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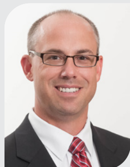
Trust disputes: 5 reasons to reconsider an arbitration provision



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Trust companies look at a variety of factors in deciding whether to accept trusts for administration. While a well-crafted estate plan, funded with straight-forward, traditional assets, created for the benefit of amicable beneficiaries is the ideal new account to onboard, even the best laid plans can be thwarted when an unforeseen fight erupts between the beneficiaries or against their new trustee. Assets once intended for children, grandchildren or charities are instead spent on attorney fees in extended lawsuits. Setting expectations with living settlors and beneficiaries in advance, documenting the settlor's capacity, and including in terrorem clauses may prevent the fight in the first place. Mandatory arbitration provisions offer an alternative to a courtroom, but there is no one-size-fits-all solution for resolving these fights.

The rise of arbitration in trust disputes

Trust disputes are on the rise and there is little doubt that this trend will continue as the largest transfer of wealth in history plays out over the next decade. While the movement of these disputes from the court system to arbitration would be a dramatic shift in the trust industry, it may also be inevitable.

The rise of arbitration in trust disputes is partly a natural result of the rise of arbitration in commercial disputes generally. For decades, federal courts have implemented a strong policy towards enforcing arbitration clauses in contracts based on the Federal Arbitration Act. The American College of Trust and Estate Counsel's Arbitration Task Force's 2006 report specifically noted this change in federal law in endorsing arbitration as an alternative to the court system for trust disputes. The report concluded that trust administration would be more efficient and less costly in a "non-traditional form of trial resolution" presided over by an individual with "extensive experience in, and knowledge of" estate planning.

Yet, in almost 15 years since the report, arbitration of trust disputes remains the exception and not the rule. Only a few states have adopted the report's model legislation. Ohio most recently adopted a statute specifically addressing trust arbitration in 2019, joining Washington (2001), Arizona (2008), Florida (2013), Missouri (2013), New Hampshire (2014) and South Dakota (2015). Ohio's statute may portend another wave of statutory changes. If more states follow Ohio, it will have a profound impact on professional trustees.

Trust companies and bank trust companies—the likely frequent fliers in this alternative system responsible for adjudicating disputes often worth millions of dollars—stand to benefit if judges are replaced by arbitrators. Because arbitration provides the same level of confidentiality to settlors and beneficiaries as disposing of property via trust, it can spare professional trustees the spectacle of public fights with beneficiaries and the embarrassment from unfortunate errors.

The information contained herein is based on a summary of legal principles. It is not to be construed as legal advice and does not create an attorney-client relationship. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

Is arbitration right for your trust?

How should the presence or absence of an arbitration provision factor into your new account acceptance model? There are, to be sure, advantages in arbitration. The wheels of the justice system turn slowly. Discovery is expensive. Judges and juries may have little prior knowledge of complex estate planning strategies. And, the entire process plays out in a forum open to the public. Arbitration can reduce or eliminate these drawbacks.

However, arbitration presents serious challenges. The following are five reasons why an arbitration provision in a trust could be a negative for trust companies and bank trust departments:

1. Enforceability of arbitration can vary

Except for the handful of states with express statutes or clear case law, the enforceability of arbitration in trusts remains an open issue. In Wisconsin, for example, no court has addressed whether an arbitration provision can be enforced against a trust beneficiary. The rationale for liberal enforcement of arbitration in commercial cases—mutual agreement to the provision—does not translate neatly to the context of transferring assets to beneficiaries. The Wisconsin State Legislature also failed to address arbitration expressly when it adopted the Wisconsin Trust Code, though the comments to the Uniform Trust Code seem to endorse it: “Settlors wishing to encourage use of alternate dispute resolution may draft to provide it.” Unif. Trust Code. § 816, cmt.

The outcome of a fight to compel arbitration in Wisconsin, which would depend on the construction of both the Wisconsin Trust Code and the Wisconsin Arbitration Act, as well as potential application of common law doctrines like direct benefits estoppel, is far from guaranteed. Even thornier issues arise in the event of minor, unborn or incapacitated beneficiaries who may be unable to consent to arbitration at all. Likewise, the validity of the trust itself is often at the heart of these disputes due to an asserted lack of capacity or undue influence. Even states like Florida and Ohio that have codified the enforceability of arbitration provisions in trusts have exempted issues regarding validity of the underlying testamentary documents.

Injecting this enforceability issue creates uncertainty in an already contentious dispute. If nothing else, a mandatory arbitration provision forced on the trustee or the beneficiaries gives them something else to fight about if state law provides no clear answer. In the absence of clear authority, litigation to compel arbitration eliminates the streamlined process and potential cost savings associated with arbitration.

2. Finding the right arbitrator

Enforceability aside, who will preside over the arbitration? An arbitrator wields an extraordinary amount of power over procedure and substance and is subject to very limited judicial oversight. Consequently, the right arbitrator is key to a successful arbitration. As a practical matter, few arbitration provisions designate a specific individual to act as an arbitrator. Instead, the parties are often left to agree among themselves on the arbitrator or are directed to one of several arbitration organizations.

This presents an opportunity (for good or ill) to trust companies and bank trust departments who will be the most frequent participants. No longer tied to the court system, what kind of person is best suited for each dispute? Arbitration may provide an opportunity to select a subject matter expert far more familiar with trust law and practice than an average probate court judge. Developing a preferred list of arbitrator candidates or a desired set of qualifications should be done at the outset of a potential dispute. Equally important, is forming a list of candidates or qualifications to avoid.

3. Arbitration may cost more than litigation

Conventional wisdom is that arbitration is faster and less expensive than a lawsuit. These savings are usually found by limiting discovery, especially depositions and expansive document requests. But if the parties fail to agree on limitations and none are imposed by the trust itself, the discovery savings depend entirely on the arbitrator. If an arbitrator, for example, allows depositions of all the beneficiaries, the trustee and the drafting attorney, how much money will be saved through arbitration as opposed to a lawsuit? A deposition is not less expensive because it

occurs in an arbitration. Similarly, an arbitrator who is unwilling to rein in overbroad document discovery by a zealous advocate destroys the expected savings.

There are also significant costs and fees unique to arbitration. Large organizations like the American Arbitration Association, for example, have overhead and charge thousands of dollars in filing fees that far exceed court filing fees. Additionally, the arbitrators themselves are typically paid hundreds of dollars per hour. As a result, there are incentives to prolong disputes that a court might resolve through a targeted dispositive motion. These unique costs can add up quickly and may ultimately end up as an expense to be borne by the trust.

4. Trust arbitration can be less predictable than litigation

There are few certainties in litigation, but state rules of procedure and evidence are known and well-developed. In arbitration, the parties may create their own rules or adopt standard rules from somewhere else. The trust itself may direct the adoption of certain procedural rules, like the American Arbitration Association's Arbitration Rules for Wills and Trusts. As aforementioned, absent agreement or direction, an arbitrator enjoys significant discretion regarding discovery, pre-hearing motions and the rules of evidence. The arbitrator can even choose to ignore, or creatively work around, substantive law. The arbitrator's discretion can make arbitration more efficient and even more equitable, but it also removes the predictability provided by judicial rules of procedure and evidence.

5. Limited opportunity to appeal trust arbitration decisions

Cementing concerns about unpredictability, arbitration awards are rarely overturned. First, state statutes set forth limited instances when an arbitration award may be vacated, such as corruption, fraud or misconduct. Second, absent a written decision that explains the arbitrator's decision, a court will not have much to review. The limited nature of this review greatly reduces the cost and time associated with the appeals process, but it leaves a disappointed party with no redress for a bad decision. Conversely, in litigation, incorrectly decided questions of law can always be appealed.

Discuss the pros and cons of trust arbitration with counsel

Despite recent trends toward increased reliance on arbitration provisions, they may not be for everyone. While a well-crafted arbitration provision can maximize the cost savings and increase predictability by setting forth the rules of the road in advance, trustees should be prepared for threshold fights with disgruntled beneficiaries until issues surrounding enforceability are resolved by legislation or case law. Even after these legal issues are resolved, arbitration is not a panacea for trust disputes. Be sure to discuss the pros and cons of a particular arbitration with your attorney. As part of your trust acceptance process, you may be able to request a trust modification to add, delete or modify an arbitration provision.

For more information on this topic, or to learn how Godfrey & Kahn can help, contact an attorney with our Trust Industry Practice Group.