IN THE SUPREME COURT OF THE STATE OF MONTANA

Supreme Court No. DA 10-0359

RICHARD A. HILL and BETTI C. HILL, HILL-NORTH STAFFORD LLC, a Delaware limited liability company, R. HILL - OAK WOOD PLAZA, LLC, a Delaware limited liability company, B. HILL - OAK WOOD PLAZA LLC, a Delaware limited liability company, GEORGE L. STEVENS and GERTRUDE L. STEVENS, G. STEVENS-PINEHURST SQUARE WEST LLC, a Delaware limited liability company, G.L. STEVENS-PINEHURST ACQUISITION LLC, a Delaware limited liability company, G. STEVENS-OAK WOOD PLAZA LLC, a Delaware limited liability company, G.L. STEVENS OAK WOOD PLAZA LLC, a Delaware limited liability company, and VICTOR J. DONOVAN and RITA M. DONOVAN,

Plaintiffs and Appellants,

v.

JACK RAY SAUTHER, CHRISTOPHER JAMES NOLT, 1031 EXCHANGE SOLUTIONS LLC, a dissolved Montana limited liability company, MONTANA WEALTH MANAGEMENT LLC, a Montana limited liability company, INDEPENDENT FINANCIAL GROUP LLC, a Delaware limited liability company,

Defendants and Appellees.

BRIEF OF *AMICUS CURIAE*, MONICA J. LINDEEN, COMMISSIONER OF SECURITIES AND INSURANCE, MONTANA STATE AUDITOR

On Appeal from the Montana First Judicial District Court
In and For the County of Lewis and Clark
The Honorable Judge Wm. Nels Swandal Presiding

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I. STATEMENT OF ISSUE

This matter involves a pre-dispute arbitration clause in an agreement required by the defendant/appellee, securities broker-dealer Independent Financial Group LLC, and its agents or affiliates for the purchase of a security. The district court correctly found that the arbitration clause was in a contract of adhesion. The issue on appeal is whether the district court erred in granting the defendants' motion to compel arbitration.

II. STATEMENT OF THE CASE

This case involves an arbitration clause in a contract of adhesion required for the purchase of a security which, by its terms, would deprive Montana investors of their fundamental constitutional right of access to Montana courts, trial by jury, due process of law, equal protection of the laws, and other procedural due process rights. The appellees moved the district court to compel arbitration. In its order filed June 22, 2010, the district court granted the appellees' motion to compel arbitration. This is on appeal of the district court's order.

III. STATEMENT OF FACTS

The appellants' statement of facts, as set forth in their principal brief, is sufficient.

IV. SUMMARY OF ARGUMENT

The pre-arbitration clause at issue was contained in a contract of adhesion. However, the district court erred in its application of the facts of this case to Montana law, primarily, *Kloss v. Edward D. Jones*, 2002 MT 129, 310 Mont. 123, 54 P.3d 1, *cert. denied*, 538 U.S. 956 (2003). The *Kloss* decision is consistent with the requirements of the Federal Arbitration Act because the Act merely requires enforcement of arbitration provisions that may not be set aside by traditional contract defenses.

In its order compelling arbitration, the district court formulated its own standard for determining enforceability of adhesion contracts, *to wit*, that contracts of adhesion are "enforceable if the [c]ourt determines that the [investor] made an informed decision to accept the terms of the arbitration agreements." Dist. Ct. Order, Cause No. XADV 09-646, p. 3:22-23 (June 18, 2010), Exhibit 10 to Appellant's Brief. This informed decision standard is not supported by precedent.

Having determined that the arbitration clause was in a contract of adhesion, the district should have applied the *Iwen* standard: "a contract of adhesion will not

be enforced against the weaker party when it (1) is not within the reasonable expectations of said party or (2) is within the reasonable expectations of said party but, when considered in its context, is unduly oppressive, unconscionable, or against public policy." *Iwen v. U.S. West Direct*, 1999 MT 63, ¶27, 293 Mont. 512, 977 P.2d 989; *Kloss*, ¶24. Here, the pre-arbitration clause was not within the appellants' reasonable expectation or it was unduly oppressive, unconscionable, or against public policy. Appellants did not voluntarily, knowingly, and intelligently waive their fundamental constitutional rights. The pre-arbitration clause is unenforceable against these appellants. The district court's order compelling arbitration should be reversed.

V. ARGUMENT

A. Standard of Review

The standard of review of a district court's disposition of a motion to compel arbitration is *de novo*. *Woodruff v. Bretz, Inc.*, 2009 MT 329, ¶5, 353 Mont. 6, 218 P.3d 486; *Howard Elec. and Mechanical Co., Inc. v. Frank Briscoe Co., Inc.*, 754 F. 2d 847, 849 (9th Cir. 1985). A district court's conclusions of law in this context are reviewed for correctness. *Martz v. Beneficial Mont., Inc.*, 2006 MT 94, ¶10, 332 Mont. 93, 135 P.3d 790.

B. The District Court Erroneously Granted the Motion To Compel Arbitration

The district court was correct in its determination that the pre-arbitration clause at issue was contained in a contract of adhesion. However, the district court erred in its application of the facts of this case to settled Montana case law because it did not sufficiently follow this Court's analysis as set forth in *Kloss*, and because it incorrectly determined that the pre-arbitration clause was within the reasonable expectations of the appellants.

Arbitration is a matter of contract, and a party cannot be required to submit to arbitration a dispute which she has not agreed to submit. *Solle v. Western States Ins. Agency*, 2000 MT 96, ¶22, 299 Mont. 237, 999 P.2d 328. "A written agreement to submit to arbitration any controversy arising between the parties after the agreement is made is valid and enforceable except upon grounds that exist at law or in equity for the revocation of a contract." Mont. Code Ann. § 27-5-114(2) (2010). Generally applicable contract law defenses may be used to set aside arbitration agreements. *See Solle*, ¶23; *State ex rel. Bullock v. Philip Morris, Inc.*, 2009 MT 261, ¶15, 352 Mont. 30, 217, P.3d 475; *Iwen*. The threshold inquiry is whether the parties agreed to arbitrate the dispute. *Solle*, ¶22; *Bullock*, ¶15.

In determining whether the parties agreed to arbitrate the dispute, the first determination in the *Kloss* analysis is whether the contract containing the

arbitration clause is a contract of adhesion. *Eg.*, *Woodruff*, ¶8, *Kloss*, ¶23, *Iwen*, ¶28. While the district court correctly determined that the contract containing the arbitration clause was adhesive, it did not proceed to the next stage of the *Kloss* analysis. Instead, the district court pronounced a new standard of enforceability of pre-arbitration dispute provisions as follows: that contracts of adhesion are "enforceable if the [c]ourt determines that the [investor] made an informed decision to accept the terms of the arbitration agreements." Dist. Ct. Order, Cause No. XADV 09-646, p. 3:22-23 (June 18, 2010), Exhibit 10 to Appellants' Brief.

Next, the district court appears to have applied what it labeled the "four *Larsen* factors" in order to determine whether the appellants made an informed decision to accept the terms of the arbitration agreement. Dist. Ct. Order, Cause No. XADV 09-646, p. 3:23-24 (June 18, 2010), Exhibit 10 to Appellants' Brief. The "four *Larsen* factors" are (1) whether the agreement was a standardized agreement, (2) whether the agreement was prepared by the superior party, (3) whether the weaker party had no opportunity to negotiate its terms, and (4) whether the superior party explained the agreement to the weaker party. *Larsen v. W. States Ins. Agency*, 2007 MT 270, ¶14, 339 Mont. 407, 170 P.3d 956; *Kloss*, ¶¶23-24, 27-28. However, as is clear from the *Larsen* opinion, the *Larsen* factors are not to be used to determine whether a party made an informed decision, but for determining whether the contract is adhesive. *Eg.*, *Larsen*, ¶14.

Applying the *Larsen* factors in its analysis, the district court determined that the agreement was a standardized agreement prepared by the superior party, acknowledged that the appellants had no opportunity to negotiate its terms by unrealistically criticizing the appellants for failing to do so, and acknowledged that the arbitration clause was not explained to the appellants. The remaining analysis of the lower court seems to be, essentially, a lecture to the appellants apparently premised on the lower court's buyer beware approach, despite the body of law established by this Court for interpreting cases such as these. The district court opined that the reasonable expectations argument raised by the plaintiffs had "no basis in law or fact," and that the argument raised by the plaintiffs that they did not knowingly waive their constitutional rights to a jury trial and access to the court system was "without support, in equity or law." Exhibit 10 to Appellants' principal brief, page 5.

On the contrary, the doctrine of reasonable expectations is part of the *Kloss* analysis. Moreover, this Court has held that the "waiver of fundamental constitutional rights must be voluntary, knowing, and intelligent." *Woodruff*, 2009 MT 329, ¶15, *citing*, *Kortum-Managhan v. Herbergers NBGL*, 2009 MT 79, ¶¶26-27, 349 Mont. 475, 204 P.3d 693. Furthermore, "it is inappropriate to consider the express written arbitration clause alone as evidence that the weaker party expected to arbitrate any disputes." *Larsen*, ¶16. Although the district court seems to have

considered other factors, those factors seem to mitigate in favor of the appellants' lack of reasonable expectation rather than to support the district court's conclusory determination that arbitration was within the reasonable expectations of the appellants.

The informed decision rule pronounced by the lower court is not part of the *Kloss* analysis and is not supported by case or statutory law. Instead, having first determined that the contract was adhesive, the district court should have applied the following rule: "a contract of adhesion will not be enforced against the weaker party when it (1) is not within the reasonable expectations of said party or (2) is within the reasonable expectations of said party but, when considered in its context, is unduly oppressive, unconscionable, or against public policy." *Iwen*, ¶27; *Kloss*, ¶24. The district court's conclusion that arbitration was within the reasonable expectations of the appellants was devoid of analysis and the lower court, having determined that arbitration was within the appellants' reasonable expectations, failed to apply prong two of the foregoing rule.

1. Facts exist upon which this Court may find that the arbitration provision was not within the appellants' reasonable expectations

The district court does not appear to have considered the facts in light of the reasonable expectations doctrine developed by this Court; however, facts exist

upon which this Court may determine that the pre-dispute arbitration provision was not within the appellants' reasonable expectations.

> The fact that an arbitration clause is contained in the contract does not by itself establish the weaker party's reasonable expectations. To hold otherwise would defeat the protections provided by principles of law pertaining to contracts of adhesion. Indeed, if the only question was whether the written terms of the contract included the challenged provision, then reasonable expectations would never be an issue and contracts of adhesion would always be enforced based on their plain language without regard to what the consumer knew or understood.
>
> Instead, reasonable expectations derive from all of the circumstances surrounding the execution of the contract, such as the consumer's business experience and sophistication, any routine practice between the parties established through prior dealings, whether the consumer studied the agreement and comprehended its terms, whether the consumer had the advice or representation of counsel, and whether the challenged provision and the consequences of the provision were fully and adequately explained to the consumer.
>
> *Woodruff*, ¶15, *citing*, *Kloss*-29; *Denton*, ¶34; *Larsen*.

It would appear from the record of the lower court proceedings, as argued in the appellants' principal brief, that (1) the appellants were not sophisticated investors, (2) they did not have a long-standing business relationship with the appellees, (3) the appellants were not represented by counsel, and (4) the pre-dispute arbitration provision and its consequences were not explained to the appellants. Whereas in *Larsen* the plaintiff had some 20 years of experience in the securities business, here, the appellants' experience was minimal. Instead, the

appellants were pressured to sign the agreement by the appellees with claims that the security was going fast. Further, the appellants did not reasonably expect to have to arbitrate their fraud claims and did not understand the extent to which they would be giving up their constitutional rights. The district court did not apply the foregoing standard; it used its own informed decision standard. The district court erred in its application of the law to the facts and reached an erroneous conclusion regarding the appellants' reasonable expectations. The district court should be reversed.

2. When considered in its context, the pre-dispute arbitration provision was unduly oppressive, unconscionable, or against public policy

Having determined that the arbitration clause was contained in a contract of adhesion, the district court should have then considered whether the provision was unduly oppressive, unconscionable, or against public policy.

a. Unconscionability

When considered in its context, the pre-dispute arbitration provision was unconscionable. Unconscionability requires a two-fold determination: (1) that the contractual terms are unreasonably favorable to the drafter, and (2) that there is no meaningful choice on the part of the other party regarding acceptance of the provisions. *Iwen*, ¶31.

Here, the contractual terms of the arbitration provision were unreasonably favorable to the appellees because the terms required the appellants to waive their fundamental constitutional rights to their day in a Montana court of law, and subjected them to a forum favorable to the appellees as a condition precedent to purchasing the security.

Clearly, the facts indicate that the appellants, or some of them, were asked to sign a document titled IFG Account Application and Agreement, a pre-printed form that contained a pre-dispute arbitration clause. The document was provided by the appellees without any choice given to the appellants to negotiate the terms or accept the provisions. It was presented as one of the documents requiring signature to complete the securities transaction. Although the unconscionability issue was raised by the appellants below, it was not considered by the district court. The district court's decision should be reversed and the pre-arbitration clause should be stricken as unconscionable.

b. Public Policy

This Court may note that the security at issue was offered to Montana investors under the Rule 506 exemption of Regulation D of the Securities Act of 1933 that preempts states from any regulatory review. 17 C.F.R. § 230.501, *et seq*. Under the federal exemption, these types of securities offerings may only be offered to sophisticated and accredited investors. The sale of the security at issue

affected 80 Montana investors and involved approximately $32 million dollars in investments.

DBSI was one of the top five tenants-in-common ("TIC") sponsors in the industry, having raised billions of dollars since its inception, including hundreds of millions of dollars every year for the last few years alone before seeking the protection of bankruptcy court in Delaware on November 10, 2008. As a result of its offering, the issuer of the security, DBSI, is faced with regulatory and civil lawsuits which allege that the issuer engaged in securities fraud, banking fraud, tax fraud, and racketeering. A class action suit alleges that DBSI engaged in a Ponzi scheme in which proceeds of sales from new properties were used to make guaranteed payments on existing properties. In their complaint, the appellants alleged that the broker-dealer appellant herein committed misrepresentation in violation of the Securities Act of Montana in the offering of the security at issue.

The Securities Commissioner has a duty to protect Montana investors, persons engaged in securities transactions, and the public interest relative to the enforcement of the Securities Act of Montana, Mont. Code Ann. § 30-10-101, *et seq*, (the "Act). It is the policy of the State of Montana to prevent the exploitation of elderly persons. Mont. Code Ann. § 52-3-802. Appellees sold DBSI TIC products, and they marketed, solicited and sold these TIC interests to Montana residents, and conducted those activities in the state of Montana. Like many of the

Montana investors, the appellants were senior citizens, or older age investors, who relied on these investments to live independently in their retirement. DBSI, through its numerous business relationships, solicited these TICs to Montana residents. Should this Court's established precedent relating to pre-dispute arbitration provisions be ignored or eroded, all Montana investors and particularly our older people may be forced to endure an unduly oppressive investment environment or one promoting exploitation without recourse to our courts of law.

The Act is remedial in nature and its primary concern is to protect the investing public. Because of this, it is broadly construed to effect its remedial purpose.

> [A]rbitration imposed by pre-dispute clauses in contracts of adhesion which, as a practical matter, the non-drafting parties have no real power to avoid or disapprove - will, if allowed to continue unchecked, largely deprive American courts of the ability to play the important social role they played so effectively throughout the last century. And it will take away, from those individuals and enterprises who need it most, the protection of the law. Whatever else arbitration may be, it is not "law" – the kind of findable, studiable, arguable, appealable, [r]estateable kind of law that has characterized the [c]ontract area for over a century. . . Maybe this process can't be stopped, but at least we should recognize it for what it is: the abdication of any public responsibility for justice based on something more than raw economic power.
>
> Charles L. Knapp, Taking Contracts Private: The Quiet Revolution in Contract Law, *71 Fordham L. Rev. 761* (2002).

In Montana, investors are guaranteed fundamental rights under the Constitution. "The right of trial by jury is secured to all and shall remain inviolate." Art. II Section 26, Montana Constitution. The fundamental right to due process is guaranteed by Art. II Section 17, and the right to equal protection is secured by Art. II, Section 4 of the Montana Constitution.

> Arbitration clauses, by their very nature, waive a consumer's fundamental constitutional rights to trial by jury, access to the courts, due process of law and equal protection of the laws. (Thus, the waiver of a fundamental constitutional right must be proved to have been made voluntarily, knowingly and intelligently.) In his specially concurring Opinion in *Kloss*, Justice Nelson stated, and a majority of the Court agreed, that for a fundamental right to be effectively waived, a consumer must be informed of the consequences before personally consenting to the waiver; waiver of a fundamental right would not be lightly presumed.
>
> *Kortum-Managhan*, ¶26.

The district court addressed the issue of whether the appellants waived their fundamental rights with the following conclusion: "The argument that the arbitration provision is unenforceable because the plaintiffs did not knowingly waive their constitutional rights is without support, in equity or law." Appellants' Exhibit 10, page 5.

> In determining whether an individual deliberately, understandingly and intelligently waived their fundamental constitutional rights to trial by jury and access to the courts, a majority of this Court concluded in *Kloss* that courts should consider the totality of the following factors:
>
> whether there were any actual negotiations over the waiver provision; whether the clause was included on a take-it-or-leave-it basis as part of a

> standard-form contract; whether the waiver clause was conspicuous and explained the consequences of the provision (e.g. waiver of the right to trial by jury and right of access to the courts); whether there was disparity in the bargaining power of the contracting parties; whether there was a difference in business experience and sophistication of the parties; whether the party charged with the waiver was represented by counsel at the time the agreement was executed; whether economic, social or practical duress compelled a party to execute the contract (e.g. where a consumer needs phone service and the only company or companies providing that service require execution of an adhesion contract with a binding arbitration clause before service will be extended); whether the agreement was actually signed or the waiver provision separately initialed; whether the waiver clause was ambiguous or misleading; and whether the party with the superior bargaining power lulled the inferior party into a belief that the waiver would not be enforced.
>
> *Kortum-Managhan*, ¶27, (*citing Kloss*).

Here, there were no negotiations over the waiver provision; the clause was included on a take-it-or-leave-it basis as part of a standard-form contract; the consequences of the waiver provision such as the right to trial by jury and right of access to the court were not explained to the appellants; there was disparity in the bargaining power of the contracting parties; there was a difference in business experience and sophistication of the parties; the appellants were not represented by counsel at the time the agreement was executed; and the appellants were pressured to purchase the security by representations that it was a good investment and was going fast. Thus, there are facts appearing that would indicate that the appellants did not knowingly waive their constitutional rights.

VI. CONCLUSION

Based upon the foregoing, and upon the reasons set forth in the appellants' brief, it is respectfully submitted that the district court's order compelling arbitration should be reversed and this matter be remanded to the district court.

RESPECTFULLY SUBMITTED this 7th day of March, 2011.

MONICA J. LINDEEN
Commissioner of Securities and Insurance
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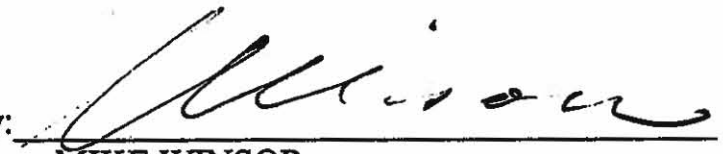
By: 

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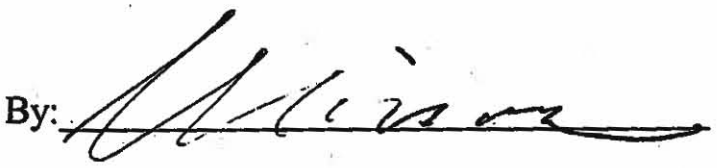
CERTIFICATE OF COMPLIANCE

Pursuant to Rule 27 of the Montana Rules of Appellate Procedure, I certify that this Brief is printed with a proportionately spaced Times New Roman text; typeface of 14 points; is double spaced; and the word count calculated by Microsoft Word 2007 is 3,687, not averaging more than 280 words per page, excluding caption, certificate of compliance, and certificate of service.

By: 

CERTIFICATE OF SERVICE

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