IN THE SUPREME COURT OF TEXAS

No. 07-0665

IN RE MORGAN STANLEY & CO., INC.,
SUCCESSOR TO MORGAN STANLEY DW, INC., RELATOR

ON PETITION FOR WRIT OF MANDAMUS

Argued October 15, 2008

JUSTICE HECHT, dissenting.

Before a court can compel arbitration under the Federal Arbitration Act,[1] it must be "satisfied that the making of the agreement for arbitration . . . is not in issue".[2] A challenge to the validity of a contract containing an arbitration provision does not put the making of the arbitration provision itself in issue; "as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract."[3] A challenge to the validity of the arbitration provision itself is for the court to decide; but "when parties agree to arbitrate all disputes arising under their contract, questions concerning the validity of the entire contract are to be resolved by the arbitrator in the first instance, not by a federal or state court."[4] Thus for example, whether the contract was fraudulently induced,[5] or whether it is usurious and therefore illegal,[6] are issues for arbitration.

[1] 9 U.S.C. §§ 1-16.

[2] *Id.* § 4 ("The court shall hear the parties, and upon 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.").

[3] *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 445-446 (2006).

[4] *Preston v. Ferrer*, 552 U.S. ___, ___ (2008).

[5] *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403-404 (1967).

[6] *Buckeye*, 546 U.S. at 446.

But what if the challenge to the contract is that it never came into being? Since "arbitration is a matter of contract",[7] the issue must be one for the court to decide. Otherwise, an arbitrator would be put in the position of deciding whether he was authorized to decide the parties' dispute, concluding either that he was not authorized, a logical circularity, or that he was, and raising himself by his own bootstraps.[8] Thus, whether a person is bound by a contract he never signed is an issue for the court.[9] So, too, would seem to be issues whether a person's signature on a contract was forged,[10] whether a person's agent was authorized to sign,[11] and whether an offer was withdrawn before a contract was signed.[12]

The issue whether a party who executed a contract lacked the mental capacity to do so is different. The rule in Texas[13] and most other jurisdictions[14] is that the contract exists and can be ratified or avoided. That distinguishes the issue of capacity from issues of signature or authorization. A person who did not sign a contract or authorize its execution cannot enforce it; a person who lacks mental capacity to sign it can. Thus, it seems to me, lack of capacity is closer to fraudulent

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[7] *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83 (2002) ("This court has determined that 'arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit.'" (quoting *United Steelworkers of Am. v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 582 (1960))).

[8] *Will-Drill Res., Inc. v. Samson Res. Co.*, 352 F.3d 211, 219 (5th Cir. 2003) ("[W]here the very existence of an agreement is challenged, ordering arbitration could result in an arbitrator deciding that no agreement was ever formed. Such an outcome would be a statement that the arbitrator *never* had any authority to decide the issue."); *Sphere Drake Ins. Ltd. v. All Am. Ins. Co.,* 256 F.3d 587, 591 (7th Cir. 2001) ("[A]s arbitration depends on a valid contract an argument that the contract does not exist can't logically be resolved by the arbitrator (unless the parties agree to arbitrate this issue after the dispute arises).").

[9] *First Options of Chicago, Inc. v. Kaplan,* 514 U.S. 938, 944 (1995).

[10] *Chastain v. Robinson-Humphrey Co.*, 957 F.2d 851, 855 (11th Cir. 1992).

[11] *Sphere Drake*, 256 F.3d at 591.

[12] *Will-Drill*, 352 F.3d at 219.

[13] *See Neill v. Pure Oil Co.*, 101 S.W.2d 402, 404 (Tex. Civ. App.–Dallas 1937, writ ref'd) ("It is the settled law in this state, we think, that a deed executed by a person of unsound mind is not void but voidable. Hence, as a voidable deed, it effectually accomplishes the thing sought to be accomplished, until set aside in a suit for rescission or cancellation." (citations omitted)).

[14] 53 AM. JUR. 2d *Mentally Impaired Persons* § 150 (2006); 17A C.J.S. *Contracts* § 145 (1999); 5 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 10:3 (4th ed. 1993); RESTATEMENT (SECOND) OF CONTRACTS § 15 (1981); 1 E. ALLAN FARNSWORTH, CONTRACTS § 4.7 (3d ed. 2004).

inducement than to lack of signature or authorization and therefore an issue for the arbitrator rather than the judge. The issue is not "the making of the agreement"; an agreement with a person lacking capacity exists — it happened. Rather, the issue is whether the agreement is valid and enforceable.

The Court reaches the opposite conclusion for two reasons, neither of which is compelling. First, the Court notes that the Supreme Court, in a footnote distinguishing "[t]he issue of the contract's validity . . . from the issue whether any agreement . . . was ever concluded", listed four cases that had been cited to it involving forgery, authorization, and mental capacity.[15] But the Supreme Court expressed no opinion on any of these issues and did not note the important difference under some states' laws that mental incapacity does not preclude an agreement. I think the Court overreads the footnote, though of course, one cannot be sure. As Professor Ware has observed:

> Incapacity has long been a defense to the enforcement of a contract formed by a minor or mentally incompetent person. Such incapacity does not prevent the formation of a contract. So under the Supreme Court's distinction between a contract's formation ("whether any agreement . . . was ever concluded") and defenses to enforcement ("the contract's validity"), incapacity plainly falls in the latter category and thus should be resolved by arbitrators rather than courts. Yet the Supreme Court in *Buckeye* grouped incapacity together with lack of assent and agency, both of which fall into the former category (formation) and both of which, *First Options* held, are resolved by courts rather than arbitrators. So it is possible that — when presented with an incapacity case — the Court will continue to group incapacity with lack of assent and agency and treat them all as questions for courts, rather than arbitrators . . . . Time will tell.[16]

Second, as between the two cases on the issue before us, the Tenth Circuit's decision in *Spahr v. Secco,*[17] and the Fifth Circuit's decision in *Primerica Life Ins. Co. v. Brown,*[18] the Court

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[15] *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 444 n.1 (2006) ("The issue of the contract's validity is different from the issue whether any agreement between the alleged obligor and obligee was ever concluded. Our opinion today addresses only the former, and does not speak to the issue decided in the cases cited by respondents (and by the Florida Supreme Court), which hold that it is for courts to decide whether the alleged obligor ever signed the contract, *Chastain v. Robinson-Humphrey Co.*, 957 F.2d 851 (C.A.11 1992), whether the signor lacked authority to commit the alleged principal, *Sandvik AB v. Advent Int'l Corp.*, 220 F.3d 99 (C.A.3 2000); *Sphere Drake Ins. Ltd. v. All American Ins. Co.*, 256 F.3d 587 (C.A.7 2001), and whether the signor lacked the mental capacity to assent, *Spahr v. Secco*, 330 F.3d 1266 (C.A.10 2003).").

[16] Stephen J. Ware, *Arbitration Law's Separability Doctrine after* Buckeye Check Cashing, Inc. v. Cardegna, 8 NEV. L.J. 107, 118-119 (2007) (footnotes omitted).

[17] 330 F.3d 1266 (10th Cir. 2003).

[18] 304 F.3d 469, 471 (5th Cir. 2002).

picks *Spahr* because the Fifth Circuit reached "a decidedly different result" in *Will-Drill Resources, Inc. v. Samson Resources Co.*[19] and *Primerica* has been criticized for misapplying the separability doctrine. But *Will-Drill* repeatedly cites *Primerica* and discusses it approvingly,[20] and the results in the two cases are entirely consistent. Primerica holds that the issue whether a contract, though made, is invalid is for the arbitrator; *Will-Drill* holds that the issue whether a contract was ever made is for the court. And even if *Primerica* was mistaken in concluding that capacity was an issue for arbitration *simply because* it was a challenge to a contract as a whole, that does not mean that the result was incorrect. Again, Professor Ware summarizes:

> [C]ourts would hear questions about mutual assent, consideration, and authority to assent on behalf of others, while sending to arbitrators questions about misrepresentation (fraud in the inducement), mistake, duress, undue influence, incapacity, unconscionability, impracticability, frustration of purpose, the statute of frauds, the statute of limitations, illegality (or "public policy"), and expiration or termination. However, these latter issues are sent to the arbitrator only if they are challenges to the container contract as a whole; if they are "directed to the arbitration clause itself," then they are heard by courts.[21]

Apart from the merits of the issue, there is another reason to hold that mental incapacity is for the arbitrator: the Fifth Circuit has done so. This Court has emphasized in the past that "it is important for federal and state law to be as consistent as possible in [applying the FAA], because federal and state courts have concurrent jurisdiction to enforce the FAA."[22] Federal courts in Texas must follow the Fifth Circuit, and state courts must follow this Court. After today, whether an issue of mental capacity is for the court or arbitrator in the first instance will depend on whether arbitration is sought in state or federal court. Today's decision encourages the forum-shopping the Court has tried hard to avoid.

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[19] 352 F.3d 211, 219 (5th Cir. 2003).

[20] *Id*. at 214-215, 218 n.41-42.

[21] Ware, *supra* note 16, at 115-116 (footnotes omitted).

[22] *In re Kellogg Brown & Root, Inc.*, 166 S.W.3d 732, 739 (Tex. 2005).

As JUSTICE BRISTER points out, the matter may end up being a small one. Helen Taylor's guardian initially sued for breach of her contract with Morgan Stanley, then dropped that claim when he realized he could not stand on the contract and disavow the arbitration provision at the same time. The guardian now sues Morgan Stanley for breach of fiduciary duty arising out of the relationship between Taylor and Morgan Stanley, for recommending unsuitable transactions in violation of state securities laws, and for negligence. But the relationship between Taylor and Morgan Stanley was created and defined by their contract. If the guardian proves the contract was invalid, and Taylor and Morgan Stanley were simply strangers, it is not clear what duty Morgan Stanley owed or breached. The Court goes out of its way to work the guardian through the problems he has made for himself,[23] but in repudiating any contract to avoid arbitration, he may well have cut off his arbitration nose to spite his litigation face.

I respectfully dissent.

Nathan L. Hecht
Justice

Opinion delivered: July 3, 2009

[23] *Ante* at ___.