Rachal v. Reitz and the Evolution of the Enforceability of Arbitration Clauses in Estate Planning Documents

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On May 3, 2012, the Supreme Court of Texas issued its opinion in *Rachal v. Reitz*, 403 S.W.3d 840 (Tex. 2013), holding that an arbitration clause in an inter vivos trust instrument is valid and enforceable against the trust beneficiaries. The court's decision is the latest step in the evolving national acceptance and enforcement of arbitration clauses in estate planning documents. This article discusses the reasoning in *Rachal* and explores the potential effect of the decision on the national debate. Based on *Rachal*, as well as case law and legislation in other states, this article also seeks to provide some practical drafting approaches for crafting arbitration clauses in trusts and wills in order to maximize the prospect of enforceability.

Rachal v. Reitz

In *Rachal*, decedent Andrew Francis Reitz (the "Settlor") established the A.F. Reitz Trust in 2000 (the "Trust"), naming his sons, James Reitz and John Reitz, as the sole beneficiaries. After the Settlor's death, Hal Rachal Jr. ("Rachal"), the attorney-draftsman, became the trustee of the Trust.

In 2009, John Reitz ("Reitz") commenced a suit against Rachal individually and as trustee alleging that Rachal had misappropriated Trust assets and had failed to provide an accounting to the beneficiaries as required by law. Reitz sought a temporary injunction, Rachal's removal as trustee, and damages. Relying on an arbitration provision in the Trust, Rachal generally denied the allegations and moved to compel arbitration of the dispute under the Texas Arbitration Act.

The trial court denied Rachal's motion to compel arbitration, and Rachal filed an interlocutory appeal. The Court of Appeals for the Fifth District of Texas affirmed the trial court's order, holding that a binding arbitration provision must be the product of an enforceable contract between the parties. The court of appeals reasoned that such contracts do not exist in the trust context because there is no consideration and because the trust beneficiaries have not consented to such a provision. In concluding that there was no contractual agreement to arbitrate, the court stated that it was for the legislature, not the courts, to decide whether and to what extent the settlor of a trust should have the power to bind the beneficiaries to arbitrate.

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The Texas Supreme Court reviewed the matter de novo and reversed the court of appeals finding that the arbitration provision in the Trust was valid and enforceable. In its analysis, the court considered the Settlor's intent for the enforceability of the provision, the relevant portions of the applicable statute, and the doctrine of direct benefits estoppel.

The court made it clear that the Settlor's intent is to be enforced to the greatest extent possible if it is expressed unambiguously through the provisions of the trust instrument, notwithstanding the objections of beneficiaries. In *Rachal*, the arbitration clause provided 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.,* the beneficiaries, Trustees) . . . ." See 403 S.W.3d at 842. The court concluded that, because this provision unambiguously required that all disputes be arbitrated, the Settlor's intent to compel arbitration must be enforced if the arbitration provision is valid under Texas law and the underlying dispute is within the provision's scope.

The court went on to analyze whether the arbitration clause would be valid and enforceable under state law. In Texas, 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*." Id. at 844–45. Parties to the agreement may revoke it "only on a ground that exists at law or in equity for the revocation of a *contract*." Id. at 845. Although the Texas statute does not define "agreement," the court found it clear that the legislature intended to enforce arbitration provisions in contracts as well as in "agreements." Indeed, by using the term "agreement" in one section of the statute and "contract" in another, the court reasoned that the Texas Legislature understood there was a difference in meaning.

The court defined the term "agreement" using the generally accepted definition, as a "manifestation of mutual assent by two or more persons." Id. The court noted that, although the term "agreement" is often used interchangeably with "contract," agreements are broader than contracts because an agreement need not meet all of the formal requirements of a contract.

To determine if the arbitration clause in *Rachal* was an "agreement," the court required a showing of "mutual assent" by the parties. Although parties typically manifest mutual assent by signing an agreement, nonsignatories also can manifest assent to the provisions through the doctrine of direct benefits estoppel, which provides for an implied manifestation of assent if a party has obtained or seeks to obtain substantial benefits under an agreement.

The court in *Rachal* likened the doctrine of direct benefits estoppel to promissory estoppel and stated that a formal contract is not required for the doctrine of direct benefits estoppel to apply. Indeed, the presupposition for the application of the theory of promissory estoppel is that no contract exists.

The court relied on its prior ruling in *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d 732 (Tex. 2005), and determined that, under a theory of direct benefits estoppel, a nonsignatory to an agreement is estopped from attempting to enforce the benefits due him while simultaneously seeking to avoid provisions of the agreement, such as the obligation to arbitrate disputes. The court in *Rachal* noted that,

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under the doctrine of direct benefits estoppel, if a beneficiary contests the trust's validity in its entirety without having accepted any benefits from the trust, the beneficiary cannot be compelled to arbitrate. But once a beneficiary attempts to enforce rights that would not exist but for the trust, he manifests his assent to a trust's arbitration clause.

In *Rachal*, the beneficiaries of the Trust attempted both to seek benefits from the Trust and to enforce the provisions of the Trust against the trustee. The beneficiaries neither disclaimed their interest in the Trust nor challenged the Trust's validity. Instead, they accepted certain benefits of the Trust. Thus, when the beneficiaries ultimately brought a claim for breach of trust against the trustee, the court held that the doctrine of direct benefits estoppel applied to bar the claim that the arbitration provision in the Trust was invalid.

After concluding that the arbitration provision in the Trust was enforceable against Reitz, the court considered whether or not the dispute between Reitz and Rachal fell within the scope of the arbitration clause. The arbitration clause provided that 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.,* the beneficiaries, Trustees) . . . ." See *Rachal*, 403 S.W.3d at 842. The court determined that the claim against the trustee fell within the scope of the arbitration provision.

Reitz, however, maintained that a separate provision of the Trust that called for trustee exoneration in the case of any proceedings brought by a beneficiary without good faith and allowed the trustee to fund costs of claims brought against him from the Trust was evidence of the Settlor's intent to allow for the litigation of disputes with the trustee. The court found Reitz's argument did not defeat the arbitration provision for two main reasons. First, the arbitration provision contained the language "[d]espite anything herein to the contrary," and therefore it necessarily prevailed over the exoneration provision by its own terms. Second, the court determined that the two provisions are not necessarily in conflict. If, for example, the doctrine of direct benefits estoppel had not applied, and a claim was brought in, and stayed in, court, the provision for payment of trustee expenses would stand on its own to dictate the source of payment for the costs of defending such a claim.

In sum, the court held that the Texas law provides that written "agreements" to arbitrate such as the one contained in the Trust are valid and enforceable when a beneficiary assents to the agreement by accepting benefits from the trust and attempts to sue the trustee for breach of the trust's terms.

Debate Regarding Enforceability

Rachal is the latest in a series of cases dealing with the enforceability of arbitration clauses in trust instruments and wills. But, although arbitration clauses continue to gain favor and have become increasingly popular for use in the estate planning context, given the varying treatment of these provisions from state to state, and especially in this era of multijurisdictional estate planning, the practitioner should be aware of the differing state approaches.

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The Case Against Arbitration Clauses in Trust Instruments and Wills

Although arbitration clauses in general are typically viewed favorably, historically a variety of statutory, procedural, and equitable arguments have been used against the enforcement of arbitration clauses in trust instruments and wills.

Contract vs. Agreement and the Ability to Bind Nonsignatories

Unlike arbitration clauses in contracts, in which each party expressly manifests its assent to the contract's provisions, beneficiaries of trusts and wills usually do not execute the documents or formally consent to be bound by the document's provisions. For this reason the highest courts in several states have declined to enforce arbitration provisions in trust instruments and wills.

In *Rachal*, the trust beneficiary argued that arbitration provisions are unenforceable based on the holdings of the courts of appeals of Arizona in *Schoneberger v. Oelze*, 96 P.3d 1078 (Ariz. Ct. App. 2004), and of California in *Diaz v. Bukey*, 125 Cal. Rptr. 3d 610 (Ct. App. 2011). Both *Schoneberger* and *Diaz* stand for the proposition that an arbitration provision in a trust instrument is not enforceable because it is not a contract. Consequently, an arbitration provision included in a trust instrument cannot bind the nonsignatory beneficiaries and require them to submit disputes to arbitration, even if a beneficiary has accepted benefits under the trust, because the beneficiary did not expressly agree to the arbitration clause.

In *Schoneberger*, the trust instrument at issue contained a mandatory arbitration provision. When the third-party beneficiaries under the trust brought suit in court, the trustees argued that these beneficiaries were subject to arbitration under the terms of the arbitration provision. The court held that, as a matter of law, trusts are not contracts, and the Arizona law relating to arbitrations covered only "contracts." In addition, the court reasoned that arbitration rests on an exchange of promises. The court explained that a trust, as opposed to a contract, does not rely on any exchange of promises; rather, the trust is simply a transfer of an interest to a trustee who holds such interest for a beneficiary under the terms of the trust.

The California Court of Appeals in *Diaz* adopted the reasoning in *Schoneberger* and declined to enforce a mandatory arbitration provision in a trust instrument, stating that such provisions are enforceable only in contracts. Unlike the Arizona arbitration law in *Schoneberger*, the California arbitration statute considered in *Diaz* refers to arbitration provisions in "written agreements" as opposed to "contracts," similar to the Texas arbitration statute.

The same reasoning was adopted by the D.C. Court of Appeals in *In re Calomiris*, 894 A.2d 410 (D.C. 2006), in which the court held that wills, like trusts, are not contracts, and therefore any arbitration of a claim under a will would not be enforceable. The Washington, D.C., arbitration statute considered by the court in *Calomiris* was similar to Arizona's in *Schoneberger* and required the existence of a "contract" rather than an "agreement."

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Due Process Issues. The procedural and jurisdictional dilemma of ensuring due process for all interested parties is also employed as another argument against the enforceability of arbitration clauses in trust instruments and wills.

While there are clear procedures for identifying and notifying interested parties to proceedings in state probate courts, and to appointing representatives for those who cannot represent themselves, such clear procedures may not exist in the arbitral setting. Going forward with an arbitration that does not include creditors, unascertained beneficiaries, incompetents, minors, or unborn issue opens up the arbitrator's decision to potential appeal, thereby undermining many of the benefits of arbitration and possibly exposing fiduciaries to risk.

This issue was raised by the Nassau County Surrogate's Court in New York in *In re Will of Jacobovitz*, 295 N.Y.S.2d 527 (Sur. Ct. Nassau Cnty. 1968). In *Jacobovitz*, although the decedent's brother was the sole beneficiary under the will, 15 other "distributees" would have been entitled to notice under New York's Surrogate's Court Procedure Act. The sole beneficiary brother under the will and some, but not all, of the other distributees entered into an agreement to arbitrate. After the dispute was submitted to arbitration, and two of the distributees won an award that would have distributed the decedent's estate among them, the sole beneficiary brother petitioned the court to probate the decedent's will, while the other distributee involved in the arbitration sought to uphold the arbitral award. The Surrogate's Court determined that the arbitration was conducted in a manner that denied some of the distributees the legal rights they would have been afforded in court and thus was unenforceable.

Public Policy Argument. A concern for the fundamental unfairness and lack of process to all the distributees was not the only consideration driving the court in *Jacobovitz*. The court made it clear that even in a situation in which all interested parties are before the court, it is against public policy to submit certain issues, such as the probate of instruments purporting to be last wills and testaments and the distribution of estates, to arbitration, and that such issues are best left to the probate courts. The New York Appellate Court in *In re Berger*, 437 N.Y.S.2d 690 (N.Y. App. Div. 1981), agreed that even when all of the interested parties agreed to submit a dispute regarding the interpretation of a letter purporting to be a decedent's will to arbitration, it is against public policy in New York to bring such disputes in a forum other than the probate courts, under the theory that the courts are best equipped to handle such disputes.

The Michigan Supreme Court also addressed this issue in *In re Estate of Meredith*, 266 N.W. 351 (Mich. 1936), in which different fiduciaries were named in a will than in the subsequent codicil. The fiduciaries agreed to submit a question regarding the validity of the codicil to arbitration. The arbitrator's decision was appealed, and the court held, after a related discussion on due process issues, that certain disputes are matters best handled by a probate court, and therefore the arbitration was not enforceable.

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It is important to note that in both these cases, the agreement to arbitrate was not contained in the estate planning document and was subsequently entered into by the parties to the dispute. Arguably, the public policy concerns may be lessened if the testator clearly intends that any disputes be arbitrated.

A Shift in Opinion

Despite these objections, state courts and state legislation have shifted toward a more favorable view of enforcing arbitration provisions for a variety of reasons.

The Case for Arbitration Clauses in Trust Instruments and Wills. Arbitration can provide families and fiduciaries with several benefits that make it an attractive option for controversies arising in the estate planning and administration context. The ability to shape arbitration provisions, including the naming or other selection of the arbitrators, can provide a significant amount of flexibility. In addition, arbitration proceedings can be faster than judicial proceedings because of more limited discovery and the avoidance of court calendar delay. Due in part to the expeditious nature of arbitration proceedings, submitting a dispute to arbitration, rather than bringing a claim in a court, often saves legal fees and other expenses. Judicial review of arbitration awards is narrower, which provides the parties with greater certainty and finality in the award.

Confidentiality is another important attribute of arbitration proceedings. Family quarrels can be hostile and involve very private family business, especially when the dispute relates to inheritance. Because arbitration proceedings are private, parties can take some comfort in knowing that their intrafamilial differences will be kept out of the public eye.

Case Law and Legislative Developments. Although *Schoneberger*, *Meredith*, and *Diaz* were leading cases at one time, these cases have largely been superseded by case law or legislation.

For example, in 2008 Arizona superseded *Schoneberger* by enacting Ariz. Rev. Stat. § 14-10205, which provides that a trust instrument can provide mandatory, exclusive, and reasonable procedures to resolve issues between the trustee and interested persons or among interested persons about the administration or distribution of the trust.

In 2009, the Michigan Court of Appeals in *In re Nestorovski Estate*, 769 N.W.2d 720 (Mich. Ct. App. 2009), held that the decision in *Meredith* does not apply if all interested parties had knowledge of the arbitration and agreed to it. Since *Meredith* was decided, Michigan has enacted various laws and developed its case law to better accommodate the arbitration of probate issues. Indeed, the court in *Nestorovski* noted that Michigan law now provides mechanisms for disputes to be submitted for alternative dispute resolution in any contested proceeding, including those in the probate court. See Mich. Ct. R. § 5.143(A); Mich. Comp. Laws Ann. § 600.847. The *Nestorovski* court made it clear that under Michigan law all interested parties, if properly notified, can agree to binding arbitrations of probate disputes.

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A similar shift occurred in California. In 2012, the California Supreme Court held that third parties were bound to a mandatory arbitration provision in an agreement even if such third parties were not signatories to the agreement. The court directed the California Court of Appeals to vacate its decision in *Diaz. Pinnacle Museum Tower Ass'n v. Pinnacle Market Dev. (U.S.), LLC*, 282 P.3d 1217 (Cal. 2012).

State Law Still to be Developed. Although a number of states have enacted statutes authorizing the enforcement of arbitration provisions in trust instruments and wills, the arbitration statutes of many states do not specifically address the applicability, or the enforceability, of those arbitration provisions in the trust and estate context. See, e.g., Fla. Stat. § 731.401; Wash. Rev. Code § 11.96A.030.

Many states have codified arbitration statutes with similar scope to that of Texas, where "written agreements" to arbitrate controversies are valid and enforceable. See, e.g., Del. Code Ann. tit. 10, § 5701; S.D. Codified Laws § 21-25A-1. Other states, like Nevada, relax the constraints even further and require only that the agreement to submit a controversy to arbitration be inscribed on a tangible medium or stored in an electronic or other medium that is retrievable in perceivable form in order for the arbitration provision to be valid and enforceable. See Nev. Rev. Stat. Ann. § 38.219; Nev. Rev. Stat. Ann. § 38.213. But, because these statutes do not specifically address trust instruments or wills, either the legislature or the state courts will have to provide further clarification and determine whether to follow the reasoning in *Rachal* or *Jacobovitz*.

In 2006, the American College of Trust and Estate Counsel (ACTEC) drafted a model arbitration act, both in long and short form, that could serve as a basis for state legislation in the trust and estate context. See Am. Coll. of Trust & Estate Counsel, *Arbitration Task Force Report* 22–23 (Sept. 18, 2006). These model acts authorize mandatory arbitration and also provide a default resolution process in the event that the provisions of the trust instrument or will are ambiguous, thereby attempting to preempt the procedural and equitable arguments used against arbitration clauses in trust instruments and wills. Although statutes specifically providing for the enforceability of arbitration clauses in trust instruments and wills have not yet been adopted by many states, the proposed ACTEC model could serve as a guideline for policymakers for the drafting and enactment of additional arbitration legislation that would unequivocally govern trusts and wills.

Drafting an Arbitration Clause

Circumventing the Contract Argument

As discussed above, historically some courts have determined that arbitration requires a contract and an exchange of promises, neither of which is usually present in the estate planning context. In addition, some states' arbitration statutes specify "contracts" as opposed to more generally described instruments, such as "agreements." Thus, the determination of whether a document is a "contract" has historically had profound effects on whether an arbitration clause within the document will be enforceable.

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An estate planner faced with a state arbitration law or case law that covers only "contracts" may be faced with an insuperable obstacle. One method for circumventing the hardship would be for all of the parties to enter into a contract to arbitrate, which can serve to mandate arbitration if the arbitration clause in the trust instrument or will is not enforced. For example, when the trust instrument is prepared, a side agreement could be entered into among the settlor, trustees, and beneficiaries to agree to arbitrate all disputes. This option presents a number of problems, and especially in the testamentary context, may be impracticable. Often in the context of wills, a testator may not want the beneficiaries to know of potential dispositions, for varying reasons. In addition, it is often difficult to identify all of the beneficiaries of a will or trust when the instrument is executed. Because a period of time will lapse before the interests of some or all of the beneficiaries vest, the members of a class of beneficiaries can change, and the vesting of their interests may be subject to contingencies.

In situations in which it may be impractical to enter into separate "contracts" when a trust instrument or will is executed, an alternative is to require in the instrument that contracts agreeing to arbitrate be entered into at the time of the devise, gift, or bequest. By use of a condition precedent, the recipient would be required to consent to arbitration before receiving the benefit of the devise, gift, or bequest. For example, a trust agreement can authorize a trustee to make distributions "to such of my descendants who agree to sign an agreement with the trustees to submit all disputes arising under the trust to arbitration."

A condition precedent, however, would still have limitations, because it would have no effect if a beneficiary refuses the gift or bequest, does not consent to arbitration, and contests the validity of the document as a whole. Another obstacle is presented when beneficiaries lack legal capacity to sign an arbitration agreement.

In the absence of a "contract," enforceability of an arbitration provision will likely rest on the ability to bind nonsignatories under theories such as direct benefits estoppel. If, however, there is a possibility that a court will refuse to accept an arbitration provision under such a theory, a possible solution may be to include additional provisions in the instrument that incentivize, instead of attempt to compel, arbitration.

One method is to use a no contest or in terrorem clause, which would provide that any person objecting to the instrument by means other than binding arbitration would be treated as though he or she predeceased the settlor or testator. Because no contest clauses threaten the party bringing the claim with disinheritance, their inclusion in estate planning documents may be a useful mechanism to dissuade judicial claims and incentivize arbitration.

Alternatively, exculpatory clauses, which are provisions that relieve a fiduciary of potential liability in certain situations, could be tailored to relieve the fiduciary of potential liability only if a claim against the fiduciary is brought by means other than mediation or arbitration. This could incentivize all claims against the fiduciary to be removed from the court and resolved via mediation or arbitration.

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No contest clauses and exculpatory clauses, however, are not without their own uncertainties and detractors. Exculpatory clauses reducing fiduciaries' duties of care, for example, are widely disfavored by courts. Many states treat such provisions as void as against public policy unless they are narrowly tailored, and their enforcement varies widely from state to state. In California, New York, and the many states that have adopted the Uniform Probate Code for instance, no contest clauses are generally viewed more favorably than in Florida, where courts refuse to enforce such provisions. Under Alaskan law, trust provisions purporting to penalize a beneficiary for instituting proceedings relating to the trust are enforceable even if there was probable cause for the beneficiary to institute such an action.

Addressing Due Process and Other Concerns

As discussed above, one of the theoretical benefits of arbitration is that it is a faster, simpler, and more economical solution than relying on the courts to resolve disputes. If, however, the arbitration presents problems with the identification or notice to all interested parties or lack of clarity regarding the selection of arbitrators and allocation of costs, the arbitration clause may, in the end, be counterproductive. Additional proceedings (either in an arbitral or judicial forum) may be required not only to settle the underlying disputes but also to clarify any ambiguities regarding the intent of the settlor or testator in his contemplation of the arbitration proceeding or to attempt to cure any due process deficiencies.

These hardships may be avoided by careful drafting. For example, in the case of unascertainable, unborn, or minor children, the arbitration clause should clearly set forth the procedure by which they can bring claims or be represented virtually or otherwise. To the extent a jurisdiction does not provide statutory default rules, model rules can be used, such as those proposed by ACTEC or promulgated by an alternative dispute resolution service provider such as the American Arbitration Association. See AAA Wills and Trusts Arbitration Rules (2012).

Although mitigating any potential due process issues through careful drafting and expressing a clear intention that arbitration provisions are to be given effect to the maximum extent allowable under state law can lead to increased enforcement of such provisions, relying on an arbitration clause in a jurisdiction that appears to have a public policy against enforcing such clauses may merely provide the testator or settlor with false comfort.

Selecting an Arbitration-Friendly Jurisdiction and Vehicle

Although careful drafting can help avoid many of the obstacles to the enforcement of arbitration provisions, to be safe a settlor or testator may wish to use the laws of a jurisdiction more favorable to arbitration clauses. To that end, he or she may wish to direct original probate of a will in a state that has a statute or case law favoring arbitration. Alternatively, a revocable trust governed by the laws of an arbitration-friendly jurisdiction can be established as a testamentary substitute. A discussion of nexus and ability to switch between "friendly" jurisdictions in such a manner is beyond the scope of this article, except to recommend involvement of local counsel in any such jurisdiction.

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An arbitration clause also can be used in ancillary documents that are more akin to "contracts," if the trust or estate property includes real estate, partnership, or LLC interests, whether in a family business or not. In the same vein, a settlor or testator may wish to consider forming, and transferring assets into, a family limited partnership, which would be governed by a partnership agreement that would mandate arbitration.

Alternatively, a settlor, testator, or estate planner also may wish to consider favoring nonprobate assets that pass via beneficiary designations or by operation of law (that is, life insurance, retirement accounts, pay-on-death accounts, joint accounts, and so on), which would perhaps avoid some of the policy concerns discussed above. Beneficiaries are often not parties to these arrangements, however, so some of the equitable concerns outlined above still pertain.

Looking Beyond Rachal

Rachal is an important case because it provides clarity under Texas law on the enforceability of arbitration clauses in trust instruments and continues the discussion about the enforceability of such provisions in other jurisdictions. Although arbitration clauses in general have traditionally been favored by courts, the case law and legislation as it relates to these provisions in trust instruments and wills remains literally and figuratively all over the map. The uncertainty about the enforceability of these clauses is a disincentive for their use despite the many benefits they offer. Although this remains an evolving area of the law that will certainly develop as these provisions become more common, *Rachal* and the prior decisions of courts in other jurisdictions provide a road map for crafting arbitration clauses in trust instruments and wills so as to maximize the prospects of enforceability given the current state of the law.

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