THE USE OF ARBITRATION CLAUSES IN ESTATE AND TRUSTS

By John K. Boyce, III*

Introduction

Arbitration has been used extensively throughout America's history to resolve issues such as the ownership of colonies, the ownership of particular pieces of territory, the recovery of money owed by one state to another, and all sorts of religious matters.[i] In the specific context of wills, no less a personage than the father of our country, George Washington, included an arbitration clause in his will:

> My will and direction expressly is, that all disputes (if unhappily should any arise) shall be decided by three impartial and intelligent men, known for their probity and good understanding; two to be chosen by the disputants—each having the choice of one and the third by these two. Which three men thus chosen shall, unfettered by Law, or legal constructions, declare their Sense of the Testators intention—and such decision is, to all intents and purposes to be as binding on the parties as if it had been given by the Supreme Court of the United States.

Perhaps because of the inchoate development of the courts, arbitration appears to have been a more favored means of resolving disputes in the nineteenth century in the area of estates and trusts. Today, however, while arbitration provisions are becoming common, even ubiquitous, in certain kinds of business contracts, in construction contracts, and even in employment agreements, they still are not widely used in wills or inter vivos trusts, despite George Washington's example and the wholehearted acceptance of arbitration at the state and federal level. To understand why this is, it is necessary to look at the cases involving these instruments.

Quasi-Arbitration Provisions

The interest in avoiding litigation is not a new one, and over the years many testators and trust settlors have included provisions in their wills and trusts that attempt to make litigation unnecessary. Because people have not changed either, these quasi-arbitration provisions were often challenged.

One of the most interesting cases challenging one of these provisions is *Pray v. Belt.*[ii] The case required the interpretation of the terms of a very prolix will left by one James P. Heath, which appointed a number of executors to handle his affairs post-mortem and left detailed instructions regarding the disposition of bonds, the construction of "fire-proof buildings" on lots he owed, etc.[iii] Recognizing that his will was "lengthy" and that it was "possible that I have committed some error or errors," Mr. Heath empowered his executors to decide disputes regarding the will by majority vote and provided that these determinations would be "*final and conclusive*, without any resort to a Court of Justice."[iv]

A dispute arose regarding the disposition of Mr. Heath's estate, and a suit was filed.[v] The executors contended that because Mr. Heath had given them the authority to construe the will, any decisions they made were final and were not subject to judicial review.[vi] In rejecting this assertion, Chief Justice Marshall noted that, while provisions empowering executors to make decisions regarding the estate are proper, they are subject to being interpreted in order to determine what the testator reasonably intended.[vii] Finding that a reasonable testator would not have intended to allow his executors to make decisions contrary to the plain language of the will—such as "paying to A, a legacy bequeathed to B"—the Supreme Court held that the executors' decisions could not be final and binding in all respects and that the only entity that could determine whether such a "gross misconstruction of the will" had occurred was the court.[viii] Over the years, other cases from other jurisdictions have reached similar results.[ix]

In essence, these cases recognize that a testator can make the determination of named individuals regarding the estate, claims against it, etc., but these decisions are nevertheless still subject to judicial oversight and review. For example, the El Paso Court of Civil Appeals cited with approval cases holding that, although the decisions of an appointed arbitrator may be "final and binding on all the parties interested," these decisions are binding only if they were "fairly and honestly made," and therefore decisions that "evidenced a gross departure from the manifest intent of the testator as disclosed in the will" are subject to judicial review.[x] In another case, the Michigan Supreme Court held that an agreement to submit the question of a testator's mental competence to "a leading Detroit attorney" for determination did not affect the probate court's right to make the same determination on its own, without reference to the decision of the agreed-upon arbitrator.[xi] A few years later, in a case involving a testamentary trust, the same court held that a provision empowering two trustees to interpret the will, which required them to seek the opinion of a third if they could not agree, did not mean that their decisions could not be reviewed by the court.[xii]

I have characterized such provisions as "quasi-arbitration provisions" because, although they somewhat resemble an agreement to arbitrate disputes, they also differ from arbitration agreements in many important respects. First, although quasi-arbitration provisions empower someone to make a binding decision without reference to the courts, the decisions are often being made not by a third-party arbitrator but instead by an individual with some interest in or connection with the estate or trust, such as the executor or the trustee. Therefore, unlike "true" arbitration provisions, the arbitral decisions are not being made by a neutral decision maker, but instead by someone whose own interest may color the result, a fact that may explain why courts are more willing to review the determinations of these quasi-arbitrators. Additionally, because these quasi-arbitration provisions are subject to broader review by the courts, they do not remove a dispute from the jurisdiction of the courts in the same way a "true" arbitration agreement does; ultimately, there is still a judge lurking in the background, perhaps even Chief Justice Marshall.

True Arbitration Provisions

The question then becomes how to include a valid and binding "true" arbitration provision in a will, trust, or family limited partnership. In this respect, the primary hurdle is also one of the central elements of any arbitration agreement: the element of consent. As set forth above, Texas courts will not send parties to arbitrate their differences unless they have all agreed to do so in a binding manner. Beneficiaries under a will, trust, or similar instrument are almost never parties to the agreement and therefore are almost never in a position to have agreed to arbitration before a dispute arises. I believe that this is the reason we have not seen arbitration clauses used more widely in connection with wills and the like, despite the fact that the advantages arbitration offers are the same in a dispute arising under a trust as they are in a dispute arising under a contract, and despite the fact that these advantages are widely recognized.[xiii] In an attempt to address this consent issue, I have come up with three possible ways to make an arbitration provision in a will, trust, or family limited partnership binding.

The first is far and away the most direct and obvious and consists simply of having those who will be affected by the document sign the document, i.e., have the beneficiaries sign off on the will or trust. However, for all of its simplicity, there are several disadvantages to such an approach. The first is that it is somewhat cumbersome, requiring potentially dozens of beneficiaries, possibly scattered all over the country, to sign a single document. Additionally, it will result in the beneficiaries knowing in advance what it is they will receive, with all the potential for trouble and hurt feelings that can be created. It may also restrict the right of the testator or settlor to change the terms of the instrument at a later date, at least without getting everyone to sign again. Finally, such a regime would be very far at odds with current practice, which means that it is less likely that lawyers and clients would be willing to adopt it.[xiv]

The second possibility is if all of the affected parties agree to arbitrate a dispute after it has arisen. Of course, the downside to this approach is obvious: It requires two or more people who are already at odds with each other to agree on something. While many clients are reasonable and rational, even during a dispute, many are not, and so it will never be certain whether such an agreement can be reached until a

dispute has arisen. Also, if one of the central purposes of arbitration is to confer certain benefits, any method that leaves the question of whether these benefits will be realized up in the air is less than optimal.

The third, and in my opinion the most interesting, option is to use an arbitration provision that is coupled with an *in terrorem* clause. Broadly, an *in terrorem* clause is a clause in a contract or will that is designed to frighten someone into compliance with the wishes of another, such as when a will provides that anyone who brings a will contest will receive only a nominal bequest, even if the challenge is successful.[xv] Although Texas law does not favor *in terrorem* clauses, they will be enforced if they apply.[xvi] Accordingly, it might be possible to insert into a will, trust, or family limited partnership a provision stating that if a dispute arises regarding the instrument, the dispute will be referred to arbitration, and if any interested party refuses to consent to arbitrate then he or she will be cut out of the will, forfeit his or her interest in the trust, etc. Although coercive, such a provision is no more coercive than a similar provision in a will, and, while it cannot be certain that an aggrieved beneficiary might not still choose to litigate (thereby cutting off his nose to spite his face), such a provision would provide a powerful incentive to arbitrate rather than to litigate.

Conclusion

The use of arbitration in estates and trusts may be a case of "back to the future." What was once accepted but fell out of vogue- perhaps because of lingering doubts about its ability to bind non-signatory parties- is coming around to be understood in a new light. Certainly unqualified judicial endorsement has played a role. The rising costs of formal litigation with its perceived deficiencies, the proliferation of controversies inherent in the non-traditional family situations of today, and even the confusing legal standards of investment management[xvii] [4] all bode well for the use of arbitration. It is common in virtually every other area of law. If arbitration can indeed deliver "better, faster, cheaper" results, it will become an integral part of dispute resolution in estates and trusts as well.

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Endnotes

i. AMERICAN ARBITRATION ASSOCIATION, MANUAL FOR COMMERCIAL ARBITRATORS 11 (1999) (citing 1 *Arbitration in Action*, Nos. 4 and 5, April-May 1943, at 5).

ii. 26 U.S. 670 (1828).

iii. *Id.* at 671-72.

iv. *Id.* at 672-73 (emphasis in original).

v. *Id.* at 673.

vi. *Id.* at 676.

vii. *Id.* at 679-80.

viii. *Id.* at 680.

ix. *See, e.g.*, *Taylor v. McClave*, 15 A.2d 213, 112 (N.J. Ch. 1940); *Nations v. Ulmer*, 122 S.W.2d 700, 703 (Tex. Civ. App.—El Paso 1938, writ dism'd); *see also* 96 C.J.S. *Wills* § 828 (2003). One Texas case, *Couts v. Holland*, 107 S.W. 913, 915 (Tex. Civ. App. 1908, writ ref'd), contains language appearing to give such appointed arbitrators the absolute authority to make decisions regarding wills—i.e. not subject to judicial review. However, as the subsequent decision in *Nations* indicates, this is likely not the case. A careful review of the decision in *Couts* shows that the appellant argued not that the decision of the executors was subject to judicial review but, rather, that the decision of the executors on a particular issue did not fall within the ambit of the authority granted to them by the will. *Id.* at 915. Accordingly, it is possible to square *Couts* with *Nations* because the *Couts* court was not asked to decide whether it had the authority to review the decisions of an executor, and therefore its statements regarding the binding nature of these decisions are *dicta*.

x. *Nations*, 122 S.W.2d at 703; *see also Coffee v. William Marsh Rice Univ.*, 408 SW.2d 269, 284 (Tex. Civ. App.—Houston 1966, writ ref'd n.r.e.) (citing *Nations* for the proposition that the court cannot interfere with the exercise of a trustee's discretion except "in a case of fraud, misconduct, or clear abuse of discretion").

xi. *In re Meredith's Estate*, 266 N.W. 351, 352-53, 356-57 (Mich. 1936).

xii. *Matter of Estate of Jones*, 99 N.W.2d 365, 367 (Mich. 1959).

xiii. *See, e.g.*, Stanard T. Kleinfelter & Sandra P. Gohn, *Alternative Dispute Resolution: Its Value to Estate Planners*, 22 Est. Plan. 147, 147-48 (1995). The authors of this article observe that arbitration provisions in wills and trusts are often not enforced, citing a number of the same quasi-arbitration cases already discussed. However, they ultimately make the prudential recommendation to include an arbitration provision in wills and trusts on the theory that it can do no harm. If the provision is challenged, the court may refuse to order an arbitration, but even if this happens, the parties are in the same place they would have been in if the provision had not been included (i.e., on their way to court). *Id.* at 150-51. I am not sure I agree with this conclusion, because the challenge itself will require the expenditure of money and resources, and so as a practical matter may not end up being the zero-sum game they suggest.

xiv. In the context of an agency/custodial agreement with a trust department, non-signatory parties are not an issue because all parties typically sign the agreement. This arrangement fits the traditional mold for arbitration where there are consenting parties to a contract. An agency or custodial agreement is, after all, no more than a contract with fiduciary implications. The same consensual arrangement is true where all general/limited partners sign a family limited partnership, itself just a specialized type of limited partnership vehicle used for years in an investment context, where arbitration clauses are commonly inserted. The issue arises when non-signatory parties have a beneficial interest in an inter vivos or testamentary trust or a donee receives a gift of a limited partnership interest as a part of estate tax planning. While research discloses no twentieth-century case on whether non-signatory parties to these types of instruments may be bound by an arbitration clause, the prior century saw three theories to uphold at least testamentary arbitration clauses: (1) "contract": a will was enough like a contract to justify contract principals to uphold these clauses, *Phillip's Estate*, 10 County Court (Pa.) Rep. 374, 378 (1891); (2) "agency": the arbitrator appointed by the testator as his agent, *Wait v. Huntington*, 40 Conn. 9, 11 (1873); and (3) "intent": the courts are bound to carry out the testator's intent in requesting arbitration, *American Bd. of Comm. of Foreign Missions v. Ferry*, 15 Fed. 696, 699 (W.D. Mich. 1883).

xv. *Black's Law Dictionary* (6th ed. 1990).

xvi. *Marion v. Davis*, 106 S.W.3d 860, 865-67 (Tex. App.—Dallas 2003, pet. denied).

xvii. For example, the Uniform Prudent Investor Act (UPIA), Tex. Prop. Code §§ 117.001-117.012 (2004), which became law in Texas effective January 1, 2004, dramatically alters standards for investment management from prior law. It adopts the so-called "total asset management" approach. *Id.* § 117.004. Similarly, the UPIA's sister Act, the Uniform Principal and Income Act, *id.* §§ 116.001-116.173, allows trustees broad discretion to reallocate between principal and interest to protect the relative rights of income versus remainder beneficiaries. *Id.* §116.105. With the spiraling of wealth in managed accounts, these statutes, given their breadth and ambiguity, are certain to spawn litigation on investment performance and trustee discretion in making adjustments. Arbitration is the perfect vehicle to provide relatively inexpensive and expeditious resolution of these sophisticated controversies with a minimum of public scrutiny. Note that the UPIA allows a trustee to delegate investment and management functions to an agent, such as a professional investment advisor, and *not* be liable to the beneficiaries for the agent's performance. *Id.* § 117.011. Interestingly, an exception to avoidance of liability is if the trustee or beneficiary is required to

arbitrate disputes with the agent. *Id.* § 117.011(c)(2).