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Client Alert

Appellate

Appellate Scrutiny of Class Action Settlements

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Class actions have penetrated every sector of American commerce. Significant resources routinely are invested in resisting class certification because of the adverse economic and business management consequences that can follow from classwide relief. In those circumstances when a class is certified, the incentive to settle and avoid a classwide trial can be compelling. In other circumstances, a pre-certification settlement can be advantageous to help contain perceived risks. Once a settlement is reached, however, a targeted defendant wants it to stick. And while appellate review of class settlements is conducted under a generous abuse of discretion standard, recent appellate decisions make clear that that standard of review is not a ticket to affirmance. Class settlements, now often subjected to attacks from professional and vocal objectors, have come under increased scrutiny in appellate courts. Those courts are looking hard at the relief that the settlements actually provide to the putative class members, and they do not hesitate to reverse a settlement if the benefits to a class do not measure up. As a result, what appellate courts have had to say when they review disputed class settlements bears a closer look so that an adequate record can be made in the district court.

Review of Class Settlements Generally Federal Rule of Civil Procedure 23(e) provides that a district court may approve a class settlement on finding that it is "fair, reasonable, and adequate." There is not much guidance in those broad criteria, and the circuit courts of appeals therefore have developed a multifactor analysis to guide review of a district court's exercise of discretion to approve a settlement. The Ninth Circuit's iteration of these factors in *In re Online DVD-Rental Antitrust Litigation*, 779 F.3d 934 (9th Cir. 2015), is typical and involves the following:

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(1) the strength of the plaintiff's case;

(2) the risk, expense, complexity, and likely duration of further litigation;

(3) the risk of maintaining class action status throughout the trial;

(4) the amount offered in settlement;

(5) the extent of discovery completed and the stage of the proceedings;

(6) the experience and view of counsel;

(7) the presence of a governmental participant; and

(8) the reaction of the class members of the proposed settlement.

Id. at 944.

As noted, other circuits take the same approach: *Tennille v. W. Union Co*., 2015 WL 1948493, at *7 (10th Cir. May 1, 2015); *Wong v. Accretive Health, Inc.*, 773 F.3d 859, 863 (7th Cir. 2014); *Vassalle v. Midland Funding LLC*, 708 F.3d 747, 754 (6th Cir. 2013); *In re Uponor, Inc. F1807 Plumbing Fittings Prods. Liab. Litig.*, 716 F.3d 1057, 1063 (8th Cir. 2013); *Day v. Persels & Assocs., LLC*, 729 F.3d 1309, 1326 (11th Cir. 2013); *Sullivan v. DB Invs., Inc*., 667 F.3d 273, 295 (3d Cir. 2011); *Nat'l Ass'n of Chain Drug Stores v. New Eng. Carpenters Health Benefits Fund*, 582 F.3d 30, 44 (1st Cir. 2009); *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc*., 396 F.3d 96, 117 (2d Cir. 2005); *Ayers v. Thompson*, 358 F.3d 356, 368 (5th Cir. 2004); *In re Jiffy Lube Sec. Litig*., 927 F.2d 155, 158–59 (4th Cir. 1991).

Specifically, as the factors suggest, the class litigation should be far enough along to permit a fair evaluation of the class members' claims in light of controlling statutes or common law. Appellate courts will look closely at the arms-length nature of the bargain, the adequacy of the relief provided to the class in light of the risks posed by a classwide trial, and any indications that self-interest, rather than the class's interests, influenced the outcome of the negotiations. Recent cases also suggest, however, that when they review class settlements, appellate courts will focus most closely on three issues: (1) the relief received by the class members; (2) the compensation of class counsel; and (3) any proposed *cy pres* distributions for residual funds. The appellate courts' treatment of each one of these three issues clearly deserves a closer look.

Compensation and Benefit to Class Members Class settlements frequently are criticized for leaving a class without a meaningful recovery. Appellate courts therefore have become particularly attentive to what the putative class members truly receive from the proposed agreement and sometimes do not affirm settlements based on this ground. Analyzing recent trends indicates that in those appeals where decisions approving settlement were reversed, the courts frequently found that the settlements' structure exposed a significant disparity

between the relief that the named representatives and the putative class would receive, or the settlements would inadequately compensate or benefit a class as a whole.

Unfair Disparities in Awards Received by Class Representatives Compared to a Putative Class *Radcliffe v. Experian Information Solutions Inc.*, 715 F.3d 1157 (9th Cir. 2013), typifies the heightened scrutiny of class member relief. There, the Ninth Circuit vacated a settlement agreement providing incentive awards to the named plaintiffs conditioned on their approval of the settlement. The court found that this sort of conditional incentive compelled rejection of the proposed settlement because it caused the interest of the named plaintiffs to diverge from those of the class and because there was too great a disparity between the incentive amount, $5,000, and the amount that the rest of the class members would receive, which ranged from $26–$750.

The Sixth Circuit sounded a similar note of caution on incentive awards in *In re Dry Max Pampers Litig*., 724 F.3d 713 (6th Cir. 2013), while reversing a proposed class settlement. The court observed that incentives are "like dandelions on an unmowed lawn—present more by inattention than by design." *Id*. at 722. Such awards "'may lead named plaintiffs to expect a bounty for bringing suit or to compromise the interest of the class for personal gain.'" *Id*. (quoting *Hadix v. Johnson*, 322 F.3d 895, 897 (6th Cir. 2003)). That sort of expectation or compromise reflects directly on the named plaintiffs' adequacy as class representatives under Fed. R. Civ. P. 23(a)(4).

Just before it decided *In re Dry Max*, the Sixth Circuit also reversed a proposed class settlement because of a special benefit received by the class representatives but not made available to the class. In *Vassalle v. Midland Funding LLC*, 708 F.3d 747 (6th Cir. 2013), the class members sued Midland, alleging that its employees routinely signed form affidavits in debt collection actions initiated by Midland without personal knowledge of the facts asserted. The Sixth Circuit based its disapproval on the fact that unlike the rest of the class members, the class representatives would have their debts to Midland forgiven as part of the settlement. In the court's view, a settlement that gives preferential treatment to the named plaintiffs and perfunctory relief to the putative class members was unfair.

Insufficient Compensation or Benefit to the Class as a Whole In *Redman v. Radioshack Corp*., 768 F.3d 622 (7th Cir. 2014), the Seventh Circuit reversed the district court's order approving a class action settlement for which the district court magistrate judge inappropriately considered a $2.2 million award for administrative costs, including the cost of notice, as compensation to the class. In particular, the Seventh Circuit found that the district court erred in considering the $2.2 million as compensation to the class when comparing the value of the settlement to the class with the compensation received by class counsel. As the

Seventh Circuit explained, administrative costs are of equal value to the class and class counsel, and by considering the administrative costs as compensation to the class, the district court "eliminated the incentive of class counsel to economize on that expense—and indeed may have created a perverse incentive; for higher administrative expenses make class counsel's proposed fee appear smaller in relation to the total settlement than if those costs were lower." *Id*. at 630.

Similarly, in *In re Pet Food Products Liability Litigation*, 629 F.3d 333 (3d Cir. 2010), the Third Circuit vacated approval of a settlement agreement in which the parties provided insufficient information regarding the allocation of $250,000 in settlement funds to a particular set of claims. The settlement agreement divided the settlement funds into categories of claims, and a particular category called "purchase claims" was allocated funds capped at $250,000. The class action stemmed from a massive pet food recall, and the purchase claims were "claims solely for reimbursement of the costs associated with the purchase of a Recalled Pet Food Product by a Settlement Class Member who has not been reimbursed for such costs to date." *Id*. at 338 n.9 (internal quotation marks omitted). Although the district court determined that the $250,000 allocation was fair, the Third Circuit disagreed primarily because the parties failed to provide the estimations of recoverable damages—including sales information quantifying the amount of recalled pet food sold to consumers and the amount of refunds already paid to consumers—that "would have enabled the court to make the required value comparisons and generate a range of reasonableness to determine the adequacy of the settlement amount." *Id*. at 354.

Along these same lines, in *Day v. Persels & Associates, LLC*, 729 F.3d 1309 (11th Cir. 2013), the Eleventh Circuit vacated an order approving a settlement agreement when the agreement provided no monetary relief to the named plaintiffs. The court determined that the decision to approve no monetary relief was based on a finding unsupported by the record—that the defendants were not financially able to pay a meaningful award. In fact, the evidence only established that one of the seven defendants was unable to pay a meaningful award.

Learning from Insufficient Class Compensation and Benefit Rationales As these decisions show, class settlements that provide insufficient compensation to class members or display a significant disparity between the relief received by the named representatives and the putative class are prime candidates for courts to reverse or to vacate. Any incentive awards in a settlement provided to the named representatives must be in keeping with their role in producing the benefits for a class and should not be so disproportionate as to raise the specter of a compromise of class interests. The proposed compensation that a settlement would provide to individual class members likewise must be adequately supported by the record and tailored to a reasonable estimation of what a class member could recover individually given the claims alleged and the risks of litigating.

Compensation to Attorneys Federal Rule of Civil Procedure 23(h) provides that "[i]n a certified class action, the court may award reasonable attorney's fees and nontaxable costs that are authorized by law or by the parties' agreement." In awarding fees under this rule, "courts have an independent obligation to ensure that the award, like the settlement itself, is reasonable." *In re Online DVD-Rental Antitrust Litig.*, 779 F.3d at 949. Appellate courts pay careful attention to the method used by the district court to calculate attorneys' fees. But no matter which method of calculation is selected, the attorneys' fees to be paid to class counsel are a major red flag for appellate courts reviewing the fairness of class settlements. *See* Michael J. Puma & Justin S. Brooks, *Navigating Developing Challenges in Approval of Class and Collective Action Settlements*, 28 ABA J. Lab. & Emp. L. 325, 341–45 (2013) (discussing the increased scrutiny of attorneys' fees and noting that "courts assess attorneys' fees in relation to the benefit to the class and are more likely to find attorneys' fees unreasonable if the fees are not appropriate relative to the class benefit"); Anna Adreeva, *Class Action Fairness Act of 2005: The Eight-Year Saga is Finally Over*, 59 U. Miami L. Rev. 385, 392-93 (2005) (discussing how proponents of the Class Action Fairness Act criticized instances in which counsel received millions in fees while plaintiffs received coupons or even less and providing specific examples). Appellate courts focus on two issues in particular in class action settlements when it comes to red flags over attorney compensation: (1) an excessive disparity between an attorneys' fees award and the relief that the class members will receive from a settlement, and (2) a fee provision that creates incentive for collusion.

The Lodestar and Percentage-of-the-Recovery Approaches to Attorneys' Fees Generally, parties may seek approval of fees under one of two methods: the lodestar approach or the percentage-of-the-recovery approach. *Id*. at 949; *Sullivan v. DB Investments, Inc.*, 667 F.3d 273, 330 (3d Cir. 2011) ("Attorneys' fees requests are generally assessed under one of two methods: the percentage-of-recovery ("POR") approach or the lodestar scheme."); *McDaniel v. County of Schenedectady*, 595 F.3d 411, 417 (2d Cir. 2010) (same). A lodestar figure is calculated by multiplying the number of hours that counsel reasonably expended on the litigation by a reasonable hourly rate and is most often used in class actions brought under fee-shifting statutes or when the relief obtained is primarily injunctive in nature. *In re Bluetooth Headset Prods. Liab. Litig*., 654 F.3d 935, 941 (9th Cir. 2011). Alternatively, when a settlement produces a common fund, courts may choose to award fees as a percentage of the recovery, with 25 percent or 30 percent serving often as a reasonable benchmark. *Id. See Faught v. Am. Home Shield Corp*., 668 F.3d 1233, 1242–43 (11th Cir. 2011) (attorneys' fee awards severally are reasonable when they make up 20–25 percent of the fund); *Waters v. Int'l Precious Metals Corp.*, 190 F.3d 1291, 1294–95 (11th Cir. 1999) (benchmark for attorneys' fees should fall somewhere between 20 percent and 30 percent of the fund).

One way that settling parties and a district court can demonstrate that a particular compensation calculation method—either lodestar or percentage of the recovery—is reasonable is to cross-check the calculation using the other method. *See In re Online DVD-Rental Antitrust Litig*., 779 F.3d at 949; *Goldberger v. Integrated Res., Inc*., 209 F.3d 43, 50 (2d Cir. 2000); *Bowling v. Pfizer, Inc*., 102 F.3d 777, 780 (6th Cir. 1996).

Notably, the Ninth Circuit has put significant emphasis on the propriety of conducting a cross-check. In *In re Bluetooth Headset Products Liability Litigation*, 654 F.3d 935, the court reversed an order approving the settlement requiring defendants to pay attorneys' fees in an amount set by the district court, not to exceed $800,000. In approving the settlement, the district court applied the lodestar method but never announced a lodestar figure; instead, the court merely announced that its lodestar calculation substantially exceeded the $800,000 that the defendants agreed to pay and thus awarded $800,000. *Id*. at 943. The objectors argued that the court should have used the percentage-of-the-recovery method. *Id*. The Ninth Circuit found that whether or not the case warranted application of the percentage-of-the-recovery method, the district court made no explicit calculation of the reasonable lodestar amount, no comparison between the settlement's fees award and the benefit to the class, and no comparison between the lodestar amount and a reasonable percentage-of-the-recovery-based award. For those reasons, it vacated the approval order. *Id. See In re Magsafe Apple Power Adapter Litig*., 571 F. App'x 560, 565 (9th Cir. 2014) ("The district court did not cross-check the attorneys' fee award against the percentage-of-the-recovery method. Although we have 'encouraged' rather than required courts to crosscheck their calculations, the fact that the court made no mention of the value of the settlement, let alone the percentage-of-the-recovery method, contributes to our determination that we 'lack a sufficient basis for determining the reasonableness of the award.'").

With respect to attorneys' fee awards, therefore, appellate courts will pay particular attention to a comparison between the compensation received by class counsel and the benefits that flow to the class members. Courts of appeals also will expect a district court to analyze this aspect of a settlement with the same rigor that is applied to the certification decision itself.

Unreasonable Disparities Between Fee Awards and Relief to Class Members

Eubank v. Pella Corp., 753 F.3d 718, 723 (7th Cir. 2014) underscores how carefully fee awards will be looked at. In that case, the Seventh Circuit reviewed a settlement that awarded $11 million in attorneys' fees to class counsel. The $11 million number was justified based on the assertion that the settlement was worth $90 million to the class. *Id*. After analyzing the settlement, however, the Seventh Circuit found that the class could not expect to receive more than $8.5 million. *Id*. at 726–27. Given that, the attorneys' fees were excessive and approval was reversed. *Id*. at 729. Similarly, in *In re Dry Max Pampers Litigation*, the Sixth Circuit

reviewed a settlement agreement that awarded class counsel $2.73 million and provided unnamed class members with "nothing but nearly worthless injunctive relief." 724 F.3d at 713. The court reversed the order approving the settlement because the fee award amounted to "preferential treatment" of counsel compared to the mere perfunctory relief offered to the class. *Id*. at 718, 721.

Fee Provisions That Create Incentives for Collusion One provision that has invited inquiry is the so-called "clear-sailing agreement." Under such an agreement, the party paying the fees agrees not to contest the amount to be awarded by the court as long as the award falls beneath a negotiated ceiling. Almost 25 years ago, the First Circuit, in *Weinberger v. Great Northern Nekoosa Corp*., 925 F.2d 518, 520 n.1 (1st Cir. 1991), addressed the suspect aspects of these agreements, noting that by their nature, they deprive a court "of the advantages of the adversary process" and that "[t]he absence of adversariness makes heightened judicial oversight of this type of agreement highly desirable." *Id*. at 525.

More recently, the Seventh Circuit, in *Redman*, 768 F.3d at 622, reversed an order approving a settlement due to an attorneys' fees award that was unreasonable, in part, because of a clear-sailing agreement. The court stated that clear-sailing agreements illustrate "the danger of collusion in class actions between class counsel and the defendant, to the detriment of the class members" and acknowledged that "[c]lear-sailing clauses have not been held to be unlawful *per se*, but at least in a case such as this, involving a non-cash settlement award to the class, such a clause should be subjected to intense critical scrutiny by the district court; in this case it was not." *Id*. at 637. *See Allen v. Bedolla*, Nos. 13–55106, 13–56685, 2015 WL 3461537, at *5 (9th Cir. June 2, 2015) (stating that the settlement agreement exhibited a subtle sign "that class counsel have allowed pursuit of their own self-interests… to infect negotiations" because the defendant "agreed not to dispute the award of fees to class counsel, as long as that award did not exceed 25 percent of the common fund").

As these decisions illustrate, appellate courts are particularly sensitive to an appearance that the class members' interest have been compromised in favor of class counsel's receipt of an excessive fee award. *Eubank*, 753 F.3d at 720 (citing *In re General Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig*., 55 F.3d 768, 805 (3d Cir. 1995) and *Plummer v. Chem. Bank*, 668 F.2d 654, 658 (2d Cir. 1982)). Here again, an adequate record needs to be made justifying a fee award in light of the complexity and the risks posed by the litigation and the efforts of counsel in achieving a classwide resolution.

***Cy Pres* Distributions** When settling parties expect that residual funds will remain after distribution to class members, settlement agreements often include provisions for *cy pres* distributions. But these provisions now invite close appellate

scrutiny as well. As explained elsewhere, "*Cy pres* is shorthand for the old equitable doctrine 'cy prés comme possible'—French for 'as near as possible.'" *Dennis v. Kellogg Co*., 697 F.3d 858, 865 (3d Cir. 2012).

Courts recognize generally that *cy pres* distributions are inferior to direct distributions and maintain that if funds remain after distributions to class members, a settlement should presumptively provide a mechanism to distribute the residual funds further to the participating class members unless the amounts involved are too small or other specific reasons exist that would make such further distributions impossible or unfair. *In re Baby Prods. Antitrust Litig*., 708 F.3d 163, 173 (3d Cir. 2013) (citing American Law Institute, Principles of Law of Aggregate Litig. §3.07(b) (2010)). Appellate courts also evaluate the proposed *cy pres* distribution recipients in these cases and expect to find a connection between the distribution recipients and the class members.

Cy Pres at the Expense of Class Compensation In *Klier v. Elf Atochem North America, Inc*., 658 F.3d 468 (5th Cir. 2011), the Fifth Circuit held that a district court abused its discretion by approving a class action settlement that included a *cy pres* distribution of unused funds to charities instead of distributing such funds to the members of the class. When $830,000 in funds went unused, the defendant proposed that the court issue a *cy pres* award to local charities. *Id*. at 473. A sub-class member opposed the *cy pres* distribution and argued that the funds should be distributed to his sub-class "whose members were the most grievously injured and had not been fully compensated." *Id*. The district court disagreed with the objector, but the Fifth Circuit reversed, holding that a *cy pres* distribution is permissible "only if it is not possible to put those funds to their very best use: benefitting the class members directly." *Id*. at 475.

Also, in *In re Baby Prods. Antitrust Litig.*, 708 F.3d at 173, the Third Circuit vacated a district court's order approving a settlement and fund allocation plan. The court declined to hold that *cy pres* distributions are only appropriate where further individual distributions are economically feasible, but vacated the district court's order because the district court "did not have the factual basis necessary to determine whether the settlement was fair to the entire class" and "did not know the amount of compensation that will be distributed directly to the class." *Id*. at 175.

Cy Pres Aligned to the Interests of Class Members When circumstances would appropriately allow a *cy pres* distribution, a distribution must be guided by the interests of the silent class members and must benefit a group that is not too remote from the plaintiff class. *Dennis*, 697 F.3d at 865; *In re Lupron Mktg. & Sales Practices Litig*., 677 F.3d 21, 33–34 (1st Cir. 2012) (holding that the interests of *cy pres* recipients should "reasonably approximate" those being pursued by the class). In *Dennis*, the Ninth Circuit reviewed a proposed *cy pres* distribution to benefit unnamed "charities that provide food for the indigent" when the underlying

class claims pertained to misrepresentations by Kellogg that its cereal improved attentiveness. The court vacated the order approving the settlement because "charities that provide food for the indigent" were not likely to serve a single person within the plaintiff class of cereal purchasers and counsel also failed to identify specifically the *cy pres* recipients. *Dennis*, 697 F.3d at 867. The Ninth Circuit reasoned that "[w]hen selection of *cy pres* beneficiaries is not tethered to the nature of the lawsuit and the interests of the silent class members, the selection process may answer to the whims and self interests [sic] of the parties, their counsel, or the court." *Id*. (quoting *Nachsin v. AOL, LLC*, 663 F.3d 1034, 1039 (9th Cir. 2011)).

Cy pres awards thus can be appropriate and are preferable to having funds escheat to the state. But as these decisions indicate, they can also cause problems in appeals if the interests of a *cy pres* recipient do not reasonably align with the interests advanced by the class litigation. *See* Wilber H. Boies & Latonia Haney Keith, *Class Action Settlement Residue and Cy Pres Awards: Emerging Problems and Practical Solutions*, 21 Va. J. Soc. Pol'y & L. 267, 293 (2014).

Insights for Appellate Counsel The recent appellate decisions reviewing class settlements communicate some very useful guidance for appellate counsel advising clients involved in class action settlements. An adequate record on the issues that the court of appeal will care about will play a critical role in overcoming objections and securing affirmance. Some particularized considerations include the following:

- *First*, if a settlement agreement will include incentive awards for named plaintiffs, consider (1) the incentive awards in comparison to the compensation received by unnamed class members and (2) the percentage of the whole settlement fund allocated for the incentive awards for the named plaintiffs.
- *Second*, all damages awards should be supported by more than mere conjecture. Parties should provide evidence that allows a district court to make a proper determination about the range of reasonable damages.
- *Third*, adequate documentation should be provided for an attorneys' fees award to provide a district court with a basis to analyze and explain the reasonableness of the fee award.
- *Fourth*, settlement provisions, such as a clear-sailing clause, that can raise questions about collusion should be avoided if possible; if such a provision is used, a proposed fee award should be factually supported to show its reasonableness.
- *Fifth*, any *cy pres* proposal should be accompanied by sufficient detail, including a rationale to explain why the distribution aligns with the interest of a class.