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Commonwealth of Kentucky

Court of Appeals

NO. 2006-CA-000311-ME

MORGAN KEEGAN & CO., INC.; WILLIAM BORDERS; AND JIM PARRISH — APPELLANTS

v.

APPEAL FROM WARREN CIRCUIT COURT
HONORABLE STEVE ALAN WILSON, JUDGE
ACTION NO. 05-CI-01541

GARY FORCE — APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: COMBS, CHIEF JUDGE; KELLER, JUDGE; BUCKINGHAM,[1] SENIOR JUDGE.

COMBS, CHIEF JUDGE: Morgan Keegan & Co., Inc., a regional investment firm headquartered in Memphis, Tennessee, and William Borders and Jim Parrish, individual representatives of the firm, appeal from an order of the Warren Circuit Court of January 10, 2006, that denied their motion to compel arbitration. After our review of the record and the pertinent law, we affirm.

[1]Senior Judge David C. Buckingham sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and KRS 21.580.

This case arose after a civil enforcement action was instituted by the Securities and Exchange Commission (the SEC) in March 2000. The SEC's investigation focused upon certain transactions involving the Morgan Keegan investment account of Gary Force, a Bowling Green businessman. There were allegations that Force had purchased and sold securities based upon non-public information ("insider-trading"). The matter was concluded in June 2005 when Force agreed to entry of judgment against him. In the consent judgment, Force agreed to pay to the SEC a civil penalty of more than $1.5 million. He was also required to pay more than $2.6 million to the SEC as a "disgorgement" of profits and interest.

In September 2005, Force filed a complaint against his broker, Chad Conner, Borders, Parrish, and Morgan Keegan. (Conner was dismissed as a party following his imprisonment in the federal penitentiary.) Force claimed that he was fraudulently induced to open an investment account with Morgan Keegan by claims of superior market analysis and investment advice offered by its agents. Force alleged that he believed that his broker would recommend profitable investment strategies based upon in-depth market research. Instead, the advice that he was given was actually based upon "insider" merger and acquisition information that had been misappropriated from New York investment banking firms. Force claimed that this insider information had been provided to him with the full knowledge, participation, and approval of the other named defendants. He asserted various other statutory violations and common law tort claims arising from his transactions with Morgan Keegan and its representatives. He sought to

recover from the defendants the sum of $2,636,984.00, the amount that he had been required to "disgorge" to the SEC.

In response to Force's complaint, Morgan Keegan and its representatives moved to compel arbitration. They argued that the all of the claims asserted in the complaint fell within the scope of a valid and enforceable arbitration clause contained in the Morgan Keegan Client Agreement.

Force had signed a Client Agreement when he opened his investment account with Morgan Keegan in 1998. Paragraph 5 of the Client Agreement, entitled "Arbitration," provides as follows:

> The undersigned agrees, and by accepting, opening or maintaining an account for the undersigned, Morgan Keegan agrees that all controversies between the undersigned and Morgan Keegan (or any of Morgan Keegan's present or former officers, directors, agents or employees) which may arise from any account or for any cause whatsoever, shall be determined by arbitration. Any arbitration under this agreement shall be before the National Association of Securities Dealers, Inc., or the New York Stock Exchange, Inc., or an arbitration forum provided by any other securities exchange or organization of which Morgan Keegan is a member, and in accordance with the rules of such organization . . . .
>
> This arbitration provision shall apply to any controversy or claim or issue in any controversy arising from events which occurred prior to, on or subsequent to the execution of this arbitration agreement.

Force resisted this motion by filing his response on October 27, 2005, arguing that the motion to compel arbitration should be denied because the terms of the

Client Agreement provided that it would be governed by the laws of the State of Tennessee. He contended that his claims of fraud in the inducement were not subject to arbitration under Tennessee law. The Warren Circuit Court agreed with Force and denied Morgan Keegan's motion to compel arbitration on January 10, 2006. This appeal followed.

We review an order of a circuit court *de novo* when it involves a question of law – *e.g.*, denial of a motion to compel arbitration. Kentucky Revised Statutes (KRS) §417.220. We independently review a circuit court's construction of a contract without deference to its interpretation of the contract provisions. *Morganfield Nat'l Bank v. Damien Elder & Sons,* 836 S.W.2d 893 (Ky. 1992).

Morgan Keegan and its representatives argue that the circuit court erred by concluding that the breadth of the arbitration clause included in its Client Agreement is governed by Tennessee law rather than by the provisions of the Federal Arbitration Act. (The Federal Arbitration Act is codified at 9 USC §§1-16.) We disagree.

Paragraph 15 of Morgan Keegan's Client Agreement, entitled "Choice of Law; termination," provides as follows:

> This agreement and its enforcement shall be governed by the laws of the State of Tennessee and federal law as applicable including the Federal Arbitration Act. . . .

We are persuaded that the trial court correctly concluded that the Client Agreement's choice-of-law provision governs the entire agreement, including the breadth of the agreement's arbitration clause. The agreement's choice-of-law provision provides

that the laws of the State of Tennessee explicitly govern and that federal law (including the Federal Arbitration Act) shall govern "as applicable." The federal authorities are clearly positioned in the agreement in a sequence secondary to the primary and pre-eminent placement of Tennessee law. Since Tennessee law closely tracks the provisions of the Federal Arbitration Act, it is likely that a conflict of laws was not anticipated to arise.

Under the provisions of the Federal Arbitration Act, contract-formation claims are to be decided by an arbitrator. *See Buckeye Check Cashing, Inc., v. Cardegna*, 566 U.S. 440, 126 S.Ct. 1204, 163 L.Ed.2d 1038 (2006). In *Prima Paid Corp. v. Flood & Conklin Mfg. Co.,* 388 U.S. 395, 87 S.Ct. 1801, 18 L.Ed.2d 1270 (1967), the Court addressed the question of "whether a claim of fraud in the inducement of the entire contract is to be resolved by the federal court, or whether the matter is to be referred to the arbitrators." *Id.* at 402, 87 S.Ct. 1801. The Federal Arbitration Act at § 4 provides as follows:

> A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court [with jurisdiction] . . . for an order directing that such arbitration proceed in a manner provided for in such agreement. . . [U]pon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement....

Referring to §4 of the Act, the *Prima* Court held that:

> if the claim is fraud in the inducement of the arbitration clause itself – an issue which goes to the making of the

> agreement to arbitrate – the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims **of fraud in the inducement of the contract generally.** (Emphasis added.)

Id. at 403-404, 87 S.Ct. 1801 (internal quotation marks and footnote omitted). Thus, under *Prima*, unless the party's challenge is **to the arbitration clause itself**, the issue of the contract's overall validity is to be determined by the arbitrator.

The provisions of the Act – where applicable – are enforceable both in state and federal courts. *See Southland Corp. v. Keating,* 465 U.S. 1, 104 S.Ct. 852, 79 L.Ed.2d 1 (1984). Contrary to the rationale of most other state and federal jurisdictions, however, Tennessee has departed from *Prima* and prohibits an arbitrator from deciding claims of fraud in the inducement of the contract as a whole.

In *City of Blaine*, 818 S.W.2d 33 at 37, the Tennessee Court of Appeals quoted and adopted Mr. Justice Black's dissenting opinion in *Prima Pain Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 407, 87 S.Ct. 1801, 1808, 18 L.Ed.2d 1270(1967) as follows:

> The Court holds what is to me fantastic, that the legal issue of a contract's voidness because of fraud is to be decided by persons designated to arbitrate factual controversies arising out of a valid contract between the parties.
>
> * * * *
>
> On the one hand, courts have far more expertise in resolving legal issues which go to the validity of a contract than do arbitrators. On the other hand, where a party seeks to rescind a contract and his allegation of fraud in the inducement is true, an arbitrator's speedy remedy of this wrong should never result in resumption of performance under the contract.

> And if the contract were not procured by fraud, the court, under the summary trial procedures provided by the Act, may determine with little delay that arbitration must proceed. The only advantage of submitting the issue of fraud to arbitration is for the arbitrators. Their compensation corresponds to the volume of arbitration they perform. If they determine that a contract is void because of fraud, there is nothing further for them to arbitrate. . . .

With respect to the question of whether contract-formation claims are subject to arbitration, Tennessee has staunchly guarded and reinforced the primacy of the jurisdiction of its courts. *See Frizzell Const. Co. v. Gatlinburg, L.L.C.,* 9 S.W.3d 79, 84 (Tenn. 1999); *City of Blaine v. John Coleman Hayes & Associates, Inc.,* 818 S.W.2d 33 (Tenn.App. 1991). By designating Tennessee law as the overriding governing law, Force and Morgan Keegan agreed that Tennessee law rather than federal law would govern the question of which claims may be submitted to arbitration.

While Morgan Keegan argues otherwise, Tennessee state law does not run afoul of federal law since it does not **bar** enforcement of §2 of the Federal Arbitration Act with respect to state-law claims brought in state court. §2 of the Federal Arbitration Act provides as follows:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform in whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, **shall be valid**, irrevocable, and enforceable, **save upon such grounds as exist at law or in equity for the revocation of any contract**. (Emphases added.)

This language of the federal Act allows for the applicability of Tennessee law. Thus, when the parties have elected by contract to apply Tennessee law rather than the provisions of the Federal Arbitration Act, the law of Tennessee regarding contract-formation claims (including fraud-in-the-inducement claims) must be decided **by a court rather than by an arbitrator**. *See Taylor v. Butler*, 142 S.W.3d 277 (Tenn. 2004); *cert denied City Auto Sales, LLC v. Taylor*, 543 U.S. 1147, 125 S.Ct. 1304, 161 L.Ed.2d 108 (2005). As the United States Supreme Court has stated:

> Arbitration under the [Federal Arbitration Act] is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit . . . [T]hey may limit by contract the issues which they will arbitrate. . . .

Volt Info. Sci., Inc. v. Bd. Of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 479, 109 S.Ct. 1248 (citations omitted).

Arbitration agreements are treated like all other contracts in Tennessee. In this case, the arbitration clause governs "where applicable." Otherwise, the law of the State of Tennessee governs. Under the express terms of Morgan Keegan's Client Agreement, where there is no conflict between Tennessee law and the Federal Arbitration Act *(e.g.*, claims involving an alleged breach of the terms of the agreement), the federal Act is "applicable," and the claim will be subject to arbitration pursuant to its terms. It is quite a separate issue if a conflict exists – as it does in this case. When there is conflict between the federal Act and Tennessee's state law specifically concerning the breadth of

the arbitration agreement, the parties have unequivocally agreed that Tennessee law will prevail.

Tennessee holds a minority position with respect to what kinds of issues are subject to arbitration. Needless to say, its preference has been much litigated, and we must presume that the parties were aware of the pitfalls inherent in Tennessee law when they designated it as the governing standard in cases involving conflict of laws. Relying on that provision of Tennessee law, the parties specifically **did not** agree that claims of fraudulent inducement would be subject to arbitration. Although Force's claims clearly could have been arbitrated under the provisions of the Federal Arbitration Act, the parties cannot be compelled to arbitrate where they directly contracted that provisions of Tennessee law would govern.

The Warren Circuit Court did not err by denying the motion to compel arbitration. We affirm its order.

ALL CONCUR.

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