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SECOND CIRCUIT REVIEW

Expert Analysis

Class Action Settlements And Arbitration

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This month, we discuss *In re American Express Financial Advisors Securities Litigation*,[1] in which the U.S. Court of Appeals for the Second Circuit affirmed in part and reversed in part a district court's order enjoining a FINRA arbitration on the grounds that the claims were released by a prior class action settlement. The court's opinion, written by Judge Robert Sack and joined by Judge Rosemary Pooler and Judge Gerard Lynch, considered whether a court has the authority under the Federal Arbitration Act to enjoin an arbitration, a previously unsettled issue in the Second Circuit.

Background

Between March 4, 2004, and May 4, 2004, various people who had dealings with Ameriprise Financial Services Inc.[2] brought putative class actions in the U.S. District Court for the Southern District of New York. The class plaintiffs asserted various federal and common law claims based on Ameriprise's alleged "canned" financial advice and advisory services, the pushing of clients into certain mutual funds in order to reap secret kickbacks, and the steering of clients into in-house mutual funds. The class actions were consolidated as *In re AEFA*, and in January 2007, the district court certified a class and approved a settlement.[3]

Prior to approval, notice of the settlement was distributed to all class members. The notice stated that class members must exclude themselves from the class, or they would be barred from bringing "released claims," which were the claims that were the subject of the class action. By the agreement's terms, District Court Judge Deborah Batts retained exclusive jurisdiction over disputes arising from the class litigation.

On Feb. 17, 2009, John and Elaine Beland (plaintiffs) filed an arbitration complaint against Ameriprise and their financial advisor (collectively, defendants) with FINRA. Their FINRA complaint alleged that defendants agreed to invest plaintiffs' funds in conservative investments, but that instead, Ameriprise invested in in-house high yield junk bonds and other risky assets that allowed Ameriprise to collect excessive fees. Plaintiffs also alleged that their financial advisor lied and covered up the mishandling of the account, which declined from more than $2.6 million in 1995 to approximately $800,000 in 2009. Plaintiffs admitted that they had received notices about the class action lawsuits, but had not taken any action, and did not share in the settlement.

> The Second Circuit panel held that the FAA permits district courts to enjoin arbitrations from proceeding when the parties have not contractually agreed to arbitrate.

Defendants moved to stay the FINRA proceedings on the basis that plaintiffs, as class members in *In re AEFA*, had released their claims. The FINRA arbitrators denied the motion. Defendants then filed a motion to enforce the settlement agreement in the district court. The district court found that plaintiffs' claims were "released claims" under the *In re AEFA* settlement, granted defendants' motion, and ordered plaintiffs to dismiss their FINRA claim with prejudice. Plaintiffs filed a motion for reconsideration, which was denied. Plaintiffs then appealed to the Second Circuit.

'Question of Arbitrability'

As an initial matter, the panel considered whether plaintiffs' claims would be arbitrable, absent the *In re AEFA* settlement. The Federal Arbitration Act (FAA) creates a "body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act."[4] Courts in the Second Circuit follow a two-part test to determine arbitrability, considering (1) whether the parties have entered into a valid agreement to arbitrate, and (2) whether the dispute at issue comes within the scope of the arbitration agreement.[5] The panel found that, absent a subsequent agreement, plaintiffs' claims are arbitrable because, by virtue of its membership in FINRA, Ameriprise has consented to arbitrate with its customers.[6]

Next, the panel considered whether the court—and not the arbitrator—has the responsibility of determining whether, in light of the settlement, any of plaintiffs' claims are "unreleased" and still subject to arbitration. Previously, defendants had moved to stay the arbitration, and that motion had been denied by the FINRA panel. Thus, a preliminary question was whether the question of arbitrability was one for the court or the arbitrators to determine.

First, the panel held that the class settlement revoked Ameriprise's consent to arbitrate certain claims. Relying on *AT&T Technologies Inc. v. Communications Workers of America*,[7] the panel found that it is the court's responsibility—and not the arbitrators'—to determine whether there is a surviving agreement to arbitrate the claims.

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Second, the panel determined that Ameriprise's FINRA membership does not show clear and unmistakable evidence of Ameriprise's intent that all future questions of arbitrability be submitted to arbitrators. Finally, the panel noted that the district court retained jurisdiction over the *In re AEFA* class action.

Having determined that the courts have the responsibility of determining the question of arbitrability, the panel considered the scope of Ameriprise's agreement to arbitrate by virtue of its FINRA membership. The panel noted that the Second Circuit had previously held that "there is nothing irrevocable about an agreement to arbitrate"[8] and that parties can choose to exclude certain claims from the scope of their arbitration agreements. Thus, the issue before the court was whether the *In re AEFA* class settlement—by which plaintiffs are bound, even though they did not file a claim—represents a revocation of the agreement to arbitrate the claims covered by the settlement.

The panel, following the U.S. Court of Appeals for the Tenth Circuit's decision in *Riley Manufacturing Company Inc. v. Anchor Glass Container Corporation*,[9] found that the class settlement superseded Ameriprise's agreement to arbitrate; "[i]n other words, the Class Settlement extinguished not only the ability of Class Members to bring Released Claims against Ameriprise as a matter of substance, but also the Class Members' right to arbitrate these claims."[10] The panel emphasized that settlement agreements do not revoke prior agreements to arbitrate in all cases and that courts should attempt to read agreements to permit arbitration clauses to stay in effect.[11] However, in this case, the settlement agreement explicitly vested the district court with exclusive jurisdiction to enforce its terms.

Unreleased Claims

Next, the panel considered whether the released claims covered by the *In re AEPA* settlement agreement included all of plaintiffs' claims, or whether any unreleased claims remained. The panel compared the language of the settlement agreement with plaintiffs' FINRA complaint and determined that, while some claims were released, certain claims did not overlap with the settlement agreement. For example, the settlement agreement specifically stated that the released claims do not include "suitability claims"[12] unless they were alleged to arise out of a common course of conduct.

The panel found that one of the core allegations in plaintiffs' FINRA complaint—the allegation that plaintiffs were promised conservative investments, but were instead provided with high-risk investments—is a suitability claim. Further, the court found that this claim did not fall within a "common course of conduct," because the common course of conduct alleged in the class action settlement involved the steering of clients to funds managed by Ameriprise. Here, plaintiffs alleged that their financial advisor mismanaged their funds contrary to their instructions.

Additionally, plaintiffs alleged in their FINRA complaint that their financial advisor engaged in a series of lies in order to obscure the mishandling of the funds, stating that, for example, the Sept. 11, 2001, attacks caused the declines. These allegations were also not released in the settlement. Finally, plaintiffs asserted claims that involved conduct occurring after the class period, which were also not released.

Power to Enjoin Arbitration

Finally, the panel addressed an issue of first impression in the Second Circuit—whether federal courts have the power to stay an arbitration under the FAA. While the issue was not contested at the district court and was not briefed or addressed at oral argument, the panel found that the issue is of importance, and should be addressed because it "implicates the remedial powers of the court."

First, the panel noted that the FAA explicitly authorizes a district court to stay litigation pending arbitration, and to compel arbitration,[13] but does not explicitly confer authority on the judiciary to enjoin a private arbitration. However, the panel noted that previous case law, including a recently decided case,[14] suggest that, when a court determines that the parties have not entered into a valid and binding arbitration agreement, the court has the authority to enjoin the arbitration proceedings.

> The Second Circuit's analysis of the settlement agreement provides helpful guidance to parties that are engaging in class action settlements, and encourages defendants to draft settlements broadly in order to maximize the release of claims.

The panel followed a U.S. Court of Appeals for the First Circuit case, *Societe Generale de Surveillance, S.A. v. Raytheon European Management and Systems Company*.,[15] which interpreted the provision in the FAA that "expressly provides federal courts with the power to order parties to a dispute to proceed to arbitration where arbitration is called for by contract."[16] The *Societe Generale* court inferred that "to enjoin a party from arbitrating where an agreement to arbitrate is absent is the concomitant of the power to compel arbitration where it is present."[17] Thus, the Second Circuit panel held that the FAA permits district courts to enjoin arbitrations from proceeding when the parties have not contractually agreed to arbitrate. Applying this rule, the panel affirmed the district court's order that enjoined the arbitration with respect to plaintiffs' released claims. The panel vacated the order with respect to the claims that were not covered by the release.

Conclusion

In re American Express Financial Advisors Securities Litigation is an important case for FINRA members (and other companies that have arbitration agreements). The Second Circuit's analysis of the settlement agreement provides helpful guidance to parties that are engaging in class action settlements, and encourages defendants to draft settlements broadly in order to maximize the release of claims. Additionally, *American Express* emphasizes the importance of including a clause giving the district court jurisdiction over the settlement after it is entered. Finally, while previously unclear, the decision confirms that district courts that retain jurisdiction over the settlement have the authority to enjoin arbitrations relating to the subject matter of the settlement.

1. Docket No. 10-3399-cv, 2011 WL 5222784 (2d Cir. Nov. 3, 2011).
2. The panel noted that, on Aug. 1, 2005, American Express Financial Advisors changed its name to Ameriprise Financial Services Inc. Id. at *2 n.1. For simplicity, all references will be to "Ameriprise."
3. See *In re AEFA*, No. 04-1773-cv (S.D.N.Y. July 18, 2007).
4. *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp*., 460 U.S. 1, 24 (1983).
5. *ACE Capital Re Overseas Ltd. v. Cent. United Life Ins. Co.*, 307 F.3d 24, 28 (2d Cir. 2002); see also 9 U.S.C. §2 (FAA provision providing that a private contract to arbitrate is enforceable).
6. See FINRA Code of Arbitration Procedure for Customer Disputes §12200.
7. 475 U.S. 643 (1986).
8. See *Baker & Taylor Inc. v. AlphaCraze Corp.*, 602 F.3d 486, 490 (2d Cir. 2010).
9. 157 F.3d 775 (10th Cir. 1998).
10. *In re Am. Express Fin. Advisors Sec. Litig.*, 2011 WL 5222784, at *14.
11. See *Bank Julius Baer & Co. v. Waxfield Ltd.*, 424 F.3d 278, 284 (2d Cir. 2005) ("if there is a reading of the various agreements that permits the [a]rbitration [c]lause to remain in effect, we must choose it").
12. A "suitability claim" is a claim that a "broker knew or reasonably believed that the securities he recommended to the customer were unsuitable in light of the customer's investment objectives but he recommended them anyway." *In re Am. Express Fin. Advisors Sec. Litig.*, 2011 WL 5222784, at *3 n.3, quoting *Murray v. Dominick Corp. of Can.*, 117 F.R.D. 512, 516 (S.D.N.Y. 1987).
13. See 9 U.S.C. §§3, 4.
14. See *Citigroup Global Mkts. Inc. v. VCG Special Opportunities Master Fund Ltd.*, 598 F.3d 30 (2d Cir. 2010).
15. 643 F.2d 863 (1st Cir. 1981).
16. Id. at 868 (citing 9 U.S.C. §3).
17. Id.