DISGORGEMENT FOR BREACH OF FIDUCIARY DUTY - GENERAL PRINCIPLES

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CHAPTER 9
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DISGORGEMENT FOR BREACH OF FIDUCIARY DUTY - GENERAL PRINCIPLES

I. INTRODUCTION

Ten years ago, the Texas Supreme Court breathed new life into the remedy of forfeiture of fees (or disgorgement, if already paid). Burrow v. Arce, 997 S.W.2d 229 (Tex. 1999). That case dealt with a claim that a lawyer had breached his fiduciary duty. The remedy is not new. It is not limited to fiduciaries who are lawyers. It can arise in many contexts. A similar remedy may be available, in appropriate circumstances, to bystanders who are not fiduciaries.

II. SIMILAR PRINCIPLES, REGARDLESS OF THE TYPE OF FIDUCIARY

Disgorgement has long been recognized as a remedy for suits against fiduciaries. As to trustees and executors, Section 243 of the Restatement of the Law (Second), Trusts states: "If the trustee commits a breach of trust, the court may in its discretion deny him all compensation or allow him a reduced compensation or allow him full compensation.” See, e.g., Alpert v. Riley, 274 S.W.3d 277, 294 (Tex.App.-Houston [1 Dist.] 2008) (trustee failed to notify each of the beneficiaries annually of their right to withdraw a certain amount from the trust); cf. Tex. Prop. Code § 114.061(b) (“If the trustee commits a breach of trust, the court may in its discretion deny him all or part of his compensation”).

As to agents, Section 469 of the Restatement of the Law (Second), Agency provides: "An agent is entitled to no compensation for conduct which is disobedient or which is a breach of his duty of loyalty; if such conduct constitutes a wilful and deliberate breach of his contract of service, he is not entitled to compensation even for properly performed services for which no compensation is apportioned.” This rule is applicable to agents in many contexts, including corporate officers, real estate agents, employees and partners. E.g., Southern Cross Industries, Inc. v. Martin, 604 S.W.2d 290, 291 (Tex.Civ.App.-San Antonio 1980, writ ref’d n.r.e.) (forfeiture of commission in light real estate broker's failure to disclose the existence of an interested buyer); Watson v. Limited Partners of WCKT, Ltd., 570 S.W.2d 179, 182 (Tex.Civ.App.-Austin, 1978, writ ref’d n.r.e.) (limited partners may recover against general partner without a showing of actual damages); Russell v. Truitt, 554 S.W.2d 948, 955 (Tex.Civ.App.-Fort Worth 1977, no writ) (even though no injury or damages was shown, forfeiture of management fee due to project manager's failure to disclose an agreement for an unauthorized company to share profits from construction); Anderson v. Griffith, 501 S.W.2d 695, 702 (Tex.Civ.App.-Ft. Worth 1973, writ ref’d n.r.e.) (because he failed to disclose the availability of an immediate resale of certain property, real estate broker was required to disgorge (i) the commission paid to him and (ii) all profits he had received); Kinzbach Tool Co. v. Corbett-Wallace Corp., 160 S.W.2d 509 (Tex. 1942) (even though the employer suffered no harm, an employee was required to forfeit a secret commission he was paid by the company selling a contract to the employer); Scott v. Kelso, 62 Tex.Civ.App. 163, 130 S.W. 610 (1910, no writ) (commission forfeited where real estate broker had a secret agreement to split commission with another).

As to lawyers, Section 49 of the Restatement of the Law (Third), The Law Governing Lawyers states: “A lawyer engaging in clear and serious violation of duty to a client may be required to forfeit some or all of the lawyer's compensation for the matter.” E.g., Burrow v. Arce, 997 S.W.2d 229 (Tex. 1999); Bryant v. Lewis, 27 S.W.2d 604, 608 (Tex.Civ.App.-Austin 1930, writ dism'd) (without any reference as to any actual damages, the court held that an attorney with conflicting interests was not entitled to any compensation for his services).

A generalized principle appears in Section 43 of the (proposed) Restatement of the Law (Third), Restitution and Unjust Enrichment:

(1) person who obtains a benefit

(a) in breach of a fiduciary duty,
(b) in breach of an equivalent duty imposed by a relation of trust and confidence, or
(c) in consequence of another’s breach of such a duty, is accountable for the benefit so obtained to the person to whom the duty is owed.

(2) The extent of recovery depends on the blameworthiness of the defendant’s conduct. As a general rule:

(a) A defaulting fiduciary, a person who breaches a duty of confidence, or a person who profits from another’s breach of duty with notice of the wrong will be required to disgorge all gains (including consequential gains) derived from the wrongful transaction.

(b) An unwitting recipient of benefit from another’s breach of duty will be liable only for the direct benefit derived from the wrongful transaction.

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III. KEY POINTS IN BURROW V. ARCE

Forfeiture (or disgorgement) of an attorney's fee is available even when no actual damages exist. 997 S.W.2d at 237-40.

A breach of an attorney's fiduciary duty does not make forfeiture automatic. Id. at 241 (quoting from Section 49 of the [then proposed] Restatement of the Law (Third), The Law Governing Lawyers). Even when forfeiture is ordered, it may be partial or complete. Id.

The remedy is restricted to "clear and serious" violations of duty. Id.

IV. MEASURE OF DISGORGEMENT

In Burrow v. Arce, The Supreme Court identified a non-exclusive list of factors to be considered in determining whether, and to what extent, disgorgement may be imposed as to lawyers:

- the gravity and timing of the violation;
- its willfulness;
- its effect on the value of the lawyer's work for the client;
- any other threatened or actual harm to the client;
- the adequacy of other remedies; and
- the public interest in maintaining the integrity of attorney-client relationships.

No single factor is dispositive. "For example, the 'willfulness' factor requires consideration of the attorney's culpability generally; it does not simply limit forfeiture to situations in which the attorney's breach of duty was intentional. The adequacy-of-other-remedies factor does not preclude forfeiture when a client can be fully compensated by damages. Even though the main purpose of the remedy is not to compensate the client, if other remedies do not afford the client full compensation for his damages, forfeiture may be considered for that purpose." See Burrow v. Arce, 997 S.W.2d at 243-45.

V. DISTINGUISH: DAMAGES VS. DISGORGEMENT

When a plaintiff presents a successful claim of breach of fiduciary duty (or similar cause of action), a plaintiff may ordinarily elect to recover a remedy at law (damages) or an equitable remedy (disgorgement). Often, damages will present a superior recovery for the plaintiff. Occasionally, however, disgorgement is a superior remedy.

Damages ordinarily require a showing of injury and causation. See, e.g., Baker Botts v. Cailloux, 224 S.W.3d 723, 735-36 (Tex.App.—San Antonio 2007, pet. denied) (although the jury found a breach of fiduciary duty in a $65 million controversy, the court of appeals rendered because there was no evidence that the breach of fiduciary duty caused any injury). On the other hand, disgorgement may be available when there have been no damages. In the Cailloux case, might there have been a disgorgement remedy available? The judge found a breach of fiduciary duty by Wells Fargo Bank (the executor of an estate and the trustee of related trusts) and by Baker Botts (which had performed estate planning for the decedent). Baker Botts became attorneys for Wells Fargo in estate administration and also attorneys for a foundation created by the decedent and her late husband. The regional president of Wells Fargo served as executive director of the foundation. The lawsuit claimed that Wells Fargo and Baker Botts had collaborated to obtain a disclaimer from the decedent during her lifetime, allowing $65 million to increase funding of the foundation to the detriment of decedent and her family. The court of appeals record does not reflect the fees paid Baker Botts not the executor and trustee fees paid Wells Fargo. If the court concluded that the breach of fiduciary duty was "clear and serious" (a question unaddressed by the opinion), then perhaps a substantial disgorgement would have been available despite the absence of evidence as to causation.

A plaintiff must choose between damages or disgorgement. The amount of damages will often vastly exceed the fees that a plaintiff had paid the fiduciary; but sometimes the fees (or other benefit received by the defendant) will be greater. For example, in Piro v. Sarofim, 2002 WL 538741 (Tex.App.—Hous. [1 Dist.] 2002) (published in part at 80 S.W.3d 717), the client was awarded disgorgement of $3,000,000 that had been paid in fees for a divorce.

VI. JURY ROLE; JUDGE ROLE

Whether a breach of fiduciary duty has occurred is a jury question. When a plaintiff seeks damages, the amount of damages and questions of causation are jury questions.

By contrast, the ordering of disgorgement, and the quantum of disgorgement, are not for the jury. The Supreme Court stated that, as to "the availability of the remedy or amount of forfeiture," "[b]oth decisions are inherently equitable and must thus be made by the court." Burrow v. Arce, 997 S.W.2d at 245-46. It is the judge's role, not the jury's, to "determine whether a clear and serious violation of duty has occurred, whether forfeiture is appropriate, and if so, whether all or only part of the attorney's fee should be forfeited." Id. at 246. The jury would be asked to resolve factual disputes, which "may include, without limitation, whether or when the misconduct complained of occurred, the attorney's mental state at the time, and the existence or extent of any harm to the client."
The failure to submit jury questions concerning the first four Burrow v. Arce factors (the gravity and timing of the violation; its willfulness; its effect on the value of the lawyer's work for the client; and any other threatened or actual harm to the client) may result in a waiver of a plaintiff's claim for disgorgement. See Dallas Fire Ins. Co. v. Texas Contractors Sur. & Cas., 128 S.W.3d 279, 303 (Tex.App.-Fort Worth 2004), rev’d on other grounds, 159 S.W.3d 895 (Tex. 2004).

VII. LIMITATIONS

The same 4-year statute of limitations applies to suits for breach of fiduciary duty, whether damages or disgorgement is sought.

The 4-year period begins from the date when the plaintiff discovered, or in the exercise of reasonable diligence should have discovered, the facts upon which the claim is based.

A defendant will commonly ask the court to characterize the plaintiff's claim as one for negligence (or, in the case of defendant lawyers, professional malpractice). If successful, then (i) the 2-year statute of limitations (applicable to negligence actions) would govern and (ii) disgorgement would not be an available remedy. See, e.g., Trousdale v. Henry, 261 S.W.3d 221 (Tex.App.-Houston [14 Dist.] 2008, pet. filed). A helpful analysis of the decisions characterizing whether various conduct is, or is not, a breach of fiduciary duty appears at Parker & Watkins, A Rose Is A Rose Is A Rose--Or Is It? Fiduciary And DTPA Claims Against Attorneys, 35 St. Mary’s L.J. 823, 830-36 (2004).

VIII. SUMMARY JUDGMENT

The factors to be considered under Burrow v. Arce, are very fact intensive. Consequently, if there is evidence that a "clear and serious" breach of fiduciary duty occurred, it is a rare plaintiff who cannot survive a motion for summary judgment as to a claim for fee forfeiture.

Summary judgment may be available if the alleged breach of fiduciary duty is not "clear and serious." A summary judgment in favor of the defendant lawyer was affirmed in the following unpublished case: Hoover v. Larkin, 2001 WL 1046266 (Tex.App.-Houston [14 Dist.] 2001). There, the plaintiff claimed that the lawyer settled her case on different terms than she had approved. She had testified that she did not think the breach of duty was intentional; that the lawyer was an honest man and had never lied to her; that she was present when the lawyer announced the settlement terms in court twice; and that it was not the lawyer's fault that she had not heard the open-court recitation of settlement terms. On that record, the court of appeals concluded "that any breach of duty on the part of [the lawyer] does not rise to the level of a 'clear and serious' breach as required by Burrow v. Arce."

Summary judgment may also be affirmed when the defendant lawyer successfully persuades the trial court (and the court of appeals) that the challenged conduct was not any breach of fiduciary duty but, at most, negligence – i.e., professional malpractice. E.g., Duerr v. Brown, 262 S.W.3d 63, 70 (Tex.App.-Houston [14 Dist.] 2008).

IX. PROPORTIONATE RESPONSIBILITY

Chapter 33 of the Texas Civil Practice & Remedies Code directs that virtually all tort actions be submitted for findings of percentage of responsibility among the plaintiff, the defendants, any settling parties, and any responsible third party. This includes lawsuits seeking damages against lawyers for their negligence or other tortuous conduct.

By contrast, the principles of proportionate responsibility very likely do not apply to a remedy based upon disgorgement. This is because Chapter 33 is designed for allocation of responsibility for damages. See § 33.003 ("for which recovery of damages is sought"); § 33.011 ("Claimant' means a person seeking recovery of damages"); § 33.012 ("the amount of damages"); § 33.013 ("the percentage of damages").

Consider a client's lawsuit against two former lawyers. If she seeks damages, the jury would be directed to allocate percentages of responsibility. By contrast, if the client seeks disgorgement of fees, defendant lawyer 1 would have the risk of disgorgement of fees paid to him, but would have no liability to return the fees paid to defendant lawyer 2.

X. FIRST COUSINS – DISGORGEMENT BY NON-FIDUCIARIES

Disgorgement can also be a powerful remedy against persons who owed no fiduciary duty to the plaintiff.

Section 43(1)(c) of the (proposed) Restatement of the Law (Third), Restitution and Unjust Enrichment, above, states that a defendant who obtains a benefit by reason of a different person's breach of fiduciary duty (or breach of a similar duty based upon special trust and confidence). Section 43(2) states that the remedy is available against a knowing or even an unwitting recipient of such benefit. A recipient of such benefit "with notice of the [fiduciary's] wrong" will be required to disgorge all gains, including consequential gains. "An unwitting recipient … will only be liable for the direct benefit derived from the wrongful transaction."

Texas cases support the principle set forth in Section 43(1)(c) of the Restatement – both as to knowing participants and as to unwitting participants.

In Pope v. Garrett, 211 S.W.2d 559 (Tex. 1948), two (of three) heirs prevented a death-bed execution of

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a will. Had the will been signed, certain property would have been devised to Garrett, instead of passing to the three heirs. As to the two heirs who forcibly prevented the execution of the will, the Court treated them as constructive trustees for Garrett: "It is a well settled general rule that if one person obtains the legal title to property, not only by fraud, or by violation of confidence of fiduciary relations, but in any other unconscientious manner, so that he cannot equitably retain the property which really belongs to another, equity carries out its theory of a double ownership, equitable and legal, by imposing a constructive trust upon the property ..." Significantly, the Court also found a constructive trust proper as to the property inherited by the third heir, who had engaged in no wrongdoing. As to the remedy against the innocent heir, the Court found support for the equitable remedy in the treatises of Professors Scott, Bogert and Perry and also in the Restatement [First] of the Law of Restitution.

The Supreme Court applied the principles of *Pope v. Garrett* to require disgorgement in a case where one client of a lawyer benefited at the expense of a different client of the same lawyer. *Ginther v. Taub*, 675 S.W.2d 724 (Tex. 1984). There, the lawyer breached his fiduciary duties to one client (Ginther) by inducing Ginther to sign an assignment to a different client (Taub). The jury also found that Taub had knowingly participated in the lawyer's breach of fiduciary relationship. The Court wrote: "The policy against unjust enrichment mandates that Taub not be allowed to retain the property he received as the beneficiary of [the lawyer's] fraud."

Citing *Pope v. Garrett*, the Court's dictum observed that "[t]he same rule applies in imposing the [constructive] trust on a knowing or unknowing beneficiary of fraud, even though he is not the actual wrongdoer."

Note: the common law tort – participation in another's breach of fiduciary duty – requires a showing that the non-fiduciary defendant was a knowing participant. *Kastner v. Jenkens & Gilchrist, P.C.*, 231 S.W.3d 571, 580 (Tex.App.-Dallas 2007, no pet.). An unwitting participant in another's breach of fiduciary duty has no liability for damages. But the equitable claim for disgorgement is different: the remedy is available even against an unwitting recipient of benefits flowing from the breach of fiduciary duty.
APPENDIX A

Hypothetical Fact Scenario A

Bank is executor of the Smith Estate. Based on the estate's $10 million in assets and Bank's standard fee schedule, Bank is paid $200,000 per year for executor fees.

The Smith Estate created the Smith Foundation. Bank holds the foundation's funds in its trust department. Bank president sits on Foundation board. Bank receives $75,000 per year as trustee fees.

Bank president directs significant gifting by Foundation to Symphony, on whose board Bank President also sits.

Bank sells Property owned by the estate to an unrelated customer of Bank, Jones, for $1 million. Jones flips Property to Abel for $5 million.

Suppose the appraised fair market value of Property is determined to be $2 million, even though Abel paid a much greater amount.

What claims do beneficiaries of the estate have against Bank for damages? for disgorgement of fees? Can they sue Jones for damages? for disgorgement of profit?
Lawyer Jones represents Bank in (i) negotiating documents for a $2 million loan and (ii) later foreclosing on the collateral.

Borrower is Henry's company. Lawyer Smith represents Henry in many business matters, transactions, and estate planning.

Smith and Jones are in different offices of the same law firm. They failed to identify any conflict.

On behalf of Bank, Lawyer Jones negotiated that Henry would guarantee the loan and there would be no "grace periods" to cure any defaults. Upon a failure to make a timely payment, Bank immediately accelerates the note and forecloses upon the property. Lawyer Jones handles the foreclosure for Bank.

Bank bids $1 million at the foreclosure sale. Bank later sells the property for $3 million.

What claims may Henry have against lawyers for damages? for disgorgement? What claims may Henry have against Bank for damages? for disgorgement?