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Arbitration agreements in trust instruments - are they binding on beneficiaries?

Agreements to arbitrate are generally binding only on the parties to the agreement and, accordingly, would not be binding on beneficiaries under many trust instruments. Some jurisdictions have legislated specifically to deal with this. In others, theories such as conditional benefits have been applied. In England, the issue remains untested.

A recent decision of the Supreme Court of Texas, in *Rachal v Reitz,* provides an interesting insight into how the courts in another common law jurisdiction have approached the issue, concluding that the beneficiaries were bound to bring any claims by way of arbitration.

Arbitration provisions in trust instruments

In England and Wales, it is an open question as to whether an arbitration provision in a trust deed can bind all beneficiaries to resolve disputes through arbitration rather than court litigation.

Arbitration requires the consent of the parties and, of course, beneficiaries under a trust instrument have not (usually) consented to be bound by any arbitration provisions contained in the trust instrument.

Certain theories exist that extend the binding effect of such arbitration provisions to non-signatories. One theory advanced to support the view that beneficiaries can be bound by the arbitration agreement is the "*deemed acceptance theory*". This proposes that since beneficiaries claim "*under or through*" a settlor, who is a party to the trust deed, they fall within s.82(2) of the Arbitration Act 1996, which provides that parties to an arbitration agreement include a "*person claiming under or through a party to the agreement*".

It has also been argued that the beneficiaries acquiesce in the arbitration agreement by seeking or accepting benefits from the trust, similar to the effect of the Contracts (Rights of Third Parties) Act 1999 on ordinary contracts.

In addition, section 8 of the 1999 Act provides that where a right for a third party to enforce a term under that act is subject to a term providing that disputes be settled by arbitration then,

Key issues

- Trust instruments may include arbitration agreements.
- It is uncertain whether such arbitration agreements are binding on beneficiaries.
- The issue has not yet come before the English courts
- Guernsey, Liechtenstein and other jurisdictions have legislated to confirm the binding effect of arbitration agreements on beneficiaries.
- The Texas Supreme Court has recently applied the theory of "direct benefits estoppel" to give effect to the intention of the settlor.
- Care needs to be taken in drafting trust instruments governed by English law until this issue is resolved.

Why arbitration?

One of the main advantages to arbitration is the fact that the proceedings are private and any decision reached by the arbitrator is confidential. In contrast, court litigation is generally open to the public with the final judgment being published. Even where the Court agrees to hear a trust dispute in private, it is sometimes keen to publish the judgment on an anonymised basis.

There are a number of other possible advantages to arbitration which may have a bearing on the settlor's decision, including:

- Finality - it is very difficult to appeal any decision reached by the arbitrator;
- Cost - arbitration may sometimes be quicker and cheaper;
- Flexibility - arbitration provides greater procedural and substantive flexibility;
- Choice of arbitrator - it is possible for the parties to choose an arbitrator with particular experience or expertise.

so long as the arbitration agreement is in writing for the purposes of the AA then "*the third party shall be treated for the purposes of that Act as a party to the arbitration agreement as regards disputes between himself and the promisor relating to the enforcement of the substantive term by the third party*. "

In light of this, it is open to argument that, given that a trust deed is in writing, it falls within the requirements of the Arbitration Act and thus beneficiaries are bound by any arbitration provision within the trust deed by virtue of the 1999 Act.

Notwithstanding these arguments, a 2008 discussion paper prepared for the Trust Law Committee of STEP found that it was "*plainly impossible*" under English law for beneficiaries to be bound to resolve disputes by arbitration in such a way.

However, to date there has not been a case before the English Courts where consideration has been given to this issue.

Some jurisdictions have sought to remove any uncertainty by legislation, but this is not an approach that has yet been taken in England.

The Decision in *Rachal v Reitz*

In *Hal Rachal, Jr., v John W. Reitz* (No. 11-0708 May 3, 2013) the Supreme Court of Texas was asked to determine whether an arbitration agreement contained in the trust instrument of an *inter vivos* trust was binding on the beneficiaries.

Andrew Francis Reitz established the A.F. Reitz Trust in 2000, naming his sons James and John as sole beneficiaries, and himself as trustee. The trust was revocable during Andrew's lifetime and irrevocable after his death. Hal Rachal, Jr., the lawyer who drafted the trust instrument, became the successor trustee upon Andrew's death.

In 2009, John Reitz sued Rachal individually and as successor trustee, alleging that Rachal had misappropriated trust assets and failed to account to the beneficiaries as required by law. Rachal denied the allegations and later moved to compel arbitration of the dispute under the Texas Arbitration Act.

The Arbitration Provision

The arbitration provision in the A.F. Reitz Trust instrument upon which Rachal sought to rely was very broadly drafted.

The provision read: "*Despite anything herein to the contrary, I intend that as to any dispute of any kind involving this Trust or any of the parties or persons concerned herewith (e.g., beneficiaries, Trustees), arbitration as provided herein shall be the sole and exclusive remedy, and no legal proceedings shall be allowed or given effect except as they may relate to enforcing or implementing such arbitration in accordance herewith. Judgment on any arbitration award pursuant hereto shall be binding and enforceable on all said parties.*"

To reinforce the point, the trust instrument also stated that it "*shall extend to and be binding upon the Grantor, Trustees, and beneficiaries hereto and on their respective heirs, executors, administrators, legal representatives, and successors*."

First Instance and Court of Appeals

Notwithstanding the broadly drafted arbitration provision, both the trial court and the court of appeals in Texas rejected Rachal's arguments that the dispute should only be resolved by arbitration.

A divided Court of Appeals held that a binding arbitration provision must be the product of an enforceable contract between the parties, reasoning that such a contract does not exist in the trust context, in part because there is no consideration and in part because the trust beneficiaries have not

consented to such a provision. The majority followed the analysis in the *Schoneberger* case from Arizona.

However, the dissent in the Court of Appeals noted that the Texas Arbitration Act does not require a formal contract to arbitrate, only a written agreement, and that accordingly the rulings in other jurisdictions that the majority had applied were not, in fact, applicable in this case.

Decision of the Supreme Court of Texas

The Supreme Court of Texas reversed the judgment of the Court of Appeals, holding that the settlor's intention had been for disputes to be settled by arbitration, the trust instrument was a valid arbitration agreement for the purposes of the Texas Arbitration Act and the dispute in question was within the scope of the arbitration provision.

Intention of the Settlor

Texan law precedent is clear that when interpreting a trust instrument, the Court's role is to divine the intention of the settlor, not to correct or redraft the instrument "*under guise of construction or under general powers of equity*." Accordingly, the Supreme Court of Texas held that Andrew Reitz had "*unequivocally stated his requirement that all disputes be arbitrated*" and that as a result of this unambiguous language the Court had no option but to "*compel arbitration if the arbitration provision is valid and the underlying dispute is within the provision's scope*."

Validity of the Arbitration Provision

The Court was required, therefore, to interpret the Texas Arbitration Act in order to determine whether a trust instrument could constitute a valid arbitration agreement for the purposes of that act.

The act states 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.*"

The act does not define "agreement", so the Supreme Court of Texas turned to look for a generally accepted definition, and noted that the term is broader than "contract" and is simply a manifestation of mutual assent by two or more persons. An agreement, therefore, need not meet all the formal requirements of a contract, thus bypassing Reitz's argument that the lack of consideration invalidated the arbitration provision.

However, the agreement must be supported by "*mutual assent*".

The Court held that a beneficiary who seeks to enforce the provisions of a trust instrument has acquiesced to its other provisions – including the arbitration clause. A beneficiary is not able to pick and choose which parts of the trust instrument he or she accepts.

Reitz had both sought the benefits granted to him under the trust and had sued to enforce the provisions of the trust; this conduct indicated acceptance of the terms and validity of the trust.

The Court therefore applied the doctrine of direct benefits estoppel. This doctrine provides that where a party has obtained, or is seeking to obtain, substantial benefits under an agreement, he is estopped from simultaneously attempting to avoid the burdens of the agreement.

Scope of the Arbitration Provision

Having thus determined that the arbitration provision in the trust instrument was binding on Reitz in principle, the Court then had to turn to the issue of whether the dispute in question was within the scope of the provision.

The Court here had a relatively straightforward task, given that the provision was drafted to cover "*any dispute of any kind*" and also, on its own terms, took precedence over any potentially contradictory wording in the trust instrument by virtue of the wording "*despite anything herein to the contrary*".

Accordingly, the Court held that Rachal had demonstrated the existence of a valid arbitration agreement that covered the claims at issue. In light of this, the appeal was upheld and the trial court was remanded to enter an order consistent with that opinion.

Approaches in other jurisdictions

Guernsey

In Guernsey, where the law relating to arbitration is based partly on the English equivalent, any doubt as to the effectiveness of arbitration provisions in trust instruments has been settled by legislation.

Article 63 of the Trusts (Guernsey) Law 2007 provides that, so long as certain conditions relating to the representation of beneficiaries at any proceedings are met, if the terms of the trust direct or authorise arbitration (or if the Court orders it) a decision by the arbitrator is binding on all beneficiaries, whether or not yet ascertained or in existence and

whether or not they are all of full age and sound mind.

Jersey

Whilst on many issues relating to trusts the two main jurisdictions in the Channel Islands are quick to follow each other's legislative developments, Jersey has not yet followed Guernsey's example. The position remains open as to whether it is possible for a Jersey trust deed to compel the beneficiaries to resolve disputes by arbitration.

In *EMM Capricorn Trustees Limited v Compass Trustees Limited* [2001] JLR 205, the Royal Court of Jersey held that beneficiaries were not bound by an exclusive jurisdiction clause in a trust deed to which they were not parties.

The Court reasoned that "*If A and B agree in a contract that they will refer any dispute to the courts of a particular country, one can well understand why they should generally be held to their bargain. They have agreed it; why should one of them then be allowed to go back on what has been freely agreed? But the position is very different in relation to a trust. The exclusive jurisdiction provision of a trust deed will have been agreed only between the settlor and the original trustee. Actions in relation to the trust may be brought by beneficiaries who were never parties to the trust deed; indeed they may not even have been alive at the time of its execution. The policy considerations which lead to a party to a contract being held to his choice of exclusive jurisdiction cannot apply to a beneficiary who played no part in the choice of exclusive jurisdiction made in the trust deed*."

It seems likely that this decision would be applicable by analogy should the Jersey courts have to consider the effectiveness of an arbitration provision in a trust instrument, because the rationale that the beneficiaries have not agreed to settle their disputes in the manner set out in the instrument is just as applicable to arbitration provisions as to jurisdiction clauses.

Liechtenstein

In Liechtenstein, legislation passed in 2010 permits the submission of practically all disputes in relation to trusts to arbitration, whilst the 1926 Law on Persons and Companies in Liechtenstein makes it mandatory for any disputes between the settlor, the trustee and the beneficiaries to be settled by arbitration where a trust is created and registered in Liechtenstein but governed by foreign law.

The Bahamas

In 2011, The Bahamas introduced the Trustee (Amendment) Act 2011. Section 91A of that act enabled a dispute or administration question relating to a trust to be resolved by arbitration if the trust instrument allows.

The arbitration provision in the trust instrument will bind all parties including beneficiaries, regardless of whether or not those beneficiaries have been ascertained or are in existence at the time, as if they were parties to an arbitration agreement.

Arizona

The Arizona Court of Appeal had, in *Schoneberger v Oelze* (No. 1 CA-CV 03-0490), declined to enforce a arbitration provision in a trust deed, in part because the Arizona statute in issue required that the arbitration provision be in a "*written contract*". The case was widely cited, influencing court decisions in California amongst other jurisdictions (including the Texan court of appeals in *Rachal v Reitz*), before being rendered nugatory by the Arizona state legislature, which amended Title 14 of the Arizona state code to permit trust deeds to prescribe mandatory dispute resolution procedures. Section 14-10205 reads "*A trust instrument may provide mandatory, exclusive and reasonable procedures to resolve issues between the trustee and interested persons or among interested persons with regard to the administration or distribution of the trust*."

Florida

The Florida legislature has taken a similar approach to that in Arizona, amending the state code to include a provision which states that a "*provision in a will or trust requiring the arbitration of disputes, other than disputes of the validity of all or part of a will or trust, between or among the beneficiaries and a fiduciary under the will or trust, or any combination of such persons or entities, is enforceable*."

Others

Malta and the state of Washington also allow the enforcement of arbitration provisions in trust deeds, whilst Singapore has introduced enabling legislation closely similar to that introduced in Florida.

The future in England and Wales

The validity of arbitration provisions in trust instruments has not come in front of the courts in

England and Wales. Accordingly it remains open to debate as to whether such provisions would be considered to be effective by the English Courts.

In light of the 2008 discussion paper prepared for the Trust Law Committee of STEP which had indicated that it was not possible for arbitration provisions in trust instruments to bind the beneficiaries under English law as it stands, a paper was prepared by the Executive Committee of the TLC in April 2012 to consider whether changes to the law were desirable. The paper suggested that the Arbitration Act should be expressly amended to confirm the enforceability of arbitration provisions in trust instruments in a manner similar to the legislation introduced in Florida in 2007.

The Law Commission has also given support to such a proposal, although no such steps have been taken to date.

The paper noted that the merits of resolving disputes by way of arbitration mean that it is desirable for settlors to be able to elect to make use of it as a method of dispute resolution, describing it as "*a valuable alternative resource*."

Concerns were also raised that as arbitration provisions in trust deeds are binding in some other jurisdictions, these jurisdictions may be more attractive venues for the arbitration of disputes that could more appropriately be arbitrated in England and Wales. The paper noted that this would be to the detriment of the development of trust law within England and Wales.

The paper noted that consideration would need to be given to ensuring the protection of interests of minor beneficiaries or unborn and unascertained beneficiaries, as is provided for in the Guernsey legislation.

In the absence of a doctrine of direct benefits estoppel, and in circumstances where the analogous statutory provisions of the Contracts (Rights of Third Parties) Act may not be applicable to trust instruments, it remains open for debate as to whether arbitration provisions in English law trust instruments are binding on beneficiaries.

Accordingly, absent change in the legislation as proposed by STEP, there is a real risk that the English courts would conclude that arbitration agreements are not in fact binding on the beneficiaries, who may therefore be able to bring their claims in the courts instead, notwithstanding the apparent intention of the settlor to the contrary.

In light of this, trustees and other wealth management professionals will need to consider carefully whether their beneficiaries are compelled to arbitrate rather than litigate by any arbitration provision in the trust deed.

If the circumstances of a particular trust mean that arbitration is preferable then, subject to other considerations, a trustee may want to consider whether they should seek to change the governing law of the trust to Guernsey law, or the law of another jurisdiction which offers certainty that beneficiaries will be bound by the arbitration provisions.

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