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Are Mandatory Arbitration Clauses Enforceable Against Trustees and Beneficiaries?

Judge Abraham J. Gafni (Ret.)
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Parties agree to mandatory arbitration for various reasons. These may include a desire for a rapid decision, avoidance of appeals, relaxed rules of evidence, opportunity to select the arbitrator, reduced costs and confidentiality.

When settlors are preparing trusts, however, other factors may heighten these motivations to arbitrate rather than to litigate. The settlor may seek to create a less contentious relationship among members of a family or business, to avoid costly litigation that will reduce the assets of a family trust, or to shield from public view confidential matters such as personal family activities and the financial status of family members or other parties. Plus, the settlor may want to have relaxed rules of evidence that typically apply in arbitration proceedings so the arbitrator can consider otherwise inadmissible (in court) evidence relating to past practices, traditions or understandings of family members or other parties.

Accordingly, a settlor may include a mandatory arbitration clause to cover disputes among the trustee and beneficiaries. But what if a trustee or beneficiary objects and wants to proceed in court? Will arbitration be required, nonetheless?

This issue was recently addressed by the Virginia Supreme Court in *Boyle v. Anderson*, 871 S.E. 2d 226 (Va. 2022). The question before the court was whether the Virginia Uniform Arbitration Act (VUAA) or the Federal Arbitration Act, 9 U.S.C. 1-16 (FAA), compels enforcement of an arbitration clause in a trust over the objection of a beneficiary.

In *Boyle*, the settlor had created an inter vivos irrevocable trust to be divided into three shares, one for his daughter, Sarah, one for his son, John, and one for the children of a third son, Jerry. Upon the settlor's death, the daughter, Sarah, became the trustee as well as one of the beneficiaries of the trust.

After John died, his widow, Linda, serving as administrator of his estate, filed a complaint in court against Sarah alleging that she had breached her duty as trustee and seeking her removal or, in the alternative, her compliance with the terms of the trust.

In response, Sarah, relying upon the VUAA, filed a motion to compel arbitration based upon an unambiguous clause in the trust document providing “any dispute that is not amicably resolved by mediation or otherwise, shall be resolved by arbitration … .”

The VUAA s provides that:

“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 is valid, enforceable and irrevocable, except upon such grounds as exist at law or in equity for the revocation of any contract.” (“Section 8.01-581.01.) [Pennsylvania’s earlier Uniform Arbitration Act contained virtually identical language. Pennsylvania’s Revised Statutory Arbitration Act now provides at sec. 7321.4(a) that, “This subchapter governs an agreement to arbitrate on or after the effective date of this subchapter.”]

Sarah, as trustee, asserted that a trust is such a “written agreement” and “written contract” and, therefore, fell within the arbitration provisions of the VUAA.

Linda, as administrator representing the beneficiary John, opposed arbitration, however, contending that the trust was neither a contract nor agreement to arbitrate and that she had never agreed to resolve a dispute with the trustee by arbitration.

Concluding that a trust is not a “contract” or “agreement” under the VUAA, the Virginia Supreme Court set forth several principles. First, it explained that trusts “are generally conceived as donative instruments.” It noted that even the earliest formulations of the Restatement of Trusts had recognized that “the creation of a trust is conceived of as a conveyance of the beneficial interest in the trust property rather than as a contract. Restatement (Second) of Trusts Section 197 cmt B (1952)”; and, further, that a trust is defined as “a fiduciary relationship with respect to property.”

Second, the court specified other differences between contracts and trusts. For instance, the existence of the contract depends on mutual assent through the actual acceptance of an offer, whereas “a trust is the conveyance of an equitable interest, the formation of which is not even dependent on the beneficiary’s knowledge or acquiescence.” In addition, most trusts are “created by gratuitous transfer” and beneficiaries do not generally provide any consideration to the settlor.

Third, the duties of contracting parties to each other differ from the fiduciary duty of loyal representation owed by a trustee to the trust property and to the trust beneficiaries.

Contracting parties have no such corresponding duty of loyalty to the opposing party to the relationship. For this reason, actions against trustees are brought as claims for breach of fiduciary duty rather than for breach of contract.

Finally, the court found that ownership in a trust differs from ownership in property in a contract. In a trust, the trustee usually has legal title, and the beneficiary has equitable title. Consequently, a trustee cannot assign a trusteeship or delegate the performance of fiduciary duties, except as permitted by statute. This contrasts to the rights and duties of parties to a contract which "generally" may be freely assigned and delegated.

For all these reasons, the court held that the trust was not a "contract" or "agreement" under the VUAA; consequently, the arbitration provision could not be enforced against Linda, the administrator of the beneficiary's estate.

The court did acknowledge that perhaps a trustee's obligations under the trust (as distinguished from those of the beneficiary) might be considered her "agreement" to the trust's arbitration provisions so that she might be bound by them. Such a finding of an "agreement", however, could not be applied to the beneficiary of a trust because the beneficiary "has not agreed to submit to arbitration".

The court similarly found no "contract" or "agreement" under the FAA, which provides, at Section 2, "A written provision in … a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction …or an agreement in writing to submit to arbitration an existing controversy … shall be valid and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

It did recognize that the U.S. Supreme Court, while giving the FAA a very broad reading, has never addressed whether an arbitration clause in a trust is enforceable under the FAA. However, in various cases, the Supreme Court has noted that although the FAA directs courts to place arbitration agreements on equal footing with other contracts, "it does not require parties to arbitrate when they have not agreed to do so." Moreover, it "does not purport to alter background principles of state contract law regarding the scope of agreements (including the question of who is bound by them)."

Thus, the court concluded that as "a trust is neither a contract nor an agreement that can be enforced against a beneficiary", arbitration could not be here compelled under the FAA. Nonetheless, the court made clear that "whether an arbitration clause in a trust can be enforced on some basis other than the VUAA or the FAA is not a question before us, and we express no opinion on the point."

In this regard, perhaps when drafting a trust instrument, one might consider whether the trust situs for purposes of the arbitration clause might be deemed to be where specific statutes

enforce such clauses (e.g., South Dakota Florida and Arizona) or where a court has determined that a beneficiary to a trust, although not a signatory, is bound by its terms based upon some concept of “direct benefits estoppel.,” (e.g., Texas).

What should be fully recognized, however, is that before inserting a mandatory arbitration provision into a trust (and perhaps a will as well), attention should be given to whether statutory or case law will allow it to be enforced in the face of an objection by the trustee or beneficiary.•

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