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California Court of Appeals Holds That an Action to Challenge the Validity of Director Elections May Be Based on an Alleged Breach of Fiduciary Duty

A California Court of Appeals has considered the scope of Section 709 of the California Corporations Code, under which a shareholder may challenge the validity of the election of directors of a California corporation, and held that a challenge to the election may be based on alleged breaches of fiduciary duties, not simply procedural matters.[1] The court considered the issue in the context of a case involving a family feud in a privately held company, offering a fascinating glimpse into the procedural machinations of an attempted private company takeover.

Background

The plaintiff Ann Morrical, filed suit to challenge the election of new directors of two family-owned companies by the respective boards of directors of those companies, arguing that her two brothers, Mike and John McGraw, who were, along with Ann, the directors of these two companies, had a material financial interest in the transactions resulting from the election, and that these transactions were unfair to the corporations and to her as a minority shareholder. While the facts in this case are complex, they are noteworthy in the context of evaluating the court of appeals' ruling on the scope of a challenge to an election under Section 709, as well as instructive for those involved as officers, directors or advisors to family-owned companies where contests for control generally require changes to charter documents and board composition.

Parents Jack and Joan McGraw transferred ownership of two sister companies and a wholly owned subsidiary to their children, Ann, John and Mike, who became the sole and equal shareholders, as well as the sole directors, of the companies. These siblings had a buy/sell agreement allowing them to buy shares at a discounted price before the shares could be sold to any third party, and their parents had a preemptive right to buy the shares at an even greater discount before the shares of one of the companies could be sold to a third party. Mike served for some time as Chief Executive Officer of the companies. In 2009 Mike was accused of misuse of corporate funds for personal expenses by his chief financial officer, who resigned upon making this allegation. An audit showed, in Ann's view, that there was "substantial abuse of corporate funds by Mike for personal use." The parents tried to negotiate a resolution of the dispute and threatened to assign or sell their preemptive rights to pressure the siblings to come to some agreement.

Instead, in November 2009 Ann and John voted to remove Mike as president and chief executive officer of the companies, and to remove the father, Jack, and two other directors from the subsidiary board. In addition, the chief

[1] *Morrical v. Rogers*, 220 Cal. App. 4th 438; 163 Cal. Rptr. 3d 156 (Oct. 10, 2013).

financial officer who had previously resigned was rehired as vice president of corporate risk and finance; additional non-family management was also hired, and in February 2010 phantom stock plans (PSPs) were adopted for the companies' managers giving them immediately vested equity interests in the companies payable on a change of control, designed as a retention and incentive tool. At about the same time, the parents sold their preemptive rights to Mike. In March 2010 Mike sued Ann and John for breach of fiduciary duty, conspiracy and waste of corporate assets relating to the adoption of the PSPs (the PSP action). John and Ann cross-complained, alleging the assignment of preemptive rights by the parents was void, and amounted to a forfeiture of Mike's and the parents' rights; one of the companies also sued Mike alleging that the sale of the preemptive rights was a misappropriation of a corporate opportunity.

The court considered the issue in the context of a case involving a family feud in a privately held company, offering a fascinating glimpse into the procedural machinations of an attempted private company takeover.

In August 2011 a management company, Altamont Capital Management, LLP, and its private equity affiliate, Altamont Capital Partners (collectively, Altamont), whose respective principals had personal relationships both with Mike and with the father, Jack (and one of whom had been one of the directors removed from the subsidiary in November 2009), proposed a variety of potential transactions for the acquisition of Mike's shares in the companies. Instead of any of these deals, however, in early 2011 the brothers Mike and John entered into a series of transactions with Altamont:

- an agreement to amend the bylaws and articles of incorporation of the companies to increase the size of each board to 8 directors, to require approval by holders of a majority of a Company's stock before it or its subsidiary could take actions such as issuing new stock, incurring indebtedness greater than $25 million, or authorizing a merger or a sale of more than 40 percent of the assets outside the McGraw Group;
- an agreement to vote Jack and Mike's shares to ensure that Altamont shall be entitled to designate 5 candidates to be elected as members of the board and to maintain the size of the board at 8 directors;
- indemnification agreements for all directors;
- a management agreement under which Altamont would provide management consulting services to the companies and subsidiary for $500,000 per year;
- loans of $4 million and $2 million, respectively, from an Altamont affiliate to Mike and John, pledging stock of one of the companies as collateral;
- cash settled option rights granted to the Altamont entity making the loan by each of Mike and John in exchange for payments to them of almost $2 million and $1 million, respectively, by the Altamont entity;
- an expense agreement by which Mike and John would pay the Altamont entity making the loan certain expenses; and
- an agreement for the sale to one of the companies of Mike's assignment of preemptive rights he had received from his parents in exchange for $500,000 paid to a charity he designated.

Mike and John then noticed a joint special board meeting on February 28, 2012 for the companies to consider the amendments to the companies' articles of incorporation and bylaws to affect these changes, the approval and adoption of the management and director indemnification agreements, the appointment of officers, and the purchase by Western of Mike's assignment of preemptive rights. Ann sought to enjoin the meeting unsuccessfully. On March 12, 2012, the trial court denied Ann's request to enjoin the board actions, and subsequently that day the joint board meeting took place; the boards of the companies approved the transactions requiring board approval. The boards then elected five Altamont designees as directors of each of the companies.[2]

[2] Interestingly, also on March 12, 2012, the court handling the PSP action considered a proposal for the settlement of the PSP action and Western's suit about the assignment of the preemptive rights. Ann opposed the settlement. The court declined to approve the settlement, stating that "It does not appear to be in the best interest of the company and the shareholders and is contrary to the Buy-Sell

After the election of the Altamont directors by the companies' boards, those boards each appointed one of those directors as chairman of each of the companies, for which he was compensated $200,000 per year, plus an annual bonus of $100,000 per year (guaranteed the first year). The directors of each of the companies also created an Executive Committee to deal with matters delegated by the board (functioning as a single body), and authorized the executive committee to consider updates to the companies' bylaws, consider the sufficiency of controls over key company functions, take actions as to the PSP action; review performance of managers under the PSPs, and consider the composition of the subsidiary board. In April 2012, the Executive Committee decided to reimburse Mike for legal fees he had incurred in the PSP action since the date he had indicated he wanted to settle the case. The Executive Committee also terminated certain of the companies' non-family management and terminated the PSPs, and appointed an Altamont director as chief executive officer of each of the companies and the wholly owned subsidiary. In May 2012, the Executive Committee revised the board of the wholly owned subsidiary to elect the Altamont directors.

Section 709 Action

On May 2, 2012, Ann sued Altamont management and the Altamont directors under Section 709, asking the court to invalidate the March 12, 2012 election and related relief, including setting aside all actions taken by the Altamont directors. She argued that Mike and John were disqualified from voting in the election because they had "material financial interests" due to the loans from Altamont and the cash settled stock option agreements, in the decisions to expand the boards, elect the Altamont directors, and adopt the management agreement with Altamont, which she claimed was unfair to the companies. She alleged that the election was invalid under Section 310.

Altamont moved for judgment on the pleadings, and argued that the action should be dismissed, inter alia, because Mike and John had not been joined; the trial court denied that motion. After a trial on the merits, the trial court held, without issuing a statement of decision, that Ann had met her burden showing that the election was invalid due to the financial interests of Mike and John, and that the Altamont directors had not showed that the actions were "just and reasonable" to the companies.

> *It is well established that section 709 and its predecessor statutes afford an equitable cause of action.*

Altamont then appealed, arguing that the conflict of interest and breach of fiduciary duty claims raised by Ann as grounds for challenge to the election were not proper grounds for a section 709 action.

Section 709 provides

> "(a) Upon filing of an action therefore by any shareholder or any person who claims to have been denied the right to vote, the superior court of the proper county shall try and determine the validity of any election or appointment of any director of any domestic corporation. . . .
>
> (b) Upon the filing of the complaint, and before any further proceedings are had, the court shall enter an order fixing a date for the hearing, which shall be within five days unless for good cause shown a later date is fixed, and requiring notice of the date for the hearing and a copy of the complaint to be served upon the corporation and upon the person whose purported election or appointment is questioned and upon any person (other than the plaintiff) whom the plaintiff alleges to have been elected or appointed. . . .
>
> (c) The court may determine the person entitled to the office of director or may order a new election to be held or appointment to be made, may determine the validity, effectiveness and construction of voting agreements and voting trusts, the validity of the issuance of shares and the right of persons to vote and may direct such other relief as may be just and proper."

Agreement." Mike challenged this ruling by writ petition, which was denied. Thus, the case continues.

As the court of appeals notes, it is well established that section 709 and its predecessor statutes afford an equitable cause of action. The defendants noted, however, that the statute authorizes only a shareholder or a person who claims to be denied the right to vote to initiate the action under section 709. The defendants therefore argued that this language implies the action is limited to voting and similar electoral process issues. The court of appeals rejected this argument, however, noting that "nothing in the plain language of section 709 restricts the grounds on which the validity of an election or appointment of directors can be challenged." The court explained that "the plain language restricts only *standing* to bring an action, but says nothing about the *grounds* on which a person with standing can challenge the validity of an election."

Defendants also argued that section 709(c) restricts the grounds on which the validity of an election can be challenged. The court rejected this argument as well, explaining that the provision "addresses the 'relief' a court may direct in a section 709 proceeding, not the grounds on which the validity of an election or appointment may be challenged. The subdivision includes a nonexhaustive list of appropriate forms of relief and a savings clause that provides the court 'may direct such other relief as may be just and proper.'"

The statute provided for "a proceeding in equity to determine all questions which may affect the validity of a contested election..."

Beyond the plain statutory language of section 709, the court also examined the legislative history, case law applying the statute and its predecessors and due process considerations, and concluded that "a trial court may properly consider breach of fiduciary duty and conflict of interest allegations in determining a corporate electoral challenge brought under section 709." The court noted that "courts have repeatedly held that an election may be challenged on any ground in a section 709 or predecessor action, and issues comparable to breach of fiduciary duty have been decided in [such] actions." Cases interpreting predecessor statutes have noted that the statute provided for "a proceeding in equity to determine *all questions which may affect the validity of a contested election*. . . . The only restriction is that the court will not decide issues unrelated to the validity of the election: 'Matters of corporate behavior, dealing with corporate management, general accounting, etc. cannot be considered *unless they affect the validity of the election*.'" [citations omitted].

Governance of family corporations can tie families together long after the family relationship has been strained to breaking point. In such cases, the business and the employees can suffer while the family struggles for control.

The appellate court then considered the trial court's denial of the motion by Altamont that Mike and John should have been joined as indispensable parties. The statute provides that the persons to be served by a plaintiff shareholder are "the corporation, the persons whose election is under challenged and any other person whom plaintiff claims is elected or appointed. " Notwithstanding the statute, the California Court of Appeals held in this case that the brothers Mike and John were additional indispensable parties who had to be joined. The court reviewed the complicated "family feud" that gave rise to this case, ultimately holding that the plaintiff's brothers, "whose alleged self-interest and breach of fiduciary duty to [the plaintiff] and to [the companies] . . . formed the necessary predicate for [plaintiff's] challenge to the election" must be joined, because a judgment might be prejudicial to these brothers. Accordingly, because indispensable parties were not joined, the court reversed the lower court decision without reaching the merits of the lower court's decision.

Takeaways

Although Section 310 is implicated in this election because the election was by the board, it is worth noting that this argument would not be relevant in a shareholder election. Directors are obligated to act in the best interests of the corporation, and Section 310 provides for voiding director actions where directors have material financial interests, unless the actions are approved by disinterested directors or the shareholders not interested in the action. Shareholders, however, are able to act in their own personal interests.

Beyond the useful review of Section 709 and clarification of the expansive grounds that may be used to challenge a director election, this decision provides an interesting case study of the problems that arise in family-owned companies where sibling disputes can lead to warfare affecting the corporation and the business. Governance of family corporations can tie families together long after the family relationship has been strained to breaking point. In such cases, the business and the employees can suffer while the family struggles for control.

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Where there is a thoroughly marketed and procedurally sound auction process free of fiduciary irregularities, a sales price may be a reliable indicator of value in an appraisal proceeding.

Recent Delaware Appraisal Proceeding Provides Guidance on Acceptable Valuation Methodologies

A recent decision of the Delaware Chancery Court should be of interest to companies defending appraisal actions, as well as stockholders considering an appraisal proceeding in lieu of accepting the per share consideration offered in an acquisition transaction. *In Huff Fund Investment Partnership v. CKx, Inc., No. 6844-VCG (Del. Ch. Nov 1, 2013)*, Vice Chancellor Glasscock held that in the absence of any viable alternative methodologies, it was appropriate to use the merger price to determine fair value of the acquired company. This holding clarifies that where there is a thoroughly marketed and procedurally sound auction process free of fiduciary irregularities, a sales price may be a reliable indicator of value in an appraisal proceeding. Nonetheless, the unique circumstances that made other valuation methodologies unreliable in the underlying proceeding also suggest that the conditions under which a future court might rely on merger price are limited. Furthermore, the merger price is still presumed to include some value related to synergies of the merger. Thus, in an appraisal proceeding to determine a company's going-concern value, even if the merger price is deemed the accurate measure of fair value of a company in an acquisition context, in calculating the appraisal price the merger price would need to be reduced by the value attributable to the merger-related synergies.

Valuation Methodologies Found Lacking

In *Huff*, the Vice Chancellor was tasked with determining fair value of the shares of CKx, Inc., as a going concern. CKx, prior to its acquisition through merger, had been a publicly traded company focused on obtaining rights in "iconic entertainment properties." Among CKx's key holdings, and possibly its most valuable, were the rights to the *American Idol* television show (which together with its related assets represented approximately 60-75 percent of Cox's cash flow). More importantly, at the time of the acquisition, CKx was in the middle of negotiating the renewal terms of an expiring agreement with Fox, the show's network distributor, relating to the future of the *American Idol* franchise. The outcome of these negotiations, and thus CKx's then-current value, was uncertain and highly speculative.

The uncertainty surrounding the negotiations with Fox also meant that valuations proposed by the plaintiff stockholders and the defendant CKx were unreliable. The plaintiffs had proposed valuations based on a comparable transactions methodology and a discounted cash-flow (DCF) methodology, and defendant proposed a valuation based on a DCF methodology. In preparing the comparable transaction analysis, the plaintiff's expert had been unable to find any companies of comparable size or with a similar asset base as CKx, or in competition with or using a comparable business model to CKx, and had instead extrapolated values based on companies he deemed as closely related as possible, referring to them as "guidelines."

Under the principle that the utility of a comparable transaction analysis is dependent on the similarities between companies being prepared, and finding that none of the "guideline" companies used were truly comparable, Glasscock rejected the plaintiff's comparable transactions valuation as unreliable.

The merger price would need to be reduced by the value attributable to the merger-related synergies.

Similarly, Vice Chancellor Glasscock dismissed both the plaintiffs' and defendant's competing DCF valuations as based on unreliable and speculative inputs. For Glasscock, the principal issue with the DCF valuations revolved around management's financial projections. Acknowledging that under Delaware appraisal law, "[w]hen management projections are made in the ordinary course of business, they are generally deemed reliable," Glasscock also noted that it was appropriate to disregard management's projections "where the company's use of the projections was unprecedented, where the projections were created in anticipation of litigation, or where the projections were created for the purpose of obtaining benefits outside the company's ordinary course of business." Here, as would be expected, management's projections included an estimate of the potential *American Idol* licensing revenue from Fox, but Glasscock found them to be relatively "optimistic," and rather than reflecting management's estimate of the most likely outcome of the Fox negotiations, it was an inflated estimate designed to result in short-term value for CKx through a potentially higher merger price.

Because the value of the *American Idol* licensing revenues used in plaintiffs' DCF analysis was speculative, Glasscock found the outcome also speculative and unreliable. Notwithstanding, Glasscock also found that it was appropriate to attribute some value to the *American Idol* asset and thus also rejected defendant's DCF valuation, which attributed only marginal value to the outcome of the negotiations, on the basis it undervalued the potential revenue and other related remuneration tied to the *American Idol* contract.

Finally, Glasscock found that for the same reasons that management was unable to confidently predict the outcome of the Fox negotiations, he too was also unable to determine the potential future cash flows from *American Idol*. Although it was agreed the outcome of the Fox negotiations on potential licensing revenues had a potential estimated range of $20 million, the evidence suggested that management itself believed predicting the outcome of these negotiations to be "little more than guesswork." The Vice Chancellor concluded that the negotiations represented a "one-time, unpredictable, irreversible and immitigable" event, "beyond [CKx's] control" and "involving idiosyncratic actors making decisions" that would have a "significant" impact on CKx's per-share value. In such circumstances, Glasscock held that the unreliability of revenue estimates was a "serious impediment," and that a DCF analysis could not be a reliable method of valuation.

Merger Price as Alternative Valuation Method

Having rejected the valuations proposed by plaintiffs and defendant, and concluding that the court could not independently perform a DCF analysis due to speculative inputs, Vice Chancellor Glasscock then discussed whether it was appropriate, under current Delaware appraisal law, to rely solely on merger price as the indicator of enterprise value. As Glasscock notes, the Delaware Supreme Court has held that the appraisal process is intended to be flexible, the Court of Chancery has a statutory mandate to consider "all relevant factors" in conducting an appraisal proceeding, and that "an arms-length merger price resulting from an effective market check is entitled to great weight in an appraisal."

Drawing on these general principles, Glasscock reviewed the auction process employed by CKx, highlighting the thorough market check and the integrity of the auction process. In such instances, Glasscock concludes that for a law-trained judge to second guess the final merger price is "at best, reasoned guesswork" and in this instance, using the merger price as the primary factor in determining the fair value of CKx shares is justified. This conclusion, however, came with a significant caveat: "the absence of any other reliable valuation analysis."

Conclusion

In *Huff*, Glasscock takes care to stress how CKx was uniquely situated, both in terms of a unique business model and incomparable revenue generating asset base, but also in relation to a significant and material event outside the control of the company, which would have substantial and unpredictable outcome on the value of the company. The only other example cited by the court of a similarly appropriate circumstance in which the court both disregarded the competing DCF valuations of the parties as based on speculative revenues and concluded that the court could not itself reasonably determine cash flows for its own DCF analysis was a case related to uncertainties of predicting the financial performance of a travel and booking website in the aftermath of the September 11, 2001 terrorist attacks.

For a law-trained judge to second guess the final merger price is "at best, reasoned guesswork."

It thus seems unlikely that the merger price will be used as the primary indicator of fair value where there are reasonably defensible inputs to a comparable transactions or DCF valuation. Note that even if the merger price is deemed the measure of fair value, the appraisal price still needs to exclude synergies resulting from the merger that are reflected in the merger price. Even if there are no meaningful synergies to be backed out, after deducting the not-insignificant expenses of an appraisal proceeding, the consideration paid to such a stockholder is less than what would have been paid had they accepted the merger consideration.

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Fall 2013 SEC Whistleblower Award Orders Will Likely Lead to a Substantial Increase in Tips and Complaints in 2014

On November 15, 2013, the US Securities and Exchange Commission released its 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program. According to the report, the number of whistleblower tips and complaints the SEC receives annually increased from 3001 in the 2012 fiscal year to 3239 in the 2013 fiscal year. Based on the publicity and incentives created by the SEC's fall 2013 whistleblower awards, the number of tips, complaints and awards is likely to increase substantially in 2014. Companies that wish to remain the first responders to such employee complaints should consider enhancing their internal reporting mechanisms and educating employees about the benefits of reporting internally.

The SEC's Whistleblower Award Program

Section 21F of the Securities Exchange Act of 1934 (Securities Whistleblower Incentives and Protection), enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, became effective on July 21, 2010, and the SEC promulgated Rules 21F-1 through 21F-17 thereunder on August 12, 2011. Under these provisions, whistleblowers are eligible for an award ranging from 10 to 30 percent of the total sanctions obtained in an SEC enforcement action if they voluntarily provide "original information" that "leads to the successful enforcement by the Commission" of an action "[i]n which the Commission obtains monetary sanctions totaling more than $1,000,000."[1]

"Original information" is information "derived from the independent knowledge or analysis" of the whistleblower, which is not otherwise "known to the Commission from any other source."[2] Such information "leads to the successful enforcement" of an action if it: (i) causes the SEC to open or reopen an investigation or to investigate different conduct as part of an ongoing investigation, and the information leads to a successful enforcement action based in whole or in part on conduct that was the subject of the original information or (ii) concerns conduct that is already under investigation and the information significantly contributes to the success of an action.[3]

The Whistleblower Program and Internal Reporting

Companies should be mindful that Section 21F of the Exchange Act does not require employees to report information internally before informing the SEC. An employee can simply bypass internal compliance, report directly to the SEC and remain eligible for an award. The obvious concern for companies is that direct reporting to the SEC could prompt an expensive and public investigation without first providing the company with a fair opportunity to investigate the alleged misconduct, resolve any misunderstandings and, if circumstances require, to fully demonstrate its cooperation with the SEC and its culture of compliance.

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[1] 17 C.F.R. § 240.21F-3(a).

[2] Dodd-Frank § 922, 15 U.S.C. § 78u-6(a)(3).

[3] 17 C.F.R. § 240.21F-4(c).

Nevertheless, the SEC provides meaningful incentives for whistleblowers to report internally. Whistleblowers who first report internally will still be deemed to have provided "original information" if they report the same information to the SEC within 120 days. Moreover, if a whistleblower's internal complaint triggers an internal investigation by the company and the company then reports its findings to the SEC, the whistleblower will benefit from all the information provided by the company after its internal investigation. The SEC will also consider whether the whistleblower reported internally in determining the amount of the award.

First Awards Under the Whistleblower Program

SEC whistleblower awards before September 30, 2013 were rare and relatively modest in value. The first payment under the program, which the SEC announced in August 2012, was for approximately $50,000 to a whistleblower who helped stop an alleged multi-million dollar fraud. The next payments, which the SEC announced in August 2013, totaled approximately $125,000 for three informants who provided tips that helped the SEC bring a case against Locust Offshore Management and its CEO.

The $14 million award on September 30 elevated the status of the whistleblower program to that of a major enforcement tool in the SEC's arsenal. Although the September 30 order did not reveal the underlying enforcement action or the total amount of funds recovered in order to maintain the informant's anonymity, the accompanying press release indicated that the amount of the award,[4] "in light of the monetary sanctions already collected," "appropriately recognizes the significance of the information [and assistance] . . . provided by the Claimant."[5] The award received widespread media attention and has been described by some commentators as a "game changer" for the whistleblower program.[6]

October 30, 2013 Orders Granting and Denying Whistleblower Awards

One month after granting the highest bounty in its history, on October 30, 2013, the SEC issued two orders in separate matters (i) granting an award of nearly $150,000 to a whistleblower who assisted the SEC in stopping a scheme to defraud investors (order 2014-1)[7] and (ii) affirming the denial of an award by the SEC's claims review staff (order 2014-2).[8]

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Order 2014-1, like the September 30 order, provided little information about the underlying enforcement action. However, it stated, significantly, that the SEC was awarding the full 30 percent of the total sanctions to be collected in the underlying action. Moreover, the chief of the SEC's office of the whistleblower, Sean McKessy, said of the award, "[t]his is continued momentum and success for the SEC's whistleblower program that is bringing our investigators valuable and timely information to stop ongoing frauds before additional investors can be harmed."

[4] In re Claim for Award in Connection with [Redacted], SEC Whistleblower Award Proc. File No. 2013-4, 2013 WL 5441622 (Sept. 30, 2013).

[5] US Securities & Exchange Comm., *SEC Awards More Than $14 Million To Whistleblower*, Release No. 2013-209 (Oct. 1, 2013).

[6] *See, e.g.*, Walter Pavlo, *The Anonymous SEC Whistleblower Award of $14M Is A Game Changer*, Forbes (Oct. 3, 2013).

[7] In re Claim for Award in Connection with [Redacted], SEC Whistleblower Award Proc. File No. 2014-2, 2013 WL 5819624 (Oct. 30, 2013).

[8] In re Claim for Award in Connection with SEC v. Advanced Tech. Group LTD, SEC Whistleblower Award Proc. File No. 2014-1, 2013 WL 5819623 (Oct. 30, 2013).

Order 2014-2 involved a claimant who provided information concerning Advanced Technologies Group LTD (ATG), Alexander Stelmak and Abelis Raskas' alleged participation in offerings of unregistered non-exempt securities in violation of Section 5 of the Securities Act of 1933. The SEC brought an enforcement action against these parties and ultimately entered into consent agreements with them resulting in their disgorgement of nearly $15 million.

The SEC held that because the majority of the claimant's information was submitted before July 21, 2010, the effective date of Dodd-Frank, it was not "original information" for purposes of Section 21F(a)(1) and Rule 21F-4(b)(1)(iv). In doing so, the SEC undertook a thorough analysis of the statutory and regulatory language and legislative history and rejected the claimant's argument that Rule 21F-4(b)(1)(iv)'s requirement that "original information" post-date Dodd-Frank is inconsistent with Section 21F(a)(1).

The SEC further held that certain information the claimant provided after July 21, 2010 did not lead to the enforcement action against ATG, Stelmak and Raskas. The SEC credited the enforcement staff's representation that it was already aware of that information and that the information did not significantly contribute to the success of the action.

Order 2014-2 finally concluded that the claimant received a fair proceeding when challenging the claims review staff's preliminary determination. The SEC held that the claimant was entitled only to publicly available materials, claimant's own submissions to the SEC, correspondence between the claimant's counsel and the SEC and sworn declarations by enforcement staff – not to any pre-decisional or internal deliberative process materials used to assist the SEC in determining the award claim.

Although order 2014-2 resulted in the denial of a whistleblower award, it is unlikely to slow the momentum of the whistleblower program. Issued on the same day as order 2014-1, it is likely to be overshadowed by that award, as well as the ground-breaking award issued on September 30. Moreover, the SEC went to great lengths in order 2014-2 to support its award denial based on a straightforward application of Rule 21F-4 that would not apply to future informants. Lastly, even though order 2014-2 resulted in an award denial, it contained language reassuring would-be informants and their counsel that it did not wish to discourage them from coming forward in future matters:

> Finally, we take this opportunity to remind counsel that the Commission has a substantial interest in granting awards to whistleblower applicants who satisfy the statutory and regulatory criteria for an award. In furtherance of that interest, our goal is to work with whistleblowers and their counsel in a collaborative, non-adversarial manner to determine whether the whistleblowers satisfy the award criteria. We firmly believe that this approach best serves the interests of whistleblowers and the Commission, and thus should help maximize the award program's overall effectiveness in the enforcement of the federal securities laws and the protection of investors.

Companies Should Educate Employees About Internal Reporting

Whistleblowers are becoming an important part of the SEC's enforcement program. Recent whistleblower awards and public statements by SEC officials have raised public awareness of the whistleblower program and substantially increased the incentives for informants to come forward with information about potential securities violations. It is likely that the already-growing number of informants will increase substantially in the coming years.

Although many companies already have internal reporting policies or "whistleblower hotlines," they should consider reviewing those policies to make sure employees have an uncomplicated and low-risk intra-company conduit for reporting potential violations, including robust non-retaliation provisions. Companies should also consider educating employees about how to use their internal reporting mechanisms, with an emphasis on the incentives for and benefits of reporting internally. Even with additional education, employees who fear retaliation or inaction may nevertheless prefer reporting to the government rather than to their employer. It is therefore critical that companies assure their employees that their concerns are welcomed and will be taken seriously by personnel with the power to act. These measures will increase the probability that the company – and not the SEC – will be viewed by would-be whistleblowers as the first stop in the reporting process.

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> *There has been a long-standing split among federal courts ... over whether the filing of a class action also stops the clock on the applicable statute of repose.*

When Will It End? Circuits Split on Whether Class Actions Toll the Statute of Repose in Securities Litigation

There is little certainty for companies, underwriters and individuals faced with high stakes class action securities litigation. Statutes of limitation and repose, however, provide limitations on the time to file such actions, allowing defendants some comfort that additional claims cannot be asserted. Federal securities claims for misrepresentation generally must be brought within the earlier of (1) a specified time period from discovery of the facts constituting the alleged violation (the statute of limitations),[1] and (2) a certain time period from commission of the alleged violation or from the offering or sale of the underlying security (the statute of repose).[2] It is well-established that the filing of a class action tolls the statutes of limitation for securities claims under the tolling doctrine set forth nearly forty years ago in the United States Supreme Court's decision in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) ("*American Pipe*").[3] There has been a long-standing split among federal courts, however, over whether the filing of a class action also stops the clock on the applicable statute of repose.

While statutes of limitation and repose are often confused with each other, and many use the terms interchangeably, they are distinct, and their distinctions are of critical importance. A statute of limitation affects the remedies available to plaintiffs and may thus be subject to equitable doctrines such as tolling and discovery rules. By contrast, a statute of repose "create[s] a substantive right in those protected to be free from liability after a legislatively-determined period of time,'" Police & Fire Retirement System of the *City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95, 107 (2d Cir. 2013) (citation omitted)(emphasis in original). It impacts the underlying right to file a claim and extinguishes a plaintiff's claim after the passage of a fixed period of time. The statute of repose clock starts running "without interruption once the necessary triggering event has occurred" and without regard to whether a plaintiff knows or should know that she has a claim, *id*. at 106, allowing potential defendants certainty that no further actions may be filed. Thus, statutes of repose provide defendants the knowledge that, by a date certain, all potential claims are extinguished.

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[1] The statute of limitations is one year after the discovery of the alleged untrue statement in connection with the offer or sale of securities under the Securities Act of 1933, 15 U.S.C. § 77m, *et seq.* (Securities Act), and two years for claims for misrepresentations in connection with the purchase or sale under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78a, *et seq.* (the 1934 Act).

[2] The statute of repose governing claims under the Securities Act is three years, *see* 15 U.S.C. § 77m, and five years for claims under the 1934 Act. 28 U.S.C. § 1658(b).

[3] The Supreme Court in *American Pipe*, a class-action antitrust case, held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class who would have been parties had the suit been permitted to continue as a class action." 414 U.S. at 554. In reaching this conclusion, the Court relied heavily on Federal Rule of Procedure 23, reasoning that tolling the statute of limitations should help avoid the multiplicity of suits that might otherwise ensue if individuals felt compelled to file their own cases to preserve their claims before the statute of limitations could run. The Court also relied on the equitable power of the courts to toll statutes of limitations, concluding that "judicial tolling of the statute of limitations does not abridge or modify a substantive right." *Id.* at 558, 558 n.29.

As discussed below, a recent Second Circuit decision relating to the statute of repose for claims brought under the Securities Act of 1933, 15 U.S.C. § 77m, *et seq.* (Securities Act), is likely to have a significant impact on securities litigants.

The IndyMac Decision

In *Police & Fire Retirement System of the City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013), the Second Circuit Court of Appeals addressed an "unsettled question of law" and held that the three-year statute of repose in Section 13 of the Securities Act is not tolled under *American Pipe* by the filing of a class action. *Id*. at 101, 102. In so ruling, the Second Circuit is squarely at odds with the Tenth Circuit's 2000 decision in *Joseph v. Wiles*, 223 F.3d 1155, 1168 (10th Cir. 2000), where the Tenth Circuit held that the Securities Act statute of repose is subject to tolling under *American Pipe*. The *IndyMac* decision thus creates a split among federal circuit courts as to whether the pendency of a class action suspends the statute of repose.

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In *IndyMac*, after consolidation of two putative class actions, the lead plaintiffs asserted claims under Sections 11, 12(a) and 15 of the Securities Act arising out of IndyMac's issuance of mortgage-backed securities in 106 different offerings. The district court dismissed for lack of standing all claims arising from the offerings of securities that were not purchased by the lead plaintiffs. Following dismissal of those claims, six members of the putative class that did purchase those securities moved to intervene in the action under Federal Rule of Civil Procedure 24 to assert claims with respect to the securities that they had purchased, even though the three-year statute of repose in Section 13 had already run on their claims, asserting that the *American Pipe* tolling rule applied with equal force to the statute of repose in Section 13. The district court denied the motions to intervene, finding that the repose period had lapsed and could not be tolled by *American Pipe* or extended by Federal Rule of Civil Procedure 15(c), see *In re IndyMac Mortgage-Backed Sec. Litig.*, 793 F. Supp. 2d 637 (S.D.N.Y. 2011). The intervenors appealed to the Second Circuit.

The Second Circuit held that the Section 13 statute of repose is not tolled by the filing of a class action complaint, reasoning that to the extent the *American Pipe* tolling rule is an equitable doctrine (as the defendants argued), its application to the statute of repose in Section 13 is barred by the Supreme Court's holding in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston*, 501 U.S. 350, 360, 362 (1991). IndyMac, 721 F.3d at 108. As noted in *IndyMac*, Section 13's three-year limitations period is "'absolute,'" and "'is a period of repose *inconsistent* with tolling.'" *Id*. at 107 (quoting *Lampf*, 501 U.S. at 363) (emphasis in original). Thus, the "purpose of the 3-year limitation is clearly to serve as a cutoff,' to which 'tolling principles' do not apply." *Id*. (quoting *Lampf*, 501 U.S. at 363). To the extent the American Pipe rule is a "legal" tolling rule based on the class action provisions of Federal Rule of Civil Procedure 23 (as argued by the intervenors), the Second Circuit concluded that its "extension to the statute of repose in Section 13 would be barred by the Rules Enabling Act, 28 U.S.C. § 2072(b)," which "'forbids interpreting Rule 23 to "abridge, enlarge or modify any substantive right."'" *Id*. at 109 (quoting *Wal-Mart Stores, Inc. v. Dukes*, __ U.S. ___, 131 S. Ct. 2541, 2561 (2011)). Because the statute of repose in Section 13 "creates a *substantive* right, extinguishing claims after a three-year period, "[p]ermitting a plaintiff to file a complaint or intervene after the repose period has run would therefore necessarily enlarge or modify a substantive right and violate the Rules Enabling Act." *Id*. (emphasis in original). Finally, the Second Circuit found unpersuasive the intervenors' argument that failing to toll the statute of repose during a class action "could burden the courts and disrupt the functioning of class action litigation," noting that any such problem would be for Congress, not the courts, to address. *Id*. at 109-10.

The Growing Split of Authority

As the Second Circuit recognized in *IndyMac*, there is a growing split among the federal courts regarding the application of *American Pipe*'s tolling rule to statutes of repose in securities cases (as well as class action practice beyond the securities context). Indeed, the *IndyMac* decision is squarely contrary to the Tenth Circuit's holding in *Joseph v. Wiles*, 223 F.3d 1155 (10th Cir. 2000), and numerous district court decisions.[4] In *Joseph*, the court reasoned that the statute of repose was "legally" tolled under *American Pipe* because earlier class actions had asserted § 11 claims on behalf of both stock and debenture purchasers, and included Joseph as an absent class member. The court also reasoned that tolling the statute of repose served Rule 23's policy of judicial economy by eliminating the need for potential class members to file individual claims, and did not compromise the purposes of statutes of limitations and repose, which are "intended to protect defendants from being unfairly surprised by the appearance of stale claims, and to prevent plaintiffs from sleeping on their rights." *Id*. at 1167. Finding that the defendants were on notice of Joseph's substantive claim because a class action complaint had been filed and therefore could not "assert Mr. Joseph's claim was stale or that he slept on his rights," the Tenth Circuit concluded that defendants' "potential liability should not be extinguished simply because the district court left the class certification issue unresolved." *Id*. at 1168. A number of district courts have followed *Joseph* and concluded that the filing of a class action tolls the statute of repose. See n.4.

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[4] *See, e.g., In re Merck & Co., Inc. Sec., Derivative & Erisa Litig.*, MDL 1658 SRC, 2012 WL 6840532 at *2-5 (D.N.J. Dec. 20, 2012) (collecting and reviewing cases).

Possible Implications of *IndyMac*

First, in giving effect to the statute of repose in Section 13, the holding of *IndyMac* allows issuers and underwriters of securities to know that all potential claims arising out of a particular securities issuance will be extinguished by a date certain, at least with respect to actions filed in district courts within the Second Circuit.

Second, the decision provides some ammunition for defendants faced with federal securities actions under other provisions of the securities laws, including Section 10(b) of the 1934 Act. As noted above, *IndyMac* dealt with the statute of repose in Section 13 of the Securities Act, but its reasoning provides defendants with strong support that no other statutes of repose may be tolled under *American Pipe*.

Third, the *IndyMac* decision will impact investors who are members of a putative classes where class claims are dismissed, as well as investors who opt out of securities class actions either to pursue individual claims or to pursue settlement discussions with defendants. The decision is likely to end the tendency of large, sophisticated institutional investors to delay filing individual actions until class actions have entered – or completed – merits discovery, or to wait to opt out after a settlement with the class has been negotiated. It may lead to the filing of more individual actions from the outset, or lead large institutional investors to seek tolling agreements with defendants.

Finally, given this split in the circuits, the Supreme Court may take an opportunity to address whether statutes of repose are subject to tolling under the *American Pipe* tolling doctrine, including the legal or equitable nature of tolling under that doctrine.

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Practice Pointers for Corporate Clients on Class Action Litigation & Arbitration – Having the Court Decide Whether Arbitration Permits a Class Action Can Be Decisive

Well-drafted arbitration class action waivers typically are broad, extending to the full range of statutory, contract and tort claims, and many companies rely on them in their consumer, commercial and employment contracts. Where the arbitration agreement does not state a class waiver in so many words, or the party seeking class arbitration argues that the waiver should not be enforced, an important issue arises: Who should get to decide whether the contract allows for class arbitration – the court or the arbitrator?

The US Supreme Court's unanimous decision in *Oxford Health Plans v. Sutter*, 133 S. Ct. 2064 (June 10, 2013) (Kagan J.) serves as a stark reminder that the answer to "Who Decides?" often determines whether the defending business must contend with costly and unpredictable class action proceedings, along with the prospect of huge legal bills, or the need to defend only against manageable smaller-dollar individual claims. Many practitioners believe that arbitrators, who typically get paid more the longer the arbitration continues, are more likely to find class arbitration permitted under the parties' agreement than courts, which are focused more on disposing of their caseloads. This article first explores the importance to businesses of raising the class arbitration issue in such a way as to maximize the probability that a court, and not an arbitrator, rules on the availability of class arbitration in the *first* instance by ensuring that the issue is treated as a threshold question of arbitrability for a judge, not an issue of contract construction for the arbitrator. *Second*, it concludes with basic drafting tips to help enforce a valid class waiver in favor of individual arbitration.

The deft drafter … and the court … hold the keys to success in enforcing class action waivers in favor of bilateral arbitration.

I. *Oxford Health Plans*: May the Deference Given to an Arbitrator's Interpretation of the Agreement Be Overcome?

Oxford Health Plans illustrates how much is at stake in the "Who Decides" question. In *Oxford*, a pediatrician filed a putative class action in New Jersey state court against the health insurer, alleging that Oxford had failed to reimburse the physicians as contractually promised. After Oxford successfully forced the case to arbitration, the parties agreed that the arbitrator should decide whether the contract allowed for class arbitration. The arbitrator found that the contract indeed permitted class arbitration, relying on the typical, standard-form direction that: "No civil action concerning any dispute arising under this Agreement shall be instituted before any court, and all such disputes shall be submitted to final and binding arbitration in New Jersey, pursuant to the rules of the American Arbitration Association with one arbitrator." This clause, the arbitrator reasoned, mandated arbitration of "the same universal class of disputes" that it barred the parties from bringing as a civil action in court. Because a class action "is plainly one of the possible forms of civil action that could be brought in a court," absent the agreement, the arbitrator held that the contract, on its face, allowed for class arbitration.

[1] See client alert, June 21, 2013 ("US Supreme Court Orders Strict Enforcement of Class Arbitration Waivers in *American Express Co. v. Italian Colors Restaurant* – A Contract Is a Contract Is a Contract").

Oxford sought to vacate the arbitrator's decision on the ground that the arbitrator "exceeded his powers" under § 10(a)(4) of the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et seq.*, in finding class arbitration permitted, but the federal district court and the Court of Appeals for the Third Circuit both rejected Oxford's contentions. See 05–CV–2198, 2005 WL 6795061 (D.N.J., Oct. 31, 2005), aff'd, 227 Fed. Appx. 135 (3d Cir. 2007). Oxford then asked the arbitrator to reconsider after the Supreme Court decided *Stolt-Nielsen S.A. v AnimalFeeds International Corp.*, 559 U.S. 662 (2010), which reversed an arbitration panel's decision to allow class arbitration because the arbitrators had ignored the parties' stipulation that they had reached "no agreement" on class arbitration. But the *Oxford* arbitrator concluded that *Stolt-Nielsen* did not affect his prior decision because he had found that the parties in fact had agreed to class arbitration. The federal district court again refused to overturn the arbitrator, and the Third Circuit agreed. 675 F.3d 215 (3d Cir. 2012).

In a rare display of unanimity on the subject of class arbitration, the US Supreme Court affirmed the Third Circuit. The Court in *Oxford* held that a court may not vacate an arbitrator's purportedly erroneous decision to allow class arbitration under the highly deferential standard of review of an arbitrator's decision under § 10(a)(4) of the FAA. To set aside the arbitrator, "[i]t is not enough . . . to show that the [arbitrator] committed an error—or even a serious error." So long as the arbitrator is "even arguably construing or applying the contract," the arbitrator's decision must stand, whether "good, bad, or ugly." The Court distinguished *Stolt-Nielsen* in that the Court "overturned the arbitral decision there because it lacked any contractual basis for ordering class procedures, not because it lacked, in *Oxford*'s terminology, a 'sufficient' one." In *Stolt-Nielsen*, the Court explained that the parties "had entered into an unusual stipulation that they had never reached an agreement on class arbitration," whereas no such stipulation controlled the arbitrator's resolution of the parties' contract dispute in *Oxford*. 133 S. Ct. at 2068, 2069, 2071.

Fortunately, the Court identified an alternative path open to businesses which, like Oxford, seek to have a court determine whether the contract allows for class arbitration. That is, the party resisting class arbitration could argue that "the availability of class arbitration is a so-called 'question of arbitrability.'" Questions of arbitrability include certain "gateway matters, such as whether parties have a valid arbitration agreement at all or whether a concededly binding arbitration clause applies to a certain type of controversy," and they are "presumptively for courts to decide." But Oxford had waived this argument by submitting the class arbitration issue to the arbitrator twice. 133 S. Ct. at 2068 n.2.

The concurring opinion of Justice Alito, joined by Justice Thomas, shows how central the "Who Decides" issue was in *Oxford*. Justice Alito expressed his view that the contract did *not* provide for class arbitration by its terms, and the arbitrator would have been overturned by the Court had *de novo* review been the standard. That is because the *Oxford* arbitrator had improperly inferred the parties' implicit agreement to class arbitration from nothing more than "the fact of the parties' agreement to arbitrate." Further, Justice Alito expressed serious doubt regarding the enforceability of a class arbitration award against absent class members who had not affirmatively opted in to the action, because there would otherwise be no basis for finding that they had "submitted themselves to th[e] arbitrator's authority in any way." This fact, according to Justice Alito, "should give courts pause before concluding that the availability of class arbitration is a question the arbitrator should decide," as it would create the possibility that absent class members could claim the benefit of a favorable judgment without subjecting themselves to the binding effect of an unfavorable one. *Id.* at 2071-2072.

II. Is the Availability of Class Arbitration a "Question of Arbitrability," and, If So, May the Arbitrator Decide the Issue Nonetheless?

The question of whether the availability of class arbitration is a "question of arbitrability" presumptively for the court, or a "question of contract interpretation" presumptively for the arbitrator, takes on crucial importance in the wake of *Oxford*. In the absence of further Supreme Court guidance, the outcome of "Who Decides" may hinge on the answers to two other questions. *First*, does the arbitration agreement include an unambiguous class action waiver? *Second*, does the arbitration agreement "clearly and unmistakably" delegate questions of arbitrability to the arbitrator?

A. Does the Agreement Include an Express Class Action Waiver?

Where the contractual clause expressly waives class actions, courts generally have held that the enforceability of such a waiver is a "question of arbitrability" for the court to decide. *Emilio v. Sprint Spectrum*, 508 Fed.Appx. 3, 4 (2d Cir. Jan. 18, 2013). That is because the enforceability of such clauses presents "a gateway dispute about whether the parties are bound by a given arbitration clause." *American Express Merchants' Litigation*, 554 F.3d 300, 311 (2d Cir. 2009) (vacated on other grounds sub nom., *American Express Co. v. Italian Colors Restaurant*, 130 S. Ct. 2401 (2010)); accord *Puleo v. Chase Bank*, 605 F.3d 172, 180 (3d Cir. 2010) (collecting cases in the First, Second, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh Circuits).

Where the arbitration agreement does not contain a clear class action waiver on the face of the contract, the issue is muddier. This is unsurprising in light of the Supreme Court's emphasis, in both *Stolt-Nielsen* and *Oxford*, that it had not yet decided the question.

Some courts have held that this issue should be treated as a matter of contract interpretation, and should thus be decided by the arbitrator. *Vilches v. The Travelers Companies, Inc.*, 413 Fed.App'x 487, 492 (3d Cir. Feb. 9, 2011); *Guida v. Home Sav. of Am.*, 793 F. Supp. 2d 611, 616 (E.D.N.Y. 2011); *Hesse v. Sprint Spectrum L.P.*, No. C06–0592JLR, 2012 WL 529419 (W.D. Wash. Feb. 17, 2012). Other courts have construed this issue, as had Justice Alito, as involving whether parties not before the court (putative class members) may be bound to the arbitration agreement, and thus treated it as one of arbitrability. *Mork v. Loram Maintenance of Way, Inc.*, 844 F. Supp. 2d 950, 953 (D. Minn. 2012). The issue has generated splits even within judicial districts. Compare *Price v. NCR Corp.*, 908 F. Supp. 2d 935 (N.D. Ill. 2012); and *Aracri v. Dillard's, Inc.*, No.10-cv-253, 2011 WL 1388613 (S.D. Ohio Mar. 29, 2011) (issue is for the arbitrator), with *Corrigan v. Domestic Linen Supply Co., Inc.*, No. 12 C 0575, 2012 WL 2977262, at *4 (N.D. Ill. July 20, 2012); and *Reed Elsevier, Inc. v. Crockett*, No. 3:10-cv-248, 2012 WL 604305, at *8 (S.D. Ohio Feb. 24, 2012) (issue is for the court).

It remains to be seen whether Justice Alito's *Oxford* concurrence shifts the tide toward finding the availability of class proceedings to be a question of arbitrability; so far, there has been no evidence of such an effect. But, as pointed out later, this concern may be overcome by deft draftsmanship and preemptive court action to compel or stay arbitration.

B. Does the Agreement Delegate Questions of Arbitrability to the Arbitrator?

A note of caution, however, is in order. The parties may expressly delegate resolution of threshold arbitrability questions to the arbitrator in their contract, so long as such delegation is "clear and unmistakable." Rent-A-Center, West, Inc. v. Jackson, 130 S. Ct. 2772, 2777 (Jun. 21, 2010). Of concern, some decisions have found the mere reference to the default rules of an arbitration provider to constitute such a "clear and unmistakable" delegation of authority to the arbitrator to decide questions of arbitrability.

For example, in *Emilio v. Sprint Spectrum*, 508 Fed. Appx. 3, 5 (2d Cir. Jan. 18, 2013), the district court overturned the arbitrator's ruling that refused to enforce a class action waiver. The Second Circuit, however, reversed the district court, on the ground that the arbitration agreement had "clearly and unmistakably" delegated "questions of arbitrability" to the arbitrator, based on its provision that "the then-applicable rules of JAMS will apply," specifically JAMS's "expedited procedures." Lo and behold, the JAMS Comprehensive and Streamlined Arbitration Rules & Procedures provide, in turn, that "[j]urisdictional and arbitrability disputes, including disputes over the existence, validity, interpretation or scope of the agreement under which Arbitration is sought, and who are proper Parties to the Arbitration, shall be submitted to and ruled on by the Arbitrator."

To the same effect are decisions that contractual reference to the rules of the American Arbitration Association (AAA Rules) "clearly and unmistakably" delegates questions of arbitrability to the arbitrator, because the AAA Rules state that "[t]he arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement." See *Petrofac, Inc. v. DynMcDermott Petroleum Operations, Co.*, 687 F.3d 671, 675 (5th Cir. 2012); *Fallo v. High–Tech Inst.*, 559 F.3d 874, 878 (8th Cir.2009); *Qualcomm Inc. v. Nokia Corp.*, 466 F.3d 1366, 1372–73 (Fed.Cir.2006); *Terminix Int'l Co., LP v. Palmer Ranch Ltd. P'ship*, 432 F.3d 1327, 1332–33 (11th Cir.2005); *Contec Corp. v. Remote Solution Co.*, 398 F.3d 205, 208 (2d Cir.2005); but see *Riley Mfg. Co. v. Anchor Glass Container Corp.*, 157 F.3d 775, 780 & 777 n.1 (10th Cir.1998).

Under this line of cases, even if Oxford had filed an action in court objecting to the arbitrator's authority to decide whether class arbitration was permitted, a court might have concluded that the agreement's reference to "the rules of the American Arbitration Association" meant that only the arbitrator could determine whether it permitted class arbitration.

III. Conclusion – Drafting and Practice Pointers

Six key lessons emerge from *Oxford Health Plans* and the unsettled legal landscape regarding 'questions of arbitrability' for businesses seeking to avoid class action proceedings in court and in arbitration.

First, companies should take care that any arbitration agreement includes an express class action waiver. The agreement should both waive the parties' right to commence or participate in any representative, class, collective, consolidated or aggregate proceeding, and affirmatively require resolution of all disputes in a bilateral arbitration on a purely individual basis.

Second, if the company wishes to specify which arbitration provider's rules will govern, the agreement should state that, notwithstanding anything in those rules to the contrary, threshold questions regarding the availability of class, collective, consolidated or aggregate proceedings are to be decided by a court in the first instance.

Third, in the employment context, the agreement should clarify that it does not preclude the filing of claims, as may be permitted by law, with the EEOC, NLRB or any other federal agency. *D.R. Horton, Inc. v. Nat'l Labor Relations Bd.*, No. 12-60031, 2013 WL 6231617 (5th Cir. Dec. 4, 2013).

Fourth, the agreement may include a jury trial waiver in the event the class waiver is invalidated and litigation of a class action in court would be preferable to class arbitration (except in states where jury trial waivers may not be enforceable such as California and Georgia).

Fifth, the party resisting class arbitration should, if at all possible, raise the question in court prior to arbitration, as a gateway issue, in an action to compel bilateral arbitration or to stay a purported class arbitration. As a procedural matter, courts have frequently granted "motions to compel individual arbitration" where the putative class action complaint was initially filed in court. *See, e.g.*, *Litman v. Cellco Partnership*, 655 F.3d 225, 227 (3d Cir. 2011);

Cruz v. Cingular Wireless, 648 F.3d 1205, 1210 (11th Cir. 2011); *Shetiwy v. Midland Credit Management*, __ F. Supp. 2d __, 2013 WL 3530524, at *3 (S.D.N.Y. July 12, 2013). If the putative class representative seeks to initiate a class arbitration without filing in court, and the claims are governed by an arbitration agreement that does not allow for class proceedings, the party resisting class arbitration may file a court action pursuant to the FAA, 9 U.S.C. § 4 (or parallel state arbitration laws), to stay the purported class arbitration and compel bilateral arbitration.

Sixth, once the parties submit to the arbitrator the question of contractual interpretation regarding class arbitration, *Oxford* requires the arbitrator's determination on that score to be subject to layers of deference, making it virtually impossible to subsequently overturn even a clearly erroneous ruling.

Thus, the answer to "Who Decides" rests, first and foremost, in the hands of the deft drafter and, only then, in court to compel a bilateral arbitration and enforce the contractual exclusion of a class action.

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