of trust property.

VIII. Other Trust Issues

- A. When the trust language is ambiguous, what can a court do to discern the trustor's intent? In Wells Fargo v Marshall, (1993) 20 Cal.App.4th 447, 24 Cal.Rptr.2d

507, the court deemed it proper to consider the trustor's letter to proposed trustee, which outlined the terms of the trust.

The trust said "If upon the death of (the trustor's son) he is married and living with his wife, if such wife was living at the time of the Trustor's death, the Trustee shall pay to such wife all such net income of trust during her lifetime." Wells Fargo, the trustee, petitioned the court to interpret the trust to determine if the son's second wife was the wife specified by the trust language.

After reading the trustor's letter, the court held that the most reasonable interpretation of the trust was that the woman married to and living with the son at the son's death was intended to be the life income beneficiary.

- B. Does a trustee have standing to appeal an order determining that a beneficiary's proposed claim will not violate the no-contest clause? The court in Estate of Goulet v Goulet, (1995) 10 Cal.4th 1074, held that a trustee must be permitted to appeal.

Goulet and (Montello) Goulet married in Las Vegas and separated the next day. They had executed a generous premarital agreement. Six weeks after the marriage, Goulet filed a petition of nullity. Montello defaulted. Goulet executed a will which disinherited Montello because Goulet "made adequate provision for her and her children in a trust." The will had a no-contest clause and provided that Montello would receive \$75,000 if she did not contest the will or the trust. A codicil to the will named Goulet's friends Burke and Ferry as co-executors and successor trustees. Montello filed for and received an order determining whether a claim against the estate to enforce her purported rights in the premarital agreement would constitute a contest within the meaning to the no-contest clause.

The court determined that a trustee's duties to protect the corpus and effectuate the trustor's intent were implicated by an adverse Probate Code section 21320 ruling. Therefore, a trustee must be permitted to appeal.

- C. Does a challenge to a trust violate the no-contest clause? According to Graham v Lenzi, (1995) 37 Cal.App.4th 248, a claim that a gift is invalid under Probate Code section 21350, nullifying donative transfers to "disqualified persons" is not a contest

nor are claims seeking construction of the terms of a trust.

Graham was the sole beneficiary of an inter vivos trust created by her parents. The trust contained a no-contest clause. After her mother died, her father amended the trust so that only one half went to Graham; the other half went to Lenzi, a stockbroker who advised the trustor.

One of Graham's claims concerned Probate Code section 21350, which invalidates donative transfers to certain "disqualified persons," and Lenzi's status as adviser/stockbroker. To prevent certain individuals - including those who helped prepare a trust - from taking advantage of trustors, the Legislature shifted the normal burden of proof in establishing an undue influence claim to the respondent. "Strong public policy concerns require[d] that Graham's section 21350 claim not be construed as a contest..."

Other claims merely sought construction of the terms of the trust - - they were not "contests."