Arbitration provisions in trusts: Are they enforceable?

By Joseph L. Bierwirth Jr.

Earlier this year, the Texas Supreme Court issued an important decision on the question of whether trust litigation can be made subject to mandatory arbitration. In its decision, the Texas court held that an arbitration provision in an inter vivos trust was enforceable against the trust beneficiaries.

This article will examine conflicting court decisions on the issue and provide guidance for determining the possible outcome when the issue is litigated in Massachusetts.

Developments in California, Arizona

In 2011, the California Court of Appeal, Second District, took up the question of the enforceability of arbitration language in a trust. *Diaz v. Bukey*, 125 Cal. Rptr. 3d 610 (2011).

The suit involved a family trust. One beneficiary became dissatisfied with her sister’s administration of the trust and brought an action to remove her as trustee. The trustee defended the action by pointing to a trust provision that provided for all disputes between the trustee and any beneficiary to be settled by arbitration.

The trial court denied the trustee’s petition to compel arbitration, and she appealed.

On appeal, the court began its analysis by noting that the California Arbitration Act requires the existence of a contract. Only parties to an arbitration contract may enforce it or be required to arbitrate.

Under basic contract law, “if there is no evidence establishing a manifestation of assent to the same thing by both parties, then there is no mutual consent to contract, and no contract formation.” *Id.* at 613 (internal citations omitted).

Since there was no evidence that the beneficiaries to the trust gave their assent to the arbitration provision, the petition to arbitrate failed on a straightforward contract theory.

The trustee, however, contended that her sister was a third-party beneficiary of the trust and cited cases in which a third-party beneficiary could be bound by an arbitration provision. However, the court rejected that theory as none of the cited cases involved a trust agreement. In addition, the court addressed the central distinctions between trusts and contracts. Relying on a case from Arizona, *Schoneberger v. Oelze*, 208 Ariz. 591, 96 P.3d 1078 (2004), the court found that the trustee could not compel arbitration because the arbitration statute requires a contract, and, as a matter of law, trusts are not contracts:

“The legal distinctions between a trust and a contract are at the heart of why [the beneficiaries] cannot be required to arbitrate their claims against the defendants. … The ‘undertaking’ between trustor and trustee ‘does not stem from the premise of mutual assent to an exchange of promises and is not properly characterized as contractual.’”

It is worth noting that, after the Schoneberger decision, the Arizona Legislature enacted a statute making reasonable arbitration provisions in trusts enforceable. Ariz. Rev. Stat. §14-10205.

Further, in October 2012, the California Supreme Court transferred *Diaz* back to the Court of Appeals with instructions to reconsider, and in December 2012, the parties requested dismissal, leaving unanswered the ultimate question of the enforceability of the arbitration provision under California law.

2013 Texas Supreme Court case

On May 3, the Texas Supreme Court found an arbitration provision in a trust to be enforceable. *Rachal v. Reitz*, 2013 WL 1859249.

Faced with a lawsuit from a disgruntled beneficiary, the Rachal trustee moved the trial court for an order compelling arbitration based on a trust provision. The trial judge denied the motion, and the trustee appealed.

The Texas Appeals Court in Dallas (sitting in an en banc session of 13 judges) upheld the trial court order, relying on the Arizona case, *Schoneberger*, and the California decision in *Diaz v. Bukey*.

On further appeal to the Supreme Court, the arbitration provision was upheld for two reasons.

First, the court determined that the donor intended for the benefits of his trust to come with conditions, and the court considered its role to enforce trust restrictions on the basis of the settlor’s intent.

Second, the court believed that the Texas Arbitration Act’s requirement of mutual assent was met through application of the doctrine of “direct benefits estoppel.”

With respect to the settlor’s intent, the Texas Supreme Court noted the general rule that the settlor's intent in an unambiguous trust is enforced even over the objections of beneficiaries who disagree with the trust’s terms.

In this instance, the settlor had expressed an unambiguous desire for all disputes to be arbitrated. The trust specified that “[d]espite anything herein to the contrary,” arbitration would be “the sole and exclusive remedy” for “any dispute of any kind involving this Trust or any of the parties or persons connected herewith (e.g., beneficiaries, Trustees) …”

According to the court, because the language was unambiguous it should be enforced as long as consistent with the state’s arbitration act.

The court next turned to examining the en-
forceability of the arbitration provision in light of the TAA. The statute provides that a "written agreement to arbitrate is valid and enforceable if the agreement is to arbitrate a controversy that: (1) exists at the time of the agreement; or (2) arises between the parties after the date of the agreement." Tex. Civ. Prac. & Rem. Code §171.001(a).

The court focused on the word "agreement" and distinguished it from "contract," finding that the Legislature could have applied the act only to contracts but instead chose the broader term "agreement."

While an agreement need not meet all of the legal criteria for creation of an enforceable contract, it must be supported by mutual assent. According to the court, assent can be manifested by obtaining or seeking substantial benefits under an agreement. This is the doctrine of "direct benefits estoppel," a type of equitable estoppel under Texas law.

Applied to the situation of a trust, the court found that direct benefits estoppel bound the beneficiary to accept the arbitration provision. By attempting to enforce rights that would not exist without the trust, a beneficiary can manifest his assent to all provisions of the trust.

Specifically, the beneficiary in Rachal did not disclaim his interest in the trust, sought benefits from the trust, and sued to enforce his interests in the trust. To the Supreme Court, it would be incongruous to allow him to attempt to hold the trustee to the provisions of the trust, but sidestep the provision he did not like — namely, the arbitration provision.

**What would a Massachusetts court do?**

To date, no appellate court has addressed the issue of the enforceability of an arbitration provision in a trust instrument under Massachusetts law. In light of the strong equity tradition in Massachusetts, there is little doubt that a court would examine critically an argument that its jurisdiction should be usurped by an arbitration provision contained in a trust.

The Massachusetts version of the Uniform Arbitration Act reads as follows:

“A written agreement to submit any existing controversy to arbitration or a provision in a written contract to submit to arbitration any controversy thereafter arising between the parties shall be valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract.” G.L.c. 251, §1.

Of critical importance is the act’s use of the term "contract," as opposed to "agreement," for later developing controversies. As noted above, the Texas Supreme Court placed great emphasis on that state’s use of the term “agreement.”

It would also seem important that the controversy arise between "parties" to a contract. Neither the Appeals Court nor the Texas Supreme Court in Rachal v. Reitz analyzed that requirement, although the Texas statute also contained the word.

In analyzing and enforcing the arbitration act, Massachusetts courts have tended to emphasize the bargained-for nature of a contract. By way of example, in a recent Rule 1:28 decision, the Appeals Court set forth its rationale for enforcing an arbitration provision, even in the face of a strong argument that an arbitrator had committed legal error:

“Assuming without deciding that the arbitrator’s construction of the CBSA was erroneous, that does not render the arbitrator’s action beyond her authority. It would mean only that one of the risks to which Daniel subjected himself when he bargained for and agreed to the arbitration clause — the risk of a legal or factual error by the arbitrator, with no mechanism for substantive review by a court — came to fruition.” McDonough v. McDonough, 83 Mass. App. Ct. 1114 (2013) (emphasis added).

That language — emphasizing the risk undertaken by a contracting party upon entering into a bargained-for agreement in a commercial enterprise — hardly seems consistent with either the fiduciary duties imposed on trustees under Massachusetts law or the nature of the trustee/beneficiary relationship as it has developed in this jurisdiction.

In Massachusetts, a trust is not simply a creature of contract, and beneficiaries and trustees are not “parties” to a contract, or even parties to the trust agreement or indenture.

Subsidiary questions would also arise if a trust arbitration provision was enforced. One question would be whether a court could defer to an arbitration panel to address appointment of a guardian ad litem for minors, unborn or unascertained interests.

Assuming the new virtual representation criteria of the Massachusetts Uniform Trust Code were not met, in cases in which a GAL appointment would be necessary, a court could consider appointing a GAL to participate in the arbitration proceedings.

However, that would require at least some court involvement; without the participation of a GAL, the litigating parties could not be assured of finality in their resolution of the dispute. The court would necessarily be involved in oversight of the GAL as well. Such court oversight and intervention in the arbitration proceedings would detract from the overriding purpose of arbitration, which is nominally to encourage the cost-effective, expedited resolution of disputes.

**Conclusion**

In sum, it would seem that the vitality of arbitration provisions in Massachusetts trusts is questionable.

Although the recent decision from the Texas Supreme Court may indicate a trend toward enforcement of such provisions, it remains to be seen whether Massachusetts trust disputes can be compelled into arbitration given the commonwealth’s strong equity tradition and focus on contract terminology and theory in its arbitration statute and caselaw.

However, trust and estate planners intent on writing enforceable arbitration clauses may elect to take some guidance from the Texas Supreme Court’s reliance on “direct benefits estoppel” and draft provisions conditioning receipt of an inheritance on a beneficiary’s execution of a binding arbitration agreement.