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## Coverage Preservation vs. Privilege Protection: Two Horns of a Dilemma?

By John Buchanan and Wendy Feng

Companies defending litigation often must simultaneously pursue a claim for insurance to cover that defense from insurers that may resist covering it. For in-house litigation counsel and their outside defense firms, the tension between litigation defense and insurance pursuit can create a frustrating dilemma. On the one hand, the insured company needs to provide its insurers with sufficient information about the underlying case to persuade its insurer that the case is covered, to avoid insurer claims of noncooperation, and to try to get its defense and settlement funded. On the other hand, if the company complies with insurers' demands for work product or attorney-client privileged information, underlying claimants may assert that the disclosure to an insurer with interests potentially adverse to the company's has waived any privilege or work product protection attaching to the material disclosed.

Otherwise stated, the company and its counsel are caught between the risk of impairing coverage (for cooperating too little with the insurer) and the risk of waiving privilege (for cooperating too much). We discuss below some of the case law addressing this dilemma and some practical suggestions for counsel facing it.

### **Horn 1: Insurance Cooperation and Disclosure Obligations**

Standard general liability policies contain a cooperation clause requiring the policyholder to cooperate with the insurer in the investigation or settlement of the claim or defense of the underlying litigation. Some insurers claim this cooperation language entitles them to review privileged materials from a defense counsel's files. In addition, in connection with settlements, the standard "voluntary payments" clause provides that no insured may voluntarily make a payment or assume any obligation without the insurer's consent. Insurers may withhold such consent until they have reviewed defense counsel's settlement evaluations and perhaps additional privileged information from counsel's files. If coverage litigation over the claim ensues, insurers will routinely assert the right to discover defense counsel's privileged files, usually relying on:

- the cooperation provisions in the insurance contract
- the common interest doctrine, which "serves to protect the confidentiality of communications passing from one party to the attorney for another party where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989) (citation omitted); *see generally, e.g.*, Barry R. Ostrager & Thomas R. Newman, Handbook on Insurance Coverage Disputes § 2.07(b) (15th ed. 2010)

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- the at issue doctrine, which is related to the general waiver doctrine and essentially holds that "[b]y taking an action that places privileged information 'at issue' the party may forfeit the privilege," *Remington Arms Co. v. Liberty Mut. Ins. Co.*, 142 F.R.D. 408, 412; *see generally, e.g., Ostrager & Newman, supra* § 2.07(b)

Where the insurer is acting under a reservation of rights, a company and its defense counsel may be reluctant to disclose privileged materials to the insurer, particularly if the insurer appears to be seeking evidence to support a coverage defense. Whether they nonetheless must do so depends on the law governing the issue.

At least one state has imposed broad duties of disclosure and cooperation on policyholders. In *Waste Management, Inc. v. International Surplus Lines Insurance Co.*, 144 Ill. 2d 178, 201 (1991), the Illinois Supreme Court held that the attorney-client privilege did not prevent the insurer from discovering the policyholder's counsel's files in the underlying litigation—even though the policyholder had independent defense counsel in that litigation, and even though the parties were actively at odds in a coverage action.

The reasoning of *Waste Management* has gained less traction outside Illinois. *See, e.g., Allianz Ins. Co. v. Guidant Corp.*, 373 Ill. App. 3d 652, 664 (2007) (applying *Waste Management* under Illinois law, but noting that "almost every foreign jurisdiction that has considered the holding of *Waste Management* has assailed the decision as unsound and improperly reasoned"); *Dedham-Westwood Water Dist. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, No. Civ. A. 96-00044, 2000 WL 33593142 (Mass. Super. Feb. 4, 2000) ("*Waste Management* has been rejected or criticized on numerous occasions."); *Rockwell Int'l Corp. v. Superior Court*, 26 Cal. App. 4th 1255, 1264, 1268 n.6 (1994) (rejecting *Waste Management's* reasoning, while recognizing that "in issue" doctrine may have more particular application). Illinois courts, however, are not the only ones to hold that insurers share a common interest with their insureds—even when they are disputing their coverage obligations. *See, e.g., Metro Wastewater Reclamation Dist. v. Cont'l Cas. Co.*, 142 F.R.D. 471, 479–80 (D. Colo. 1992) (policyholders cannot shield documents from their insurers due to common interest doctrine).

In several other jurisdictions, the courts have variously addressed the cooperation clause, the common interest doctrine, and/or the "at issue" doctrine and held that they do not require a policyholder to disclose defense counsel's privileged files to its insurers. For example, a Connecticut court rejected all three grounds for disclosure, finding that if an insurer had reserved its rights or denied coverage, it was not entitled to receive privileged communications between the policyholder and its independent defense counsel. *Metro. Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 249 Conn. 36, 60–63 (1999). Similarly, a Florida court denied an insurer's motion to compel discovery of communications between a policyholder and independent counsel, rejecting the insurer's argument based on the cooperation clause and the "at issue" doctrine. *E. Air Lines, Inc. v. U.S. Aviation Underwriters, Inc.*, 716 So. 2d 340, 343–44 (Fla. App. 1998).

Finally, some states partially regulate insurers' rights to information and cooperation by statute. For example, California's so-called *Cumis* statute requires that if the policyholder selects independent defense counsel to defend an underlying action, the insured and its counsel have a duty "to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action." Cal. Civ. Code § 2860(d). Alaska has a similar statute. *See* Alaska Stat. § 21.89.100(e). Both statutes, anticipating the potential for disputes inherent in such disclosure obligations, expressly provide a process for court resolution of privilege issues.

In sum, when an insurer demands confidential information about its policyholder's underlying defense, counsel may need to parse uncertain rules, or choose among conflicting rules, to determine what, if anything, must be disclosed.

### **Horn 2: Waiver of Privilege as to Third Parties**

Whether or not applicable law requires disclosure, in the real world of insurance claims—handling, a policyholder may have financial reasons to disclose privileged or protected information to its insurer voluntarily. For example, the insurer may require such information as a condition of its consent to a proposed settlement, or of a defense cost payment. Here the policyholder encounters the second horn of its dilemma: how can it share confidential materials with its insurer without exposing the materials to discovery by adversaries in the underlying litigation? If the insurer has not agreed to cover the policyholder's underlying liability and thus the information does not clearly fall within the protection of the common interest doctrine, an underlying plaintiff or another third party could assert that the policyholder has waived privilege or work product protection for any materials that it shared with its insurer.

Unfortunately, case law addressing what the company may safely disclose is sparse and conflicting. First, courts in a number of jurisdictions have held that no insurer-insured privilege independently protects communications with insurers. *See, e.g., Linde Thomson Langworthy Kohn & VanDyke, P.C. v. RTC*, 5 F.3d 1508, 1514–15 (D.C. Cir. 1993) ("if what is sought is not legal advice but insurance, no privilege can or should exist"). Instead, the insurer's interest must be deemed sufficiently "common" with the policyholder's to preserve privilege or work product protection for materials disclosed to the insurer.

A cautionary tale for policyholder counsel is found in cases such as *In re Imperial Corp. of America*, 167 F.R.D. 447 (S.D. Cal. 1995). Counsel for the insureds (individual directors and officers named as defendants in a shareholder derivative suit) sent letters to their insurer addressing the likelihood of success in the underlying defense, as well as a settlement demand by plaintiffs in that action. *Id.* at 450. After learning of these letters during a deposition in the underlying case, the shareholder plaintiffs demanded their production. In spite of a joint defense agreement signed by both the policyholders and their insurer (which was deemed ineffective because the parties were potentially adverse in coverage litigation), the court found no attorney-

client protection for the letters. *Id.* at 452–53. The court further held that the policyholders' defense counsel had waived work product protection in disclosing the letters to an insurer that had not committed to coverage because it knew "a future coverage action pitting the insured against the insurer [was] a distinct possibility." *Id.* at 454–55; *see also, e.g., Cont'l Cas. Co. v. St. Paul Surplus Lines Ins. Co.*, 265 F.R.D. 510, 523, 528 (E.D. Cal. 2010) (in contribution action by defending insurer against non-defending insurer, the latter was required to produce its communications with policyholder and underlying defense counsel; both attorney-client privilege and work product protection were waived due to lack of common interest).

Another California federal court, however, applied a more nuanced analysis in rejecting waiver. In *Lectrolarm Custom Systems, Inc. v. Pelco Sales, Inc.*, 212 F.R.D. 567 (E.D. Cal. 2002), the underlying plaintiff (Lectrolarm) sought discovery of documents the policyholder (Pelco) sent to its insurer, which was partially paying Pelco's independent defense counsel under a reservation of rights. The court acknowledged that because of "inherent tension between the carrier's interest and the interests of the insured," and because of their separate counsel, "communications between Pelco and [its insurer] are not privileged per se"; and that "[g]enerally, disclosure of otherwise privileged communication to a third party waives the attorney client privilege and/or the attorney work product privilege." *Id.* at 571–72. But despite the parties' potential adversity on coverage for the claim, the court held that the common defense doctrine, typically applied only to codefendants in the same litigation, precluded a waiver. *Id.* at 572. Looking at the particular communications at issue—those "relating to the claims and defenses in the underlying lawsuit"—the court found sufficient "commonality of interest" to preserve both attorney-client privilege and work product protection. In contrast to the *Imperial* court, therefore, the *Lectrolarm* court's waiver analysis implicitly distinguished insurer-insured adversity on the coverage side of their relationship from their common interest in the underlying defense. Accordingly, it barred the underlying plaintiff from discovering policyholder-insurer communications supporting the latter interest. *Id.* at 573.

Other courts have distinguished attorney-client privilege from work product. For example, in *Go Medical Industries PTY, Ltd. v. C.R. Bard, Inc.*, No. 3:95MC522 (DJS), 1998 WL 1632525, at \*1 (D. Conn. Aug. 14, 1998), *rev'd in part on other grounds*, 250 F.3d 763 (Fed. Cir. 2000), one party in patent infringement litigation (Bard) sought documents that the other party (Go) had shared with its insurer. *Id.* at \*1. The court found that Go's and its insurer's interests were "insufficiently compatible for the common interest rule to apply," and therefore that Go's disclosure to its insurer waived the attorney-client privilege. *Id.* at \*3–4; *see also Linde Thomson Langworthy Kohn & Van Duke, P.C. v. Resolution Trust Corp.*, 5 F.3d 1508, 1515 (D.C. Cir. 2003) (much communication between a policyholder and its insurer has "little to do with the pursuit of legal representation or the procurement of legal advice," and is thus not protected by the attorney-client privilege). Work product shared with the insurer fared better, however: "unlike the attorney-client privilege, the work product privilege is not automatically waived by any disclosure to third persons." *Go Med. Indus.*, 1998 WL 1632525, at \*7 (internal quotations



omitted). Because Go's disclosure to its insurer "did not substantially increase the opportunity for *C.R. Bard* to obtain its work product," it did not waive work product protection. *Id.*; see also *In re Pfizer, Inc. Secs. Litig.*, No. 90Civ.1260(SS), 1993 WL 561125, at \*8 (S.D.N.Y. Dec. 23, 1993) (policyholder waived attorney-client privilege but not work product protection when it disclosed documents to its insurer).

Policyholders whose claims fall within the purview of California's independent counsel statute may also find some statutory protection against waiver, at least with respect to underlying plaintiffs. In *First Pacific Networks, Inc. v. Atlantic Mutual Insurance Co.*, 163 F.R.D. 574, 584 (N.D. Cal. 1995), the court relied on the statutory provision that "information disclosed [to the insurer] by the insured or by independent counsel is not a waiver of the privilege as to any other party," to hold that a policyholder did not waive the attorney-client privilege for documents provided to its insurer. The court suggested, however, that absent the statute, waiver would have occurred because no common interest existed between the policyholder and an insurer acting under a reservation of rights. *Id.* at 579–80.

In sum, some courts have rejected underlying adversaries' claims of waiver when policyholders have disclosed privileged or protected defense-related materials to their insurers. Other policyholders have been less fortunate.

### **Tips for Company Counsel**

In the ambivalent, rights-reserved relationship of liability insurance claims, few safe havens emerge from the case law on cooperation and privilege waiver. When an insurer who is not funding and controlling the policyholder's defense demands privileged or protected defense information as a precondition to coverage, policyholder counsel faces a dilemma with no perfect solutions. Nonetheless, we offer here a few practical pointers to consider.

*Learn the traps, or bring in help.* In-house counsel and defense counsel should first inform themselves about the rules of cooperation and waiver under the law (or, more likely, laws) potentially governing them. Alternatively, experienced coverage counsel can provide guidance both with the rules and with the practices of particular insurers.

*Coordinate litigation defense and coverage pursuit.* Defense counsel and coverage counsel should consult whenever questions about disclosure and privilege arise—as they inevitably will, both in the coverage claim and in the underlying defense. Defense counsel should carefully segregate these coverage-related communications from their underlying defense files and preferably open a separate billing file for coverage-related work.

*Assume hostile eyes will see time entries.* The ABA ethics opinions recognize that billing and time records should generally be "protected by the confidentiality rule or the attorney-client privilege or both." ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 01-421 (2001).

The parties should explore alternatives to producing counsel's time records to insurers, such as summaries or redactions. Nonetheless, underlying defense lawyers should understand that the insurer may eventually see their time records if the policyholder is to receive the benefit of its defense coverage. Moreover, an underlying plaintiff may seek to discover what was disclosed to the insurer. Thus, timekeepers should record their time accurately and informatively, but with sufficient lawyerly generality to avoid revealing the specifics of strategy or sensitive matters to adversaries.

*Assume hostile eyes will see settlement and litigation analyses.* For similar reasons, written settlement evaluations and litigation analyses should stick to the objective facts, particularly those that relate to causation and the plaintiff's quantifiable damages. If the company's conduct or intent is the litigation's focus, counsel wishing to discuss sensitive or nuanced defense issues should remember that an old-fashioned conversation is usually preferable to an exchange of emails.

*Consider mediation.* Many states recognize some form of statutory mediation privilege, cloaking communications made during mediation with enhanced protection from disclosure to third parties. *See, e.g.,* Cal. Evid. Code § 1119; D.C. Code §§ 16-4203 to -4205. If the parties are otherwise inclined toward a coverage resolution, a formal mediation procedure can provide the context for the policyholder's responses to insurer requests for defense invoices or other sensitive information. Thus, the mediation process may relieve the tension between insurance cooperation and privilege protection; and if it succeeds in eliminating policyholder-insurer adversity on coverage, it will reduce the risk of privilege waiver against third parties going forward.

*Craft an appropriate insurance information protocol.* An early policyholder-insurer agreement can both define the parties' information expectations and memorialize their intent to protect confidentiality and privilege. Of course, as the *Imperial* case demonstrates, a one-size-fits-all "joint defense agreement" between policyholder and insurer may prove ineffective against third parties. *See* 167 F.R.D. at 455–56. But by clarifying and memorializing the parties' interests and intentions, an information agreement could help a court to distinguish the friendly side of the policyholder-insurer relationship from its unfriendly side, so that it protects confidential communications supporting the former (as the *Lectrolarm* court did, 212 F.R.D. at 573). Such agreements must be tailored to the specific circumstances, but should include the following features:

- Regulate disclosure of protected material. As indicated above, summaries or other alternatives may suffice instead of actual protected documents. It is in both parties' interest to minimize the waiver risk by limiting sensitive disclosures in the first instance.
- Define and confine the scope of policyholder-insurer adversity. The insurer's reservation or denial of coverage may be limited to particular issues, for example, a punitive damages claim in the underlying complaint. The agreement should identify the boundaries of the



parties' adversity and the circumstances under which adversity may disappear, for example after dismissal of a claim.

- Define common interests, and confine disclosures to their support. The agreement should memorialize where the parties' interests are aligned, for example, in preventing or minimizing the underlying liability. It should further clarify that confidential information is provided solely to further common interests.
- Document the expectation of privacy. The agreement should provide for confidential treatment of privileged or protected information, confine its use to common interests, and memorialize the parties' intent to preserve applicable privileges without waiver.

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## **AT&T Mobility's Impact on Employers' Arbitration Agreements**

By Andrée P. Laney

On April 27, 2011, in *AT&T Mobility LLC v. Concepcion*, 563 U.S. \_\_\_, 2011 U.S. LEXIS 3367 (2011), the Supreme Court held in a 5–4 decision that the class action waiver in a consumer arbitration agreement was enforceable, even though the state law expressly held such waivers to be illegal in consumer agreements of this type. The Concepcions, a California couple, had attempted to bring a class action against AT&T in federal district court in 2006 after they were charged \$30 apiece for cell phones the company purportedly had advertised as "free."

### **Read the Fine Print**

AT&T moved to compel arbitration based on the consumer arbitration agreement in its cell phone service contract, which required consumers to arbitrate all disputes and expressly waived class actions.

The Concepcions opposed AT&T's motion, claiming that the consumer arbitration agreement's class action waiver was unconscionable under California's *Discover Bank* rule and, therefore, unenforceable under the Federal Arbitration Act (FAA), 9 U.S.C. § 1 et seq. Applicable to all arbitration agreements involving interstate commerce, the FAA encourages arbitration of disputes and seeks to ensure that agreements are enforced as written by the parties. Under section 2 of the FAA, known as the "savings clause," arbitration agreements are unenforceable only "upon such grounds as exist at law or in equity for the revocation of any contract," such as fraud or duress, or unconscionability. 9 U.S.C. § 2.

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The Concepcions argued that their service contract with AT&T Mobility was an adhesion contract, wherein the much more powerful corporation had unilaterally drafted nonnegotiable terms and conditions that greatly disadvantaged the less powerful consumer. Because California law stated that class action waivers in consumer adhesion contracts are unconscionable, the Concepcions reasoned their contract with AT&T Mobility likewise was unconscionable and, therefore, unenforceable under section 2 of the FAA.

Derived from the decision of California's highest state court in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), the *Discover Bank* rule prohibits as unconscionable class action waivers in consumer contracts of adhesion ("take it or leave it" contracts). The state court reasoned that class action waivers in consumer agreements—where the parties' bargaining powers are inherently unequal—would unconscionably disadvantage consumers. Merchants' misconduct would go unchecked, as consumers' damages would be so small individually that they would be far less likely to pursue and vindicate their claims separately than they would if allowed to band together.

The court's reasoning in the *Discover Bank* case was persuasive to many. Indeed, both the district court and Ninth Circuit denied AT&T's motion to compel arbitration, finding that the class action waiver in AT&T's service contract with the Concepcions violated the *Discover Bank* rule and was therefore unenforceable under the FAA.

**Supreme Court Compares FAA and State Law**

The U.S. Supreme Court granted certiorari, determining that "[t]he question in this case is whether § 2 [of the FAA] preempts California's [*Discover Bank*] rule classifying most collective arbitration waivers in consumer contracts as unconscionable." *AT&T Mobility*, 2011 U.S. LEXIS 3367, at \*11.

Typically, when federal and state law conflict, the state law is preempted. However, in the *AT&T Mobility* case, the state law and federal law appear to work in tandem. The FAA says that unconscionable agreements are unenforceable and, furthermore, the FAA does not define the term "unconscionable." Arguably, the *Discover Bank* rule merely clarifies that certain arbitration agreements are per se unconscionable. Right?

**Mere Preference Is Not Law**

Not so fast, said the Supreme Court, which was not convinced that the *Discover Bank* rule met the enforcement exception in the FAA's savings clause. The Court criticized the California court's failure to demonstrate that class-wide waivers in consumer agreements met the state's legal standard of unconscionability: substantive and procedural unconscionability. *Id.* at \*11–12. Instead, the Court found, California's *Discover Bank* rule evolved from the state's disfavor of bilateral arbitration to resolve disputes where merchants have used superior bargaining power to avoid responsibility for defrauding consumers.

While the rule's intent to protect "the little guy" was laudable, the Court found the ends did not justify the means. In an unmistakable criticism of California's judiciary, the Court noted that "California's courts have been more likely to hold contracts to arbitrate unconscionable than other contracts," *id.*, and cautioned that arbitration agreements would be "eviscerated" if courts allowed unconscionability to be defined by "a State's mere preference for procedures that are incompatible with arbitration," *id.* at \*16–17.

### **Competing Interests**

In the end, the Court concluded that the *Discover Bank* rule tried to do an end run of sorts around the FAA's standard for not enforcing arbitration agreements, i.e., that grounds exist that would render "any contract" unenforceable, by carving out a type of agreement (those with class action waivers) and deeming them unconscionable. Rejecting this effort, the Court reasoned that "a court may not rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable, for this would enable the court to effect what the state legislature cannot," *id.* at \*31.

### **Federal Law Prevails**

Rejecting the *Discover Bank* rule's authority to change parties' agreements to class action waivers after the fact, the Court concluded that "[a]rbitration is a matter of contract and the FAA requires courts to honor parties' expectations." *Id.* Found to stand "as an obstacle to the accomplishment and execution of the full purposes and objectives of the FAA," *id.* at \*33, the *Discover Bank* rule was preempted.

### **What Does This Mean in the Employment Context?**

#### *Consumers and Employees Are Similar*

Admittedly, *AT&T Mobility* is a consumer protection case and, unlike adhesion contracts, employment agreements are typically entered into "at will." But there are similarities. The relationship of employers and employees, like that of businesses and consumers, has been governed by federal legislation (e.g., Title VII, Sherman Act). Like their consumer counterparts, employees are legally empowered to bring claims to vindicate their rights. In fact, the analytical similarities between arbitration agreements in consumer contracts and employment agreements have prompted courts analyzing employment cases to borrow rationales from consumer cases. *E.g., Sutherland v. Ernst & Young*, 2011 U.S. Dist. LEXIS 26889 (S.D.N.Y. Mar. 3, 2011) (court rejects employer's class action waiver based on application of test that was developed in a consumer law case).

#### *Arbitration Is Good for Business*

The Court could have limited its preemption analysis to the fact that the *Discover Bank* rule conflicted with the FAA. But it didn't. Instead, the Court went further to strongly endorse bilateral arbitration to resolve business disputes. Conceding that parties could agree to class arbitration, the Court nevertheless made clear that "[a]rbitration is poorly suited to the higher



stakes of class litigation" *AT&T Mobility*, 2011 U.S. LEXIS 3367, at \*29. Instead, the Court extolled many benefits of bilateral arbitration—namely, informality, efficiency, cost-effectiveness, and procedural flexibility. *Id.* at \*19–20.

The Court then painted a daunting portrait of how class arbitrations would terrorize businesses into settling questionable claims, bog down once-streamlined processes into a complex and procedure-heavy morass, and give both parties very few bases on which to review and challenge an arbitrator's decision. *Id.* at \*25–29. The Court also cautioned that plaintiffs' lawyers would have little incentive to represent individual plaintiffs and businesses would have even less incentive to entertain and resolve individual plaintiffs' claims. *Id.* at \*23–24.

In essence, the Court cautioned, if you change arbitration, the "little guy" would lose.

#### *No Adhesion Contract Here*

While employees have repeatedly challenged employment agreements as unenforceable adhesion contracts, citing the oft-pre-printed forms and "take it or leave it" nature of many job offers, courts have held consistently that mandatory arbitration agreements are not unconscionable and are enforceable. *Cf. Am. Gen. Life Ins. Co. v. Wood*, 429 F.3d 83 (4th Cir. 2005) (arbitration agreement was valid and enforceable, despite being an adhesion contract); *Desiderio v. NASD*, 191 F.3d 198 (2d Cir. 1999) (Form U4, which mandates arbitration in securities industry, found not to be unconscionable); *Seus v. John Nuveen & Co. Inc.*, 146 F.3d 175, 184 (3d Cir. 1998) (U4 arbitration clause is not a contract of adhesion).

### **What Should Employers Do?**

#### *Revise Your Agreements*

The Court's pro-arbitration analysis and holding in *AT&T Mobility* suggest that employers without arbitration agreements should consider them. Employers who have such agreements should consider amending them to add class action waivers.

Employers who choose to revise their arbitration agreements in light of the *AT&T Mobility* case should be mindful of certain considerations regarding statutory rights, scope, and notice in drafting or revising their arbitration agreements to include class action waivers.

#### *Give Employees Proper Notice of Revisions*

If amending an existing arbitration agreement to include a class action waiver, provide clear and unequivocal written notice to employees of that fact. In *Skirchack v. Dynamics Research Corp.*, 508 F.3d 49 (1st Cir. 2007), the First Circuit held that an employer could not communicate the addition of a class action waiver to its employees via an email buried within a document that neither identified itself as containing a class action waiver nor required that its employees agree to the waiver. The court concluded that the timing, the language, and the format of the email rendered the class action waiver both procedurally and substantively unconscionable. *Id.* at 60.

*Identify Statutory Claims*

There is no prohibition to employers requiring employees to arbitrate their statutory rights. *Cf. Circuit City Stores, Inc. v. Adams*, 532 U.S. 105 (2001); *Desiderio*, 191 F.3d 198 (found no evidence that Congress intended to preclude waiver of judicial forum in Title VII claim). However, and of particular importance in collective bargaining agreements, employers must specify the statutes under which disputes are referable to arbitration and expressly waive any rights the employee may have to litigate those statutory claims (such as those under Title VII of the Civil Rights Act, the Age Discrimination in Employment Act, and the Americans with Disabilities Act) as part of a class or in a judicial forum. *Cf. Wright v. Universal Mar. Serv. Corp.*, 525 U.S. 70, 80 (1998) (Court denied defendant's motion to compel arbitration of an Americans with Disabilities Act (ADA) claim where the collective bargaining agreement only called for arbitration of "all disputes" in general and, in the absence of specificity, the Court deemed the federal court system is better suited for a claim under the ADA).

*Assess Procedural Costs and Benefits*

An employer who requires its employees to arbitrate any such statutory claims must ensure that the class action waiver (as well as the rest of the agreement) protects the employees' substantive statutory claims. *14 Penn Plaza v. Pyett*, 129 S. Ct. 1456, 1469 (2009) ("By agreeing to arbitrate a statutory claim a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum"). In *Sutherland v. Ernst & Young*, 2011 U.S. Dist. LEXIS 26889 (S.D.N.Y. Mar. 3, 2011), for example, the court allowed the plaintiffs' overtime class action to go forward in litigation despite the employer's mandatory arbitration provision. The court applied a costs-benefits test developed in *In re American Express Merchants' Litigation*, 554 F.3d 300 (2d Cir. 2009), which had dealt with a class action waiver in merchants' service agreements with Amex. The *Sutherland* court concluded that the potential employee's individual claim of \$2,000 was "too meager to justify" the costs of pursuing that claim, which were likely to exceed \$200,000. In essence, the costs so far outweighed the benefits, the court concluded, that the practical effect of the class action waiver was to prevent employees from vindicating their statutory rights and to give the employer de facto immunity for any alleged wage law violations. *Sutherland*, 2011 U.S. Dist. LEXIS 26889, at \*19–20.

Using a similar costs-benefits analysis, the Court in *AT&T Mobility* demonstrated that courts will review the terms of an arbitration agreement to discern whether it impermissibly discourages employees from pursuing claims against an employer. Although the Court's holding relied primarily upon the judicial deference afforded parties' agreements under the FAA, the Court did note, nonetheless, that AT&T Mobility's agreement provided consumers many procedural benefits—such as requiring AT&T Mobility to (1) pay all costs for non-frivolous claims, (2) hold the arbitration in the consumer's county, (3) allow for punitive damages, (4) forfeit claims to recover attorney fees, and (5) pay at least \$7,500 to any consumer who recovered more in arbitration than AT&T Mobility had previously offered to settle the case—noting that the district court had concluded that the Concepcions were in fact better off under the arbitration



agreement than they would have been under a class action litigation. *AT&T Mobility*, 2011 U.S. LEXIS 3367, at \*32.

*Specify Your Choice of Law*

In addition to thinking about statutory claims, employers who operate in more than one state need to consider which state's laws to apply to disputes that arise under the arbitration agreement. An employer's choice of law will impact possible awards rendered under their arbitration agreements. While the FAA has generated substantive law determining whether a dispute is arbitrable, state law may control such things as the availability of punitive damages and the standards applied to review or vacate arbitration awards.

*Define the Scope of the Arbitrator's Authority*

Finally, employers should ensure that they specify the scope of an arbitrator's authority regarding resolution of disputes. Pursuant to the FAA, courts are directed to resolve all ambiguities regarding the scope of an arbitration agreement in favor of arbitrability. *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 475–76 (1989). In the absence of clear direction from the agreement, however, courts will refer to litigation issues they determine the "contracting parties would likely have expected a court" to decide, such as whether a contract is valid or applies to the type of dispute at hand. *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83 (2002). Accordingly, if employers want to increase the likelihood of keeping the dispute within the arbitral forum, they should specify, for example, that issues regarding not only arbitrability, but also the arbitrator's jurisdiction, construction of the agreement, and substantive defenses to arbitrability, should be expressly subjected to the arbitrator's authority.

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## Asserting and Defending Class Actions in Bankruptcy

By Angela C. Zambrano and Margaret Hope Allen

Under chapter 11 of the United States Code (the Bankruptcy Code), claimants in a bankruptcy must file proofs of claim to participate in a reorganization and obtain any consideration from the estate. *See* Bankruptcy Rule 3003(c). Because the Bankruptcy Code contains no explicit provision authorizing the filing of a class proof of claim, whether a proof of claim could be filed on behalf of a class of individuals was a hotly disputed question up until the late 1980s, when the Seventh Circuit issued the landmark decision of *In re American Reserve Co.*, 840 F.2d 487 (7th Cir. 1988) (Easterbrook, J.). As of the late 1980s, the majority of courts to consider the question did not allow class proofs of claim. *See In re Standard Metals*, 817 F.2d 625 (10th Cir. 1987), *vacated and rev'd on other grounds sub nom. Sheftelman v. Standard Metals Corp.*, 839 F.2d

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1383 (1987), *cert. dismissed*, 488 U.S. 881, 109 S. Ct. 201, 102 L. Ed. 2d 171 (1988); *In re Allegheny Int'l, Inc.*, 94 B.R. 877 (Bankr. W.D. Pa. 1988); *In re Great W. Cities, Inc.*, 88 B.R. 109, 112 (Bankr. N.D. Tex. 1988); *In re Vestra Indus., Inc.*, 82 B.R. 21, 22 (Bankr. S.C. 1987); *In re Elec. Theatre Restaurants Corp.*, 57 B.R. 147 (Bankr. N.D. Ohio 1986); *In re Cont'l Airlines Corp.*, 64 B.R. 874, 880 (Bankr. S.D. Tex. 1986); *In re Computer Devices, Inc.*, 51 B.R. 471 (Bankr. D. Mass. 1985); *In re Johns-Manville Corp.*, 53 B.R. 346 (Bankr. S.D.N.Y. 1985); *In re Baldwin-United Corp.*, 52 B.R. 146, 147 (Bankr. S.D. Ohio 1985); *In re Shulman Transp. Enters., Inc.*, 21 B.R. 548 (Bankr. S.D.N.Y. 1982), *aff'd*, 33 B.R. 383 (S.D.N.Y. 1983), *aff'd*, 744 F.2d 293 (2d Cir. 1984); *In re Soc'y of the Divine Savior*, 15 Fed. R. Serv. 2d 294 (E.D. Wis. 1971). *See also Secs. & Exch. Comm'n v. Aberdeen Secs. Co.*, 480 F.2d 1121, 1128 (3d Cir.), *cert. denied*, 414 U.S. 1111, 94 S. Ct. 841, 38 L. Ed. 2d 738 (1973) (affirming refusal to treat individual claims as part of a class action in a proceeding under old Bankruptcy Act and Securities Investor Protection Act of 1970, 15 U.S.C.A. §§ 78 et seq.); *In re Stirling Homex Corp.*, 579 F.2d 206, 209 n.5 (2d Cir. 1978), *cert. denied sub nom. Jezarian v. Raichle*, 439 U.S. 1074, 99 S. Ct. 847, 59 L. Ed. 2d 40 (1979) (noting but not reaching district court's disallowance of bankruptcy claims to the extent made on behalf of class of claimants); *In re Grocerland Coop., Inc.*, 32 B.R. 427 (Bankr. N.D. Ill. 1983) (dicta); *In re Cartridge Television, Inc.*, 535 F.2d 1388 (2d Cir. 1976) (mooting bankruptcy court's ruling against class claim); *In re U.S. Truck Co., Inc.*, 89 B.R. 618, 623 n.3 (E.D. Mich. 1988) (dicta); *In re The Woodmoor Corp.*, 4 B.R. 186 (Bankr. D. Colo. 1980) (dicta).

Aside from the Bankruptcy Code's lack of express authorization allowing class proofs of claim, the other main reason why historically courts found that class proofs of claim should not be allowed is because the class procedures afforded by Rule 23 are already mimicked by the bankruptcy claim filing process. *See In re Am. Reserve Corp.*, 840 F.2d at 490 (discussing whether class device should be applicable in bankruptcy proceedings as bankruptcy achieves benefits of consolidation of claims "without the need for class suits—class actions are a headache for judges"). The Seventh Circuit found that class proofs of claim were not per se invalid. In the wake of this decision, courts now routinely accept that proofs of claim can be filed on behalf of a class of individuals.

But there remain numerous and substantial hurdles to asserting a class claim in bankruptcy. The largest hurdle is that recognition of a class proof of claim is not automatic—the bankruptcy court has broad discretion to decide whether to allow the claim to proceed as a class claim. Generally, in determining whether to permit class treatment, a bankruptcy court will determine that

(1) the class claimant has moved to extend application of Rule 23 of the Federal Rules of Civil Procedure

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(2) the benefits to be gained from the use of a class claim device are consistent with goals of bankruptcy such that the bankruptcy court should allow the application of Rule 23, and, if so,

(3) the claims sought to be certified fulfill the requirements of Rule 23. *See In re Mortg. & Realty Trust*, 125 B.R. 575, 580 (Bankr. C.D. Cal. 1991); *In re CommonPoint Mortg. Co.*, 283 B.R. 469, 479 (Bankr. W.D. Mich. 2002); *In re Tarragon Corp.*, No. 09-10555 DHS, 2010 WL 3842409, at \*3 (Bankr. D.N.J. Sept. 24, 2010); *In re Blockbuster Inc.*, 441 B.R. 239, 241 (Bankr. S.D.N.Y. 2011); *In re Motors Liquid. Co.*, No. 09-50026(REG), 2011 WL 284933, at \*4 (Bankr. S.D.N.Y. Jan. 28, 2011); *In re Circuit City Stores, Inc.*, No. 08-35653, 2010 WL 2208014, at \*7 (Bankr. E.D. Va. May. 28, 2010).

This article is a road map to plaintiffs' counsel and debtor's counsel to help them navigate the potential pitfalls and technical hurdles that arise when litigating class actions in bankruptcy.

**Moving for Application of Rule 23 under Bankruptcy Rule 9014**

A plaintiff who seeks to bring a class proof of claim must comply with the applicable procedural requirements. *See, e.g., In re Am. Reserve Corp.*, 840 F.2d at 494 (noting applicability of Bankruptcy Rule 9014 and its procedural requirements); *see In re Ephedra Prods. Liab. Litig.*, 329 B.R. 1, 6–7 (S.D.N.Y. 2005) (same). These procedural requirements are not complicated, but are often overlooked. As discussed in further detail below, because a claim "cannot be allowed as a class claim until the bankruptcy court directs that Rule 23 apply," the putative class representative must file a motion with the bankruptcy court requesting the application of Rule 23 pursuant to Bankruptcy Rule 9014. *In re Woodward & Lothrop Holdings, Inc.*, 205 B.R. 365, 370 (Bankr. S.D.N.Y. 1997). As discussed below, class counsel should file this motion as soon as possible because if it is filed later in the bankruptcy process, the bankruptcy court may be less inclined to allow the class claim due to the risk of delay to the reorganization process and prejudice to the debtors and other creditors. *Id.* at 368, 370 ("Rule 23 does not say who must make a timely motion, but the duty ordinarily falls on the proponent of the class action.").

In addition, a purported agent (like class counsel or class representative) should consider filing a verified statement of multiple creditor representation pursuant to Bankruptcy Rule 2019. *See Fed. R. Bankr. P. 2019*. While failure to file a statement under Rule 2019 is unlikely to be fatal to a class claim, it may be necessary in some jurisdictions. In general, bankruptcy courts are loath to pour out class claims due to failure to comply with "hyper-technical" bankruptcy rule requirements. *See, e.g., In re Charter Co.*, 876 F.2d 866, 873 (11th Cir. 1989) (holding failure to file Bankruptcy Rule 2019 statement was irrelevant because "[i]f class certification is appropriate, compliance with the class action procedures would satisfy the rule's objectives *nunc pro tunc*; and, on the other hand, if the bankruptcy judge exercises his discretion not to apply Rule 23, the question of compliance with 2019 is moot"); *In re Craft*, 321 B.R. 189, 198 (Bankr. N.D. Tex. 2005) ("[A] court decision certifying a class, in and of itself, satisfies the requirements of Rule 2019."); *but see Reid v. White Motor Corp.*, 886 F.2d 1462, 1471 (6th Cir. 1989), *cert.*

*denied*, 494 U.S. 1080 (1990) ("Failure to comply with Rule 2019 is cause for denial of the proof of claim."); *In re Baldwin-United Corp.*, 52 B.R. at 148 (ruling that claimants' failure to comply with Rule 2019(a) barred their ability to file class proof of claim); *In re GAC Corp.*, 681 F.2d 1295, 1299 (11th Cir. 1982) (affirming disallowance of class proof of claim filed on behalf of debtor's debenture holders where, among other things, proposed class representative failed to comply with the predecessor of Rule 2019).

### **The Court's Discretion to Apply Rule 23**

There is no absolute right to file a class proof of claim under the Bankruptcy Code. *See In re Bally Total Fitness of Greater N.Y., Inc.*, 402 B.R. 616, 619 (Bankr. S.D.N.Y.), *aff'd*, 411 B.R. 142 (S.D.N.Y. 2009); *In re Sacred Heart Hosp.*, 177 B.R. 16, 22 (Bankr. E.D. Pa. 1995) (noting that class action device may be utilized in appropriate contexts, but should be used sparingly). Instead, application of Bankruptcy Rule 7023 (which provides that Rule 23 applies in adversary proceedings) to class proofs of claim lies within the sound discretion of the court. Part VII of the Bankruptcy Rules, which includes Bankruptcy Rule 7023 (the Bankruptcy Rule that incorporates Rule 23 of the Federal Rules of Civil Procedure), only applies to adversary proceedings. *See Fed. R. Bankr. P. 7001*. Bankruptcy Rule 9014 adopts certain of the rules from Part VII for application in contested matters. But Bankruptcy Rule 7023 is not among them. *See Fed. R. Bankr. P. 9014*. Thus, plaintiffs seeking the application of Bankruptcy Rule 7023 (and, by implication, Rule 23) to a class proof of claim are required to *move* under Bankruptcy Rule 9014 for a court to apply the rules in Part VII. *See Fed. R. Bankr. P. 9014*; *accord In re Woodward*, 205 B.R. at 369 (stating that "[f]or a Class Claim to proceed . . . the bankruptcy court must direct Rule 23 to apply"). *See, e.g., Reid*, 886 F.2d at 1470; *In re Charter Co.*, 876 F.2d at 876 (holding that proof of claim filed on behalf of class of claimants is valid, but that "does not mean that the appellants may proceed, without more, to represent a class in their bankruptcy action. Under the bankruptcy posture of this case, Bankruptcy Rule 7023 and class action procedures are applied at the discretion of the bankruptcy judge."). In exercising that discretion, the bankruptcy court first decides under Bankruptcy Rule 9014 whether or not to apply Rule 23 to the purported class claim; if and only if the court decides to apply Rule 23 does it then determine whether the requirements of Rule 23 are satisfied. *In re Ephedra Prods. Liab. Litig.*, 329 B.R. at 5.

When determining whether to apply Bankruptcy Rule 7023, courts focus on whether the benefits to be gained from the use of a class claim device are consistent with goals of bankruptcy. In making that determination, courts have considered a variety of factors, including, *inter alia*,

- whether claimants are in "compliance with the Bankruptcy procedures regulating the filing of class proofs of claim in a bankruptcy case" (*See, e.g., In re Thomson McKinnon Secs Inc.*, 133 B.R. 39, 41 (Bankr. S.D.N.Y. 1991) (disallowing class proof of claim where named plaintiff failed to file Bankruptcy Rule 9014 motion requesting that Rule 7023 apply).)

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- whether the debtor intends to liquidate, *see id.* at 41 (noting that context of liquidating chapter 11 plan supports rejection of class proofs of claim)
- whether or not a purported class was previously certified (*See, e.g., In re Bally Total Fitness*, 402 B.R. at 620 (refusing to allow class proof of claim where class was not certified prepetition); *In re Sacred Heart Hosp.*, 177 B.R. at 23 (classes certified prepetition are "best candidates" for class proof of claim).). A number of other courts have held that class proofs of claim may be inappropriate where a class was not certified pre-petition in a non-bankruptcy forum. *See, e.g., In re Trebol Motors Distrib. Corp.*, 220 B.R. 500, 502 (B.A.P. 1st Cir. 1998); *In re Ret. Builders, Inc.*, 96 B.R. 390, 391 (Bankr. S.D. Fla. 1988); *In re Ephedra Prods. Liab. Litig.*, 329 B.R. at 5. However, the authors are not aware of any case within the Second Circuit in which a class proof of claim was allowed when the class was not certified prepetition.
- whether the class action has been filed and allowed to proceed as a class action in a non-bankruptcy forum for a considerable time prepetition (*In re Sacred Heart Hosp.*, 177 B.R. at 22.)
- whether the class claim device will result in "increased efficiency, compensation to injured parties, and deterrence of future wrongdoing by the debtor" (*See In re Woodward*, 205 B.R. at 376 (internal citations omitted); *accord In re Thomson*, 133 B.R. at 40 ("Manifestly, the bankruptcy court's control of the debtor's affairs might make class certification unnecessary.").)
- whether the entertainment of class claims would subject the administration of the bankruptcy case to undue delay (*See, e.g., In re Ephedra Prods. Liab. Litig.*, 329 B.R. at 5 ("[A] court sitting in bankruptcy may decline to apply Rule 23 if doing so would . . . 'gum up the works' of distributing the estate.").)
- whether or not adequate notice of the bar date was afforded to potential class members (*See In re Jamesway Corp.*, No. 95 B 44821 (JLG), 1997 WL 327105, at \*10 (Bankr. S.D.N.Y. June 12, 1997) (refusing to certify class where adequate notice of bar date was afforded to potential class members, and thus to certify class would be "unwarranted, unfair, and possibly violate the due process rights of other creditors") (internal quotations omitted).)

The application of these factors by courts may differ across the circuits. For instance, there are some courts, notably in the Third Circuit, that seem to be more inclined to apply Rule 23. *See, e.g., In re United Cos. Fin. Corp.*, 277 B.R. 596, 601 (Bankr. D. Del. 2002); *In re Kaiser Grp. Int'l, Inc.*, 278 B.R. 58, 63–64 (Bankr. D. Del. 2002). These cases are in the minority and have been criticized by other courts. *See In re Craft*, 321 B.R. at 192 (criticizing *Kaiser Group Int'l, Inc.*). If the bankruptcy court denies application of Rule 7023 in an exercise of its discretion, the result will be that class claims will be denied and expunged. *In re Thomson*, 133 B.R. at 40–41.

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The factor of whether or not a purported class was previously certified closely relates to the factor regarding whether the entertainment of class claims would subject the administration of the bankruptcy case to undue delay because a large certification battle could be costly to the estate and potentially delay confirmation of a plan and distributions to creditors. As a result, in some jurisdictions, such as the Second Circuit, this factor can be nearly dispositive. There are no published cases in the Second Circuit allowing class treatment for a proof of claim where the class was not certified pre-petition and the propriety of certification was in dispute. But in some other jurisdictions, courts are willing to permit class treatment where the class was not certified pre-petition. *See, e.g., In re Mortg. & Realty Trust*, 125 B.R. at 578 (permitting class claim where class was certified post-petition by district court); *In re Kaiser Group Int'l, Inc.*, 278 B.R. at 64 (permitting class claim where class was not certified pre-petition). Further, decertification of a class or a denial of a pre-petition motion for class certification is grounds for denial of the application of Rule 23. *See In re Blockbuster Inc.*, 441 B.R. at 242.

The question of whether the entertainment of class claims would subject the administration of the bankruptcy case to undue delay is possibly the most important, as delay of the administration of the bankruptcy estate stands to prejudice the debtor and other creditors. As stated in the *In re Ephedra Productions Litigation* decision, "a court sitting in bankruptcy may decline to apply Rule 23 if doing so would . . . 'gum up the works' of distributing the estate." *In re Ephedra Prods. Liab. Litig.*, 329 B.R. at 5. In this regard, class counsel should not wait to file a motion under Bankruptcy Rule 9014 for application of Rule 23 until the debtor objects to the class claim, as doing so late in the bankruptcy proceedings or on the eve of plan confirmation may heighten the risk of prejudice to the debtor and other creditors and, thus, denial of the class claim. *See In re Musicland Holding Corp.*, 362 B.R. 644, 654 (Bankr. S.D.N.Y. 2007) (citing *In re Computer Learning Ctrs., Inc.*, 344 B.R. 79 (Bankr. E.D. Va. 2006)) (holding that motion to apply Rule 23 "should be filed as soon as practicable" and should be denied if it comes so late as to prejudice any party). There is some authority for the proposition that a class claimant need not assert a motion under Bankruptcy Rule 9014 for application of Rule 23 until the debtor objects to the claim. *See In re Charter Co.*, 876 F.2d at 874. But this authority is at odds with the plain language of Rule 23, and has been roundly rejected by many courts. Fed. R. Civ. P. 23(c)(1)(A) (class certification decision should be made "at an early practicable time"); *see In re Ephedra Prods. Liab. Litig.*, 329 B.R. at 7 (disagreeing and distinguishing *In re Charter Co.*, and holding claimants had right to move for class certification from moment debtors' chapter 11 petition was filed); *see also In re Musicland Holding Corp.*, 362 B.R. at 652 (where claimants moved for certification before debtor filed claim objection, court noted that claimants "could have made the motion sooner," and "[a]lthough the delay does not automatically disqualify the class claim, it bears on the exercise of the discretion whether to apply Rule 23"); *In re Thomson*, 133 B.R. at 40 (disallowing class claim for failure to file motion under Bankruptcy Rule 9014 because "the costs and delay associated with class actions are not compatible with liquidation cases where the need for expeditious administration of assets is paramount so that all creditors, including those not within the class, may receive a distribution as soon as possible").

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With respect to defending class claims from a debtor's perspective, a good defense starts with a good offense. Adequate notice of the bar date (i.e., the claimants' deadline to file claims against the debtor's estate) is of the utmost importance. A bankruptcy court will be less inclined to disallow a class claim if doing so means that hundreds or thousands of individuals stand to be barred from asserting claims against the estate because they failed to file proofs of claim on their individual behalf; as a result, if there is a question as to whether notice of the bar date was adequate to these individuals, the bankruptcy court may require additional notice to be issued and extend the deadline to file individual claims. One of the principal goals of the Bankruptcy Code is to ensure that creditors of equal rank receive equal treatment in the distribution of a debtor's assets. Therefore, the Bankruptcy Code and Bankruptcy Rules require creditors to file proofs of claim before a bar date. *See* 11 U.S.C. § 502(b)(9); Fed. R. Bankr. P. 3003(c)(3). Regardless of how worthy their claims may be, claimants who fail to file before an applicable bar date "shall not be treated as a creditor with respect to such claim for the purposes of voting and distribution." Fed. R. Bankr. P. 3003(c)(2). But if the notice program is found to be adequate, there is authority holding that members of a putative class that was not certified prepetition cannot rely on the filing of a class claim to reserve their rights, and must file claims on their individual behalf. *See In re Jamesway Corp.*, 1997 WL 327105, at \*10 (denying motion for class certification of class claim where "[n]o class was pre-certified such that purported class members who did not choose to file a proof of claim should or could have had any reasonable expectation that they need not comply with the Bar Date Order").

In determining whether a class proof of claim should be allowed, courts consider whether adequate notice of the bar date was afforded to potential class members. *See In re Jamesway Corp.*, 1997 WL 327105, at \*8 ("The proper inquiry is whether [the debtor] acted reasonably in selecting means likely to inform persons affected by the Bar Date and these chapter 11 proceedings. . . ."). As with any good notice program, actual notice of the bar date should be as broad as reasonably practicable, and at a minimum include class counsel in pending class actions and class members whose identities and addresses are known or easily ascertainable by the debtor. *In re Amdura Corp.*, 170 B.R. 445 (D. Colo. 1994) (stockholders' actual identities were known and addresses were "easily ascertainable" and could be obtained from class representatives); *In re Am. Reserve Corp.*, 840 F.2d at 491 (stating that trial court judge "might consider" directing additional notice and invite individual proofs of claim as opposed to allowing class proof of claim where debtor insurance company could "identify its own policyholders without difficulty" to mail individuals notice). If the identities and addresses of class members are not known, notice by publication will likely be upheld as adequate. *See Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 317 (1950) (holding notice by publication is constitutional in the case of unknown persons, "however great the odds that publication will never reach the eyes of such unknown parties"). Further, while certain circumstances may warrant notice to foreigners, such as in the event putative class members likely reside outside the United States or the debtor was engaged in worldwide operations, there is authority holding that foreigners are not entitled to bar date notice. *See Vancouver Women's Health Collective Soc'y v.*



*A.H. Robins Co.*, 820 F.2d 1359, 1363 (4th Cir. 1987) (affirming denial of motion to extend or abolish bar date for foreign claimants because "[t]he Constitution does not extend its guarantees to nonresident aliens living outside the United States").

### **Application of Rule 23**

Even if the bankruptcy court decides to apply Rule 23, the court will then have to decide whether the class meets the appropriate certification requirements under Rule 23. This means that the class must meet (i) all four requirements of subsection (a) of Rule 23, *see Moore v.*

*PaineWebber, Inc.*, 306 F.3d 1247, 1252 (2d Cir. 2002); *see also In re Woodward*, 205 B.R. at 371; (ii) one of the requirements of Rule 23(b), *see, e.g., In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 290 (2d Cir. 1992) (evaluating certification under Rule 23(b)(3)); and (iii) any other "inherent" requirements under Rule 23, such as that the proposed class must be identifiable or ascertainable, *see In re Methyl Tertiary Butyl Ether Prods. Liab. Litig.*, 209 F.R.D. 323, 336–37 (S.D.N.Y. 2002); *Dunnigan v. Metro. Life Ins. Co.*, 214 F.R.D. 125, 135 (S.D.N.Y. 2003).

Notably, certification for classes seeking injunctive relief pursuant to Rule 23(b)(2) may be denied as moot when the debtor is not currently operating a business or is liquidating. *See In re Ephedra Prods. Liab. Litig.*, 329 B.R. at 9 n.5 ("Insofar as the class claims seek injunctive relief against Twinlabs under Rule 23(b)(2), they are moot now that Twinlabs has gone out of business and existence."). Further, the availability of the so-called limited fund class action device under Rule 23(b)(1)(B) has been severely curtailed by the Supreme Court's decision in *Ortiz v. Fireboard*, 527 U.S. 815 (1999), and any party seeking to certify a limited fund class action in the bankruptcy context should be familiar with this case (in *Ortiz*, the Supreme Court adopted a narrow, historically based model for limited fund class actions under Rule 23(b)(1)(B) and rejected a \$1.545 billion settlement arising out of asbestos litigation; the Supreme Court's reasons for rejecting the settlement establish the minimum requirements that a Rule 23(b)(1)(B) class action settlement must meet). There is no prohibition against utilizing limited fund settlement procedures in the bankruptcy setting. There has been a volume of articles and case law addressing whether limited fund settlement procedures are available in the bankruptcy context under the rationale that bankruptcy procedures should be sufficient to address any claims that might otherwise be addressed by the limited fund class action rule. *See, e.g., In re Simon II*, 982 F.2d 721, 735–36 (2d Cir. 1992). But the Supreme Court has apparently attempted to settle the matter by going out of its way to note that "there is no inherent conflict between a limited fund class action under Rule 23(b)(1)(B) and the Bankruptcy Code." *See Ortiz*, 527 U.S. at 860 n.34; *see also* Leonard Gerson, "Use of a 'Limited Fund' Class Action in a Bankruptcy," *Am. Bankr. Inst. J.*, June 2009, at 48. Moreover, while limited, there is some precedent for allowing limited fund class action settlements in bankruptcy settings. *See, e.g., In re Drexel Burnham Lambert Group, Inc.*, 960 F.3d at 292.



Another consideration is the status of class-related discovery. Almost all class actions filed pre-petition will be stayed immediately upon the commencement of the bankruptcy proceedings as a result of the automatic stay. As a result, the parties might be required to brief Rule 23 issues without the benefit of full discovery. Accordingly, the parties may wish to ask the bankruptcy court to permit discovery before the bankruptcy court rules on Rule 23 issues.

### **Conclusion**

How courts address class claims in bankruptcy is ever-evolving. While a generation ago most courts wholly rejected the idea of class claims outright, nowadays most courts will recognize that class claims may be permissible in certain, although limited, contexts. There are still substantial hurdles to asserting a class claim in bankruptcy, including that the bankruptcy court has discretion as to whether to permit class treatment. In making this determination, the impact of class treatment on other creditors and the debtors' estates will be paramount.

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## **In-House Spotlight: All Things In-House at the Auction House**

By Zachary G. Newman

Jonathan Olsoff, a 1985 graduate of American University, clerked with the Tenth Circuit of the U.S. Court of Appeals before joining national law firms first in Washington, D.C., and then in New York.

He is now the North American general counsel and worldwide director of litigation of Sotheby's. Sotheby's is a leader in the auction world, with multiple locations in numerous countries and well over a hundred auctions each year in numerous categories.

*In-House Litigator* contributor Zachary Newman of New York-based Hahn & Hessen recently sat down with Jonathan to talk about his in-house practice.

### **Q: What is the size of Sotheby's legal department?**

A: Right now we have 13 in-house lawyers in the legal department worldwide with six based in New York, six based in London, and one based in Paris. Our legal department also has about five paralegals. We also have a separate compliance department staffed with four very experienced attorneys.

### **Q: What would be the one piece of advice you would impart to outside firms looking to represent Sotheby's?**

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A: The one piece of advice I would impart probably would be that it is important to understand our business in order to represent Sotheby's. Our outside counsel are expected not just to provide sound legal advice, but also to understand how a particular legal issue may impact the company's business objectives and goals that transcend any individual matter.

**Q: What is the most difficult aspect of your in-house job as compared to when you practiced with a law firm?**

A: I would say that the pace of the business is the most difficult aspect of the job when compared to my law firm days. The rapidity with which you have to make decisions is very different than in a law firm, and you do not always have the luxury of time that outside lawyers typically have to think through issues. This is especially the case in our business, which by its nature is fast moving. As a result, you often need to learn to trust your instincts. Also, as many of our auctions carry press coverage, there is an extra layer of complexity when managing legal issues that was not as prevalent when I was working with private law firms.

**Q: For lawyers that are contemplating a transition to in-house, what suggestions can you give to assist them in their preparation and job hunt?**

A: I am often asked by young lawyers starting out how they can become "art lawyers." I always advise them that when we are hiring new lawyers, we never set out to hire "art lawyers" but instead look for lawyers who have had the best training available and who enjoy the craft first of being a lawyer.

**Q: What are the biggest challenges you face in your current position?**

A: The cost of litigation is really becoming prohibitive and, as a result, we are turning more often to alternative dispute resolution possibilities. Nevertheless, we often need to make strategic decisions to litigate a particular matter, knowing it might be costly when we perceive the need to defend and validate the integrity of our business practices or our adversary is being unreasonable. Choosing when to go the distance is a challenging aspect of my job, but it is really at the core of the advice we provide management.

**Q: Do you interact with law firms outside the United States, and, if so, what are the most notable differences, if any, with the U.S. firms?**

A: I have had very productive relationships with both U.S. and foreign law firms. That said, interestingly, I have noticed some differences with the legal services rendered by domestic firms compared to foreign firms. One of the biggest differences I have noticed is that foreign firms approach legal issues with a greater formality than do domestic firms. By this I mean that domestic firms seem to be more comfortable in formulating, discussing, and implementing business solutions to legal problems whereas—and this is admittedly a generalization because there are indeed notable exceptions—their foreign counterparts tend to limit their advice to the legal implications (focusing largely on risk, probability, and procedure). This, frankly, may just be because I have had longer relationships with the domestic firms that we do business with, but



the point is that I value those lawyers here and abroad who can be flexible enough to devise a variety of legal, business, or practical solutions to the legal issues we encounter in our business.

**Q: More and more companies are requiring their in-house or outside lawyers to perform detailed early case evaluations of matters to assist in analyzing and managing risk and early settlement possibilities. What are your views on this and the role of early case evaluations in your litigation matters?**

A: We have always employed early case evaluations in the matters that reach our attention. We evaluate cases at their inception largely because of the need to address issues on a timely basis given the nature of our auction business. Frankly, our business is driven by relationships, and we employ risk analyses as often and as early as possible. This is not to say that Sotheby's avoids litigating legitimate issues. Rather, we employ and rely upon early case evaluation models in order to manage risk, and we believe that early and periodic evaluations are beneficial in the management and supervision of pending litigation matters.

**Q: What advice can you impart to in-house counsel as to how to communicate legal issues with senior management as opposed to middle or junior management?**

A: The only advice I can think of passing along is to remember that senior management usually focuses on a broader, macro view. Senior management usually, and rightly, factor into their analysis broader business and franchise implications. Senior managers likely will rely on their in-house counsel to assist in balancing the costs, risks, and merits of any litigation with the overall impact the litigation may have on imminent business events and overall company initiatives. Thus, in-house counsel should be mindful of senior management's agenda and objectives prior to communicating about any particular legal matter.

**Q: In-house counsel as part of their procurement and case management seem to rely more heavily on litigation estimates and budgets. How much stock do you put in litigation budgets and estimates, and what role do they play in your management of litigation matters?**

A: They play a relatively small role in our business because our group of outside firms has represented Sotheby's for a number of years and they understand the expectations of the legal department as well as management. That said, the in-house staff needs to have a clear understanding with outside counsel as to the expected costs of litigation to avoid misunderstandings or failed expectations. But litigation is an unpredictable endeavor, and we are realistic about the difficulty in accurately budgeting litigation given the number of contingencies and the inherent uncertainty of the process.

**Q: What is the best "value added" benefit outside counsel can offer in-house counsel?**

A: We especially value outside counsel who can anticipate problems that our business might face in the future. I see a benefit in our outside counsel staying tuned to developing legal issues that could impact our business even though we do our best to stay very informed. If outside counsel



keep us abreast of these developments, we are more prepared and we can try to be proactive instead of reactive. This relates back to what I mentioned earlier about how critical it is for our outside lawyers to understand our business and business needs.

**Q: What do you miss most about private practice?**

A: I actually miss writing briefs. I enjoyed the whole writing process. I do not want to say as an in-house lawyer that I do not have the opportunity to think through legal issues or formulate solutions, but I do miss having the direct responsibility for developing the legal arguments and composing the legal brief.

**Q: What don't you miss from private practice?**

A: Being on the front lines of litigation. I always enjoyed analyzing and formulating litigation strategies more than the endless discovery disputes and unproductive squabbling that occurs during, and too often dominates, the discovery process.

**Q: I trust you interface with both litigators and non-litigators, so, here is the question. The litigators are the better lawyers, right?**

A: Since I work with both, no comment!

**Q: How much is too much when it comes to updating you on pending litigation cases?**

A: It really depends on the matter. If, for example, the issue touches upon the core of our business, we may expect constant, real-time updates. On other matters, we do not need to hear about every development. Our outside lawyers know how we work, and, over time, we develop a trust as to what information needs to be imparted and when. Outside counsel should not be afraid to ask their in-house counterparts as to the frequency and nature of the updates that are expected for any particular matter.

**Q: What would you say is the biggest blunder outside counsel make in their invoices (in other words, what should outside counsel strive to avoid in preparing their invoices)?**

A: I think getting the invoices out in a timely manner is really one of the most important things concerning the billing process. If I receive a large invoice six months after the work was performed, it is really unhelpful and unwelcomed.

**Q: Email or phone call from outside counsel—which do you prefer, and why?**

A: I prefer email unless it is something very urgent. An email as opposed to a phone call allows me to review it based on my availability. The nature of our business makes it difficult for me to take unscheduled calls during the day, and with an email I can decide how much involvement is needed or if I require additional information.

**Q: What is your favorite auction held by Sotheby's during the year and why?**

A: My favorite auction was back in 1997 when we auctioned a *Tyrannosaurus rex* skeleton,



According to the complaint, after the government told McDermott that its initial document production on behalf of J-M contained privileged records, McDermott resubmitted another production that still included 3,900 privileged documents out of a production of about 250,000 documents. For copies of the complaint and demurrer in the malpractice suit as well as pleadings from the underlying qui tam action, see [www.AKershaw.com/j-m](http://www.AKershaw.com/j-m).

Whatever the ultimate truth may be in the J-M case, many of the various public postings about contract attorney review work in general (i.e. not directed at McDermott) should serve to put in-house counsel on notice that there could be issues with pre-production reviews using contract attorneys, e.g.

- Fraudulent time reporting, *ABAJ*, comment 14 (agencies allowing false timesheets), 34 (witnessed timesheet fraud), and 35 (billing every minute from arrival to departure).
- Minimal or poor supervision, *ABAJ*, comment 24 (15-minute conversation with temps at the beginning of the project), 27 (no list of known attorneys for privilege review), 35 (widely divergent training, difficult to understand what they were seeking to produce or protect); TPL (large number pointed out reviews in D.C. and New York where improper instructions on privilege were given by junior attorneys and/or case administrators who obviously gave didn't know the difference between attorney-client privilege and the attorney work product doctrine).
- Poor quality control, *ABAJ*, comment 20 (low bids result in no selection process for reviewers) and 35 (writing on original documents, spilling food and drinks).
- Demeaning work conditions, *ABAJ*, comment 11 (treat like servants), 31 (one bathroom for 100 people), 37 (85 member staff on windowless first floor using one locked bathroom on ninth floor).
- Production quota, *ABAJ*, comment 35 (daily review quotas).
- Significant markups of contract review attorney billing rates, *ABAJ*, comment 11 (paying as low as \$12/hr., billing over \$350) and 47 (personally worked on case where temps billed as associates).
- Long work hours, *ABAJ*, comment 24 (12 hours/day, 7 days/week), 35 (12–16 hours a day), TPL (10–12 hours/day); *see also* "[Lawyers Settle . . . for Temp Jobs](#)," *Wall Street Journal*, June 15, 2011, which mentions long-hour work days.
- Reviewers being told to just look for specific terms, *ABAJ*, comment 37 ("I promise you, I was told to look for specific terms.").

### **Implications for In-House Corporate Counsel**

The document reviews provided by your outside counsel may not suffer any of the infirmities alleged in the J-M complaint or in the numerous postings that have been made about the case or contract attorneys in general. On the other hand, they might. Do you want angry, malcontented



attorneys handling your sensitive corporate documents? Consider amending your outside counsel guidelines to incorporate some of the following suggestions:

- Set maximum billable hours per day and require mandatory breaks. It is impossible from a human factor engineering standpoint to deliver quality review work for more than 8 or at the very most 10 hours a day on a sustained basis, especially without adequate rest breaks.
- Ask for the work history of contract attorneys reviewing your documents. Ideally the bulk of the reviewers would have a history with the law firm conducting the review.
- Require that contract people working on your projects be advised of your company tip hotline.
- Explicitly address whether the costs of contract attorneys will be marked up by the firm.
- Talk to the attorneys who are providing day-to-day guidance for the reviewers. Determine for yourself if they are conversant with the issues in the case and are able to discuss privilege, work product, and waiver intelligently.
- Have the firm advise whether basic cost saving technology is being used. Processes like duplicate consolidation, clustering or near-duping, and email threading can dramatically reduce review time. Review should never be conducted just to find a set of predefined search terms; software will do that faster, cheaper, and more accurately.

You might also consider whether the use of technology-assisted review could provide faster, cheaper, and more replicable results than manual review. To develop data to see how consistent the results are from current manual review, have multiple review teams review the same set of documents and measure the consistency of the results. The set of documents does not need to be large—perhaps as small as one or two thousand documents. Pick a set that includes a representative number of responsive, privileged, and redacted documents.

—[Anne Kershaw](#), *A. Kershaw P.C., Tarrytown, NY*

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## **D.C. Circuit Takes the SEC to Task in Vacating Proxy Access Rule**

Traditionally, a company's proxy statement for a shareholder election of directors includes only candidates who were nominated by incumbent directors. To nominate a candidate different from those on the directors' ballot, a shareholder must separately file his or her own proxy statement and solicit votes from other stakeholders, thereby initiating a proxy contest.



In August 2010, the Securities and Exchange Commission adopted a controversial proxy access rule that provides shareholders an alternative path for nominating and electing directors. Under Rule 14a-11, a public company must include in its proxy materials "the name of a person or persons nominated by a [qualifying] shareholder or group of shareholders for election to the board of directors." 75 Fed. Reg. 56,682–83, 56,782/3 (2010).

In September 2010, the Business Roundtable and U.S. Chamber of Commerce petitioned for review of the SEC's order, claiming that (1) the SEC's promulgation of the Rule was arbitrary and capricious because the SEC failed to adequately assess the Rule's impact on efficiency, competition, and capital formation, and (2) the Rule violated the First Amendment. On July 22, 2011, the U.S. Court of Appeals for the D.C. Circuit granted the petition and vacated the Rule, holding that the SEC's promulgation of the Rule was "arbitrary and capricious." *Business Roundtable v. SEC*, No. 10-1305, slip op. (D.C. Cir. July 22, 2011).

The Court found that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."

In reaching its holding, the court criticized the SEC's adoption of the Rule on several grounds. First, the court chastised the SEC for not fully considering the adverse economic affects of the Rule. The opinion characterized the Rule's proxy access regime as a "management distraction" that would reduce "the time a board spends on strategic and long term thinking." The court dismissed the SEC's efforts to minimize these costs as "illogical" and "unacceptable."

Second, the court criticized the SEC's reliance on "insufficient empirical data," finding that the SEC did not "sufficiently support[] its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value."

Finally, the court chided the SEC for failing to address the risk that unions and public pensions might use the Rule to exact concessions unrelated to shareholder value from the company.

In addition to finding that these deficiencies rendered the Rule "arbitrary and capricious" on its face, the court found that the Rule was invalid as applied to investment companies, such as mutual funds.

The court did not reach petitioners' claims that the Rule's proxy access regime is fundamentally unconstitutional, leaving open the possibility that a proxy access rule addressing the above defects could be implemented in the future. That the SEC can sort through the rubble and make



## Corporate Counsel

FROM THE SECTION OF LITIGATION COMMITTEE ON CORPORATE COUNSEL

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another pass at the Rule is hardly a victory; the D.C. Circuit's harsh opinion is a significant setback for a proxy access initiative that was years in the making.

—*Joe Woodring, Cooley LLP, San Diego, CA*

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ABA Section of Litigation Committee on Corporate Counsel

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