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Shutting Down a “Fiduciary” Who Is Misusing Trust Assets

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When bad fiduciaries need to be sued, they (and their bad lawyers) are not likely to just let litigation play out and responsibly preserve trust assets until there is a final judgment on the merits. Rather, bad fiduciaries will misappropriate trust assets while using their lawyers and the legal process to make their removal and restitution to the trust prohibitively expensive and time consuming.

This article is for good lawyers representing good clients that are beneficiaries of trusts administered by bad fiduciaries represented by bad lawyers. When bad fiduciaries need to be sued, they (and their bad lawyers) are not likely to just let litigation play out and responsibly preserve trust assets until there is a final judgment on the merits. Rather, bad fiduciaries will misappropriate trust assets while using their lawyers and the legal process to make their removal and restitution to the trust prohibitively expensive and time-consuming. As a result, even if a beneficiary is ultimately successful against a bad fiduciary, it may be a hollow victory.

It would be helpful to shut down a fiduciary's ability to steal trust assets at the start of litigation, not at the end. Fortunately, courts have broad discretion over trustees and trust assets at all stages of litigation. This broad discretion stems from the fact that beneficiaries have equitable title to trust property and disputes involving trust assets are actually equitable actions. Firmly established case law gives courts broad discretion over trustees or other fiduciaries that have legal title to property that is the subject of an equitable action. *Hunter v. United States*, 30 U.S. 173, 188 (1831) (“It is the peculiar province of equity, to compel the execution of trusts.”); see also *Hopkins v. Granger*, 52 Ill. 504, 510 (1869) (“It is one of the oldest heads of chancery jurisdiction, to execute and control trusts and trust funds.”). In fact, California law implicitly recognizes the broad discretion a court has over trustees and trust assets by broadly permitting an injunction before final judgment “where the obligation arises from a trust.” Cal. Civ. Proc. Code § 526(a)(7). The courts' broad discretion means that the remedies available in a trust-related dispute—even when there is no actual loss—broadly include instructing the trustee about the terms of the trust, setting aside decisions of the trustee, removing the trustee, and appointing a temporary fiduciary with highly customizable powers. Restatement (Third) of Trusts § 95, cmt. c.

Most courts, however, are not used to giving potentially litigation-ending relief at the outset of a case. Consequently, once the lawyer and client have determined the relief to seek, the lawyer must convince the court that it has the authority to grant this relief and that the relief is a reasonable exercise of the court's broad discretion over the trust. This article gives the legal framework for why it is appropriate for a court to exercise its broad discretion over trust assets and trustees at the outset of a case and provides some ideas about three categories of relief to request: injunctions

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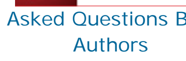

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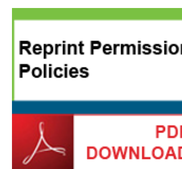

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prohibiting use of funds a trustee has already stolen, injunctions limiting a trustee’s future access to trust assets, and temporary replacement of the fiduciary.

Preliminary Injunctions Prohibiting Use of Funds a Trustee Has Already Stolen

When a trustee has already stolen money and that can be traced to the trustee’s possession, or to the possession of an entity the trustee controls, enjoining future use of those funds would help to prevent the funds from being further misused or dissipated during the course of the litigation. If you are bringing suit to enjoin use of stolen trust funds, consider whether to do it indirectly by petitioning for the court to appoint a trustee ad litem (discussed in more detail below) to bring the preliminary injunction. The elements of a preliminary injunction are well-known and similar in most states. For example, in Illinois a preliminary injunction must meet the following four-part test:

> [T]here must be a sufficient showing by plaintiff that (1) it possesses a certain and clearly ascertained right which needs protection, (2) it will likely succeed on the merits, (3) irreparable injury will be sustained without the protection of the injunction, and (4) there is no adequate remedy at law.

Exchange Nat’l Bank of Chicago v. Harris, 466 N.E.2d 1079, 1083 (Ill. App. Ct. 1984). New York law essentially collapses the first and second pairs of elements of the Illinois test and adds the requirement that the movant demonstrate a “balance of equities.” *Doe v. Axelrod*, 532 N.E.2d 1272 (N.Y. 1988).

In states that follow traditional injunction analysis (which are most states besides California), the lawyer runs into problems with the irreparable injury and adequate remedy at law prongs when the relief the client seeks is about money. Locking down money to satisfy a claim that has not yet been reduced to judgment is an equitable attachment that is prohibited in most states. See *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999) (parts III-IV); *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 729 N.E.2d 683 (N.Y. 2000); *Lewis v. West Side Trust & Savings Bank of Chicago*, 6 N.E.2d 481, 484 (Ill. App. Ct. 1937).

Litigation to recover from a trustee that has misused trust funds is fundamentally about money, so a preliminary injunction to prevent a trustee from misusing additional funds seems like it would violate the prohibition on equitable attachments. In many states, however, the rule against equitable attachments has an exception, the “specific funds exception,” when the property that a litigant seeks to enjoin is the specific subject of the controversy. *Keeshin v. Schultz*, 262 N.E.2d 753, 757 (Ill. App. Ct. 1970); *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 729 N.E.2d 683 (N.Y. 2000). A court should be willing to use the specific funds exception to enjoin use of money allegedly stolen by a fiduciary because the stolen money is the subject of the suit.

If your state does not follow the specific funds exception, Restatement (Second) of Trusts § 202 may allow you to reach the same result. Under section 202, a court can impose a constructive trust or equitable lien on stolen property, or the product of stolen trust property, held by the trustee and traceable. If the goal of the litigation is to obtain a constructive trust or equitable lien on a particular piece of property, then the remedy the client seeks is no longer strictly money damages, and traditional injunction analysis can be used to obtain a preliminary injunction on the specific property even if it is just a bank account.

Finally, it is important to note that California does not follow the traditional injunction analysis. Rather California law appears to allow equitable attachments and broadly permits “[a]n injunction against disposing of property . . . if disposal would render the final judgment ineffectual.” *Heckmann v. Ahmanson*, 214 Cal. Rptr. 177, 189 (Ct. App. 1985).

Preliminary Injunctions Prohibiting Use of Current Trust Assets

Traditional injunction analysis can be used to argue for an order prohibiting use of current trust assets while litigation moves forward. Whenever a suit involves current trust assets, that suit necessarily involves questions about how the assets should be invested, used, or distributed. Consequently, the specific funds exception applies to any argument that enjoining use of trust funds is inappropriate before there is a final judgment, because the funds and their use are the specific subject of the litigation. In addition, the prohibition on equitable attachment should not apply to a trustee’s control of trust funds because the trustee has only legal title to the funds—not equitable or beneficial title. In fact, as already noted, California recognizes a court’s authority to issue preliminary injunctions to protect trust assets based purely on the discretion of the court. Cal. Civ. Proc. Code § 526.

Because courts have broad discretion to issue orders concerning trustees and trust funds, *Hunter*, 30 U.S. at 188, it seems like traditional injunction analysis should not be necessary. The more prudent course, however, is to argue both that the court has broad discretion to issue the injunction because the suit is equitable in nature and to argue that a preliminary injunction should be granted because the jurisdiction’s three- or four-part test is satisfied. In *Gruder v. Gruder*, 433 So. 2d 23, 24 (Fla. Dist. Ct. App. 1983), a three-judge panel of the Florida appellate court correctly determined that the trial court had broad discretion to issue a preliminary injunction preventing removal of trust funds from a particular Florida county. But the third judge on the panel dissented because there was no

showing of irreparable harm, and consequently the movants had not satisfied their burden of showing that a preliminary injunction was warranted. Although this case came out properly, it demonstrates that a particular judge may be uncomfortable with the concept of having broad discretion to make significant rulings concerning trustees and trust funds early in litigation simply because the case involves a beneficial interest. Consequently, putting forward an alternate argument framed using tests the court is more familiar with may help give the court confidence to grant the requested relief.

Even if you successfully obtain a preliminary injunction, the client may not have much peace of mind because the fiduciary being sued is a bad guy represented by bad lawyers and is unlikely to obey a bare injunction not to use trust funds. The following paragraphs describe a few ideas for additional remedies that can be strapped on to the injunction to give it teeth.

Account Restrictions

An additional remedy that can provide more protection than a bare injunction is for the financial institution holding the funds to place a restriction on the account. The restriction would not allow any employee of the institution to release funds from the account without a court order. To have an account restriction put in place, ask the court to issue an order directly to the financial institution controlling the accounts. Because the account restrictions prevent the trustee from withdrawing account funds and do not restrict the financial institution's ability to use the funds, there is no need to give the financial institution notice before the order is entered. The order simply needs to be served on the institution once it is entered.

A simpler option is to ask the court to order the trustee to put the funds in a restricted account and bring proof of the restriction to the court on a short time frame. Although this approach relies on the bad trustee to take actions to secure the funds, it also has teeth—contempt of court—that can be used to punish the trustee for failure to abide by the order.

A third option is to simply show the financial institution the bare injunction. Often this is enough for the bank to lock down the funds out of fear of being sued if the funds are released and used in a way that is inconsistent with the injunction. A potential concern is that showing the order to the bank could lead to some type of tortious interference claim by the trustee against the client. It is hard to see, however, where damages would come from if showing the bank the order prohibits the fiduciary from doing something the court told him not to do anyway.

Finally, obtaining account restrictions does not guarantee that the funds will not be misused. Most attorneys with experience administering or litigating trusts and estates have seen instances of bank employees unintentionally or willfully ignoring a restriction. This is particularly a problem when the fiduciary has personal relationships with bank employees.

Require the Fiduciary to Post Bond

Asking the court to require a rogue trustee to post bond may seem like an obvious way to ensure that the client does not obtain a hollow victory if trust funds are misappropriated during the course of litigation. Although the court has authority to require the trustee to use trust funds to post bond, it is unlikely that the court will actually require this remedy. Courts often find a bond to be an unnecessary expense not contemplated by the trust grantor. *Application of Beiny*, gives some sense of how courts view the issue. In that case, the appellate court modified a lower court order appointing a special receiver and requiring bond of $20 million by affirming the special receiver and striking the bond component of the order. 518 N.Y.S.2d 767 (N.Y. App. Div. 1987).

Give Notice of Litigation

If the trust holds real property, filing a *lis pendens* will make it difficult for the trustee to liquidate the property and misappropriate the resulting funds. Consider whether any other property held by the trust can be made less fungible or otherwise harder to transfer by somehow giving notice to potential purchasers that the property is the subject of litigation.

Court Takes Control of Funds

Many states have procedures that allow parties holding funds that are the subject of a dispute to petition the court for an order allowing them to deposit the funds with the court. Generally, however, no procedure allows a party to a dispute to file a motion to obtain an order that compels a third party to deposit funds with a court. Rather, as discussed in more detail below, when a court affirmatively wants to take control of funds held for beneficiaries it can appoint a temporary receiver to stand in the place of the court and take control of the money.

Appointment of a Temporary Fiduciary

Courts always have authority to appoint a temporary fiduciary during litigation that could result in the actual trustee's permanent removal:

> If proceedings are brought for the removal of the trustee and it appears necessary or proper during the course of the proceedings that the trust should be administered under the supervision of the court, the court may appoint a receiver until it is determined whether the trustee should be removed . . . .

Restatement (Second) of Trusts § 199(d); see also *In re Leverich's Estate*, 239 N.Y.S. 741, 743 (Sur. Ct. 1930); Cal. Prob. Code §§ 15642, 17206. In addition, the simple existence of a conflict of interest in the outcome of the litigation is grounds for appointing a temporary fiduciary because "the purpose of removing a trustee is not to inflict a penalty for past action, but to preserve the trust assets."

Getty v. Getty, 2252 Cal. Rptr. 342 (Ct. App. 1988); see also *In re Gerbing's Estate*, 37 N.E.2d 29, 32 (Ill. 1975) ("When it became apparent that one result in the litigation would prove to be more beneficial to Frank personally than another he should have temporarily been replaced as executor until the conflicting issues were finally determined.").

Although courts always have power to appoint a temporary fiduciary, a court may leave the existing fiduciary in place for several reasons, even when there is an allegation that the trustee misappropriated funds or has an interest in the outcome of the litigation. First, there are often rolling administrative and tax deadlines, and changing the person who has responsibility for administering the trust could jeopardize the trustee's ability to comply with those deadlines. Second, the trustee has a legal duty to defend against attacks on a trust's validity. Consequently, a court may find that the simple fact that the trustee has an interest in the outcome of the litigation is not a sufficient reason to remove a trustee in a trust contest that is obligated to defend the trust validity anyway. One possible "compromise" to propose to a court that is disinclined to remove a trustee because of the obligation to defend the trust assets and to administer the trust in the face of running deadlines is to suggest that a temporary receiver take control of trust funds while the trustee still acts to administer and defend the trust. See *Buckley v. Harrison,* 31 N.Y.S. 999, 1003–04 (Com. Pl. 1895).

When a court is unwilling temporarily to remove a trustee, but there may be a cause of action against a third party that the trustee will not bring (like a claim to claw funds back from a business owned by the trustee), a trustee ad litem is a possible solution. Restatement (Third) of Trusts § 107(3). The appointment of a trustee ad litem, rather than a temporary fiduciary, to litigate against third parties is "particularly useful" when the existing trustee has a conflict of interest but there are reasons to keep the trustee in place "with respect to other aspects of administration." Id. cmt. d. A trust beneficiary can also bring claims against third parties on behalf of the trust, id. § 1.7(2); however, the appointment of a trustee ad litem is a much more powerful tool because it allows the trust to directly pay the costs of litigating against the third party.

Finally, the different forms of relief to limit a bad trustee's ability to misuse trust assets are not independent of each other. In general, injunctive relief is viewed as less intrusive, and consequently a preferable remedy, to appointment of a receiver or other temporary fiduciary. Consequently, a litigant that seeks to have a temporary fiduciary appointed should demonstrate that injunctive relief is not sufficient to protect the beneficiaries' interests. See *Pfeiffer v. Pfeiffer*, 394 S.W.2d 679, 681 (Tex. Civ. App. 1965) ("Under the record before us we are unable to say with certainty that injunctive relief would be as effective as a receivership in preserving the estate . . . . The trial court, therefore, did not abuse his discretion in appointing the receiver.").

Conclusion

The wide discretion courts have over trustees and trust assets creates opportunities for a party challenging a trustee's actions to obtain litigation-ending relief at the outset of a case. Obtaining this relief, however, requires overcoming a court's reluctance to exercise discretion before there has been discovery or other standard litigation activity on which courts are used to basing decisions. To overcome this reluctance, it is important to think creatively about what relief to request, to understand fully the court's broad discretionary power over trustees and trust assets, and to be able to relate that discretionary power to traditional injunction analysis.

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