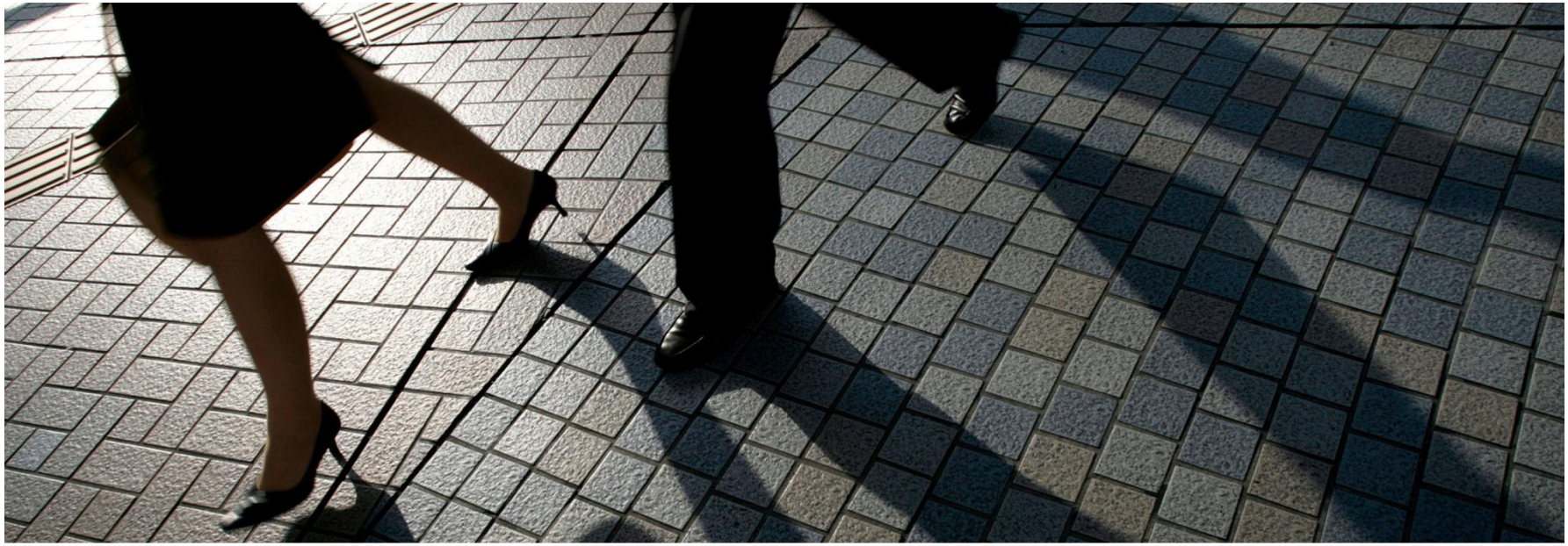


REUTERS/Stringer

Ethical Hurdles When Settling a Class Action

June 17, 2015

Presenters:

Deborah H. Renner, *BakerHostetler*

Paul G. Karlsgodt, *BakerHostetler*

Karl Fanter, *BakerHostetler*

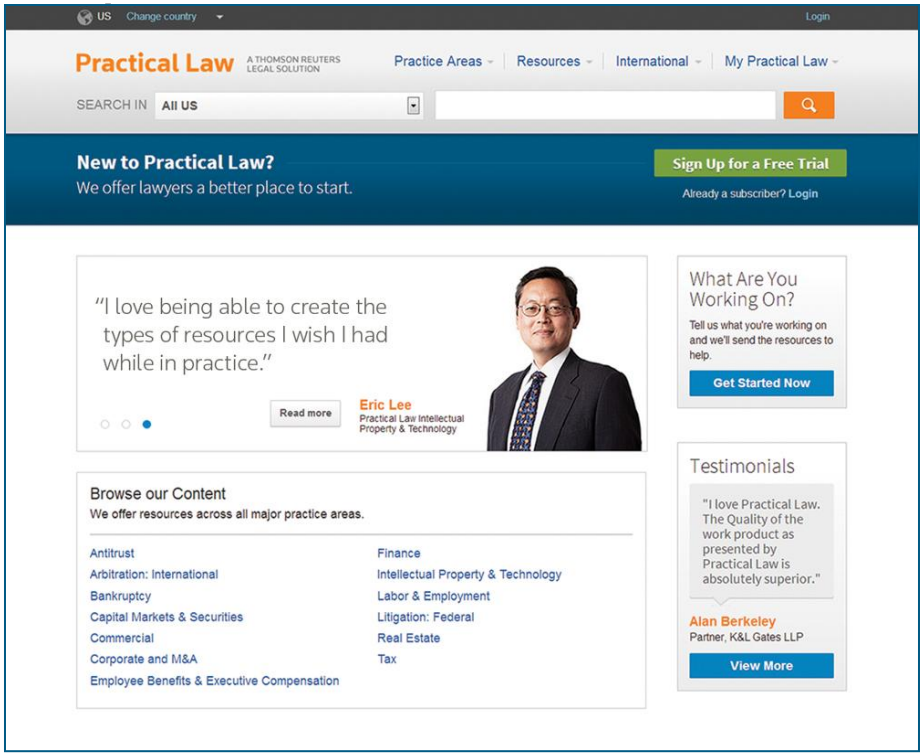
David McMillan, *BakerHostetler*

Sarah Heckman Yardeni, *Practical Law Litigation*

Practical Law™ A THOMSON REUTERS LEGAL SOLUTION

About Practical Law

- Practical resources covering all major practice areas.
- Overviews, model documents, trend articles and more created by our expert attorneys.
- Dedicated areas for law firms and law departments.
- Practice centers for specialists
- Brief Bank, a searchable database of recently filed court documents.
- Updates on the latest legal and market developments.
- *Practical Law The Journal* magazine covering key issues and developments in litigation practice and procedure.



Ethical Hurdles to Overcome When Settling a Class Action

There are numerous overlapping ethical and legal issues that must be taken into account to successfully settle a class action, including:

- Deciding whether incentive awards to representative plaintiffs are appropriate.
- Determining reasonable attorneys' fees.
- Avoiding questionable *cy pres* distributions.
- Properly dealing with objectors.

Class Action Settlements, Potential Rule Changes

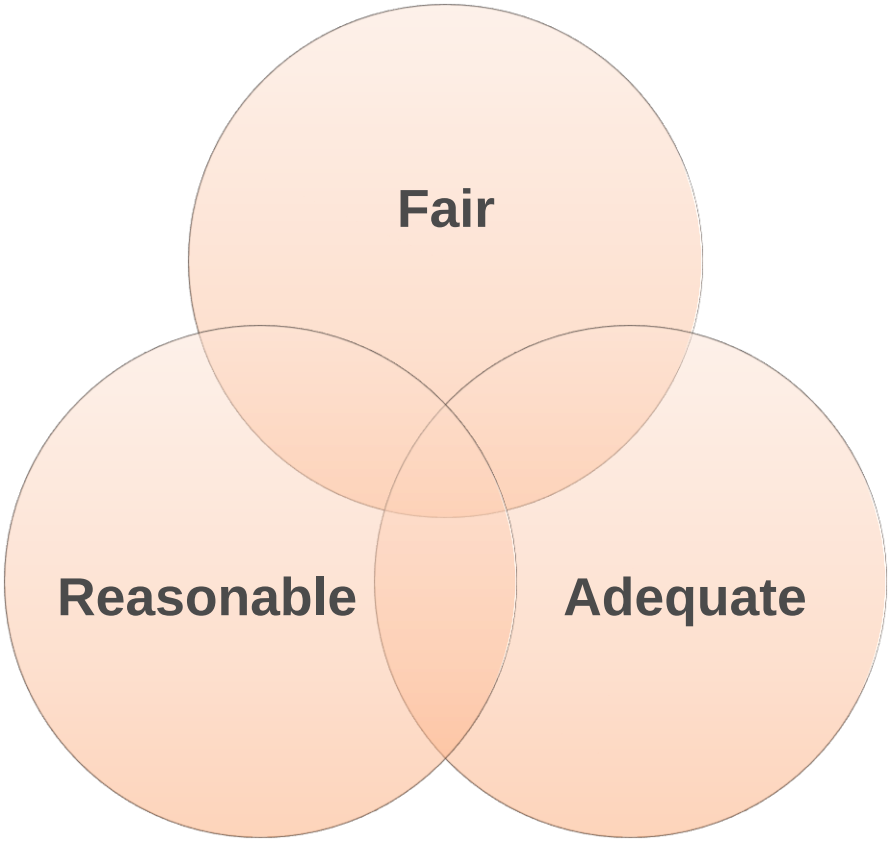
- In April 2015, the Rule 23 Subcommittee to the Federal Rules Advisory Committee issued a Report outlining and explaining potential revisions to Federal Rule of Civil Procedure (FRCP) 23 governing class actions.
- The Subcommittee intends to present possible draft amendments, if any, to the full Committee at its fall 2015 meeting.
- While the Subcommittee offered no assurances that it will ultimately recommend any amendments, it identified issues that warrant "serious examination."
- One of the main issues tackled in the Report relates to various aspects of class action settlements.

Class Action Settlements, Need for Oversight

- Class action settlements are different from settlements in traditional litigation.
- In contrast to ordinary settlements, class action settlements affect not only the interests of the parties and counsel who negotiate them, but also the interests of unnamed class members who are not present during the negotiations.
- As a result, there is a danger that the parties and counsel will bargain away the interests of unnamed class members to maximize their own.

The “Fair, Reasonable, and Adequate” Standard

A court may approve a settlement agreement in a certified class action only after a hearing to determine that the agreement is:



(*FRCP 23(e)(2)*).

The “Fair, Reasonable, and Adequate” Standard

- There are no clear-cut standards for determining whether a class action settlement is “fair, reasonable, and adequate,” and various federal circuit courts apply differing analyses, often consisting of a long laundry list of factors to consider.
- The Rule 23 Subcommittee addressed this issue in its Report and its proposal to potentially amend FRCP 23(e) includes a list of factors that would be incorporated into the rule and supersede the list adopted by various circuits.

Incentive Awards to Representative Plaintiffs

- An incentive award is a payment to the representative plaintiff for assistance in prosecuting the action.
- Recognizes that named plaintiffs may take on a more demanding role than passive class members, such as participating in discovery and reviewing motions.
- Provides an incentive to remain in the litigation and incur any associated costs.
- These are common features in class action settlements.

Incentive Awards to Representative Plaintiffs, Amounts of Approved Awards

- Consumer cases – $500 to $25,000
- Antitrust cases – up to $50,000
- Employment cases – More than $100,000
- Securities cases under the PSLRA, limited to actual expenses (*15 U.S.C. § 78u–4(a)(4)*).

Incentive Awards to Representative Plaintiffs, Ethical Limitations

Several of the American Bar Association's Model Rules of Professional Conduct (Model Rules) potentially apply to incentive awards.

✓ Model Rule 1.7, Conflict of interest, provides:

> [A] lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client; or
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Incentive awards can create a conflict of interest because class counsel represents both the unnamed class members and the named plaintiff.

Incentive Awards to Representative Plaintiffs, Ethical Limitations

- A prohibited conflict might occur where the award encourages a representative plaintiff to compromise the claims for personal gain.
- Examples might include an award that:
  - Is tied to approval of the settlement agreement.
  - Serves to make the representative plaintiff *more* than whole.
  - Is so large that it diminishes the damages received by the class.

Incentive Awards to Representative Plaintiffs, Ethical Limitations

Additional ethical rules also may apply to incentive awards to representative plaintiffs, including:

- ✓ Model Rule 5.4: Improper fee splitting (see, for example, *In re Gould Sec. Litig., 727 F. Supp. 1201, 1209 (N.D. Ill. 1989)*).
- ✓ Model Rule 3.3: Candor to the tribunal.
  - ✓ No undisclosed agreements.
  - ✓ See also Rules 3.3(b) and 8.3, related to the duty of disclosing misconduct.
- ✓ Model Rule 2.1: Advisor.
  - ✓ Representative plaintiff entitled to know up front that fees are not guaranteed.

Incentive Awards to Representative Plaintiffs, Ethical Limitations

As a result, courts will scrutinize these awards for legal, policy and ethical concerns.

As one court recently noted:

> [T]his court . . . will not routinely decide to 'tip' [representative plaintiffs] simply because their names appear in the caption, and will view with some skepticism conclusory arguments that they actually made a meaningful substantive contribution to the lawsuit.

(*City of Providence v. Aeropostale, No.11-cv-7132, 2014 WL 1883494, at *20 (S.D.N.Y. May 9, 2014)*; see also *In re Indymac Mortgage-Backed Sec. Litig., No. 09–cv–4583, 2015 WL 1315147, at * 6 (SD.N.Y. Mar. 25, 2015*).)

Incentive Awards to Representative Plaintiffs, Practical Implications

When considering including incentive awards in a settlement agreement, counsel should consider:

- The types of claims at issue (consumer, employment, securities, antitrust, etc.).
- Prior relevant binding or persuasive authority from the jurisdiction.
- The individual predilections of the judge.
- Whether the representative has provided meaningful assistance in prosecuting the claims in a way that could not have been done by his or her attorneys.
- The benefits being conferred to the settlement class.

Determining Reasonable Attorneys' Fees, Court's Discretion

- Reasonable attorneys' fees may be awarded in a certified class action, subject to court approval (*FRCP 23(h)*).
- The court exercises discretion in approving the award and serves as a "fiduciary of the class" in these circumstances (see *Pearson v. NBTY, Inc. 772 F.3d 778, 780 (7th Cir. 2014); In re IndyMac Mortgage Backed Sec. Litig. 2015 WL 1315147, at *1*).

Determining Reasonable Attorneys' Fees, Methods

- Fees generally are calculated using either:
  - A lodestar multiplier.
  - A percentage of the common fund awarded in the class action.
- These also may be used to cross-check reasonableness.
- With either method, however, the incentives of attorneys and the class they represent may become misaligned:
  - The lodestar may encourage needless billing.
  - The percentage of the common fund approach may encourage attorneys to settle more quickly than they otherwise would.
    - This amount also may be overvalued in the case of injunctive relief or where it is based on the highest possible, as opposed to the actual or likely, settlement value.
- For coupon settlements, the Class Action Fairness Act dictates how attorneys' fees must be calculated (*28 U.S.C. §1712*).

Determining Reasonable Attorneys' Fees, Ethical Considerations

- ✓"A lawyer shall not make an arrangement for, charge, or collect an unreasonable fee." Model Rule 1.5.
- ✓"[A] lawyer shall not represent a client if the representation involves a concurrent conflict of interest," which exists if "there is a significant risk that the representation of one or more clients will be materially limited by . . . a personal interest of the lawyer." Model Rule 1.7(a)(2).

Determining Reasonable Attorneys' Fees, Conflicts of Interest

The US Court of Appeals for the Seventh Circuit recently emphasized the inherent conflict of interest in the provision of attorneys' fees through the settlement process:

> [C]lass counsel, in complicity with the defendant's counsel, [are incentivized] to sell out the class by agreeing with the defendant to recommend that the judge approve a settlement involving a meager recovery for the class but generous compensation for the lawyers - the deal that promotes the self-interest of both class counsel and the defendant and is therefore optimal from the standpoint of their private interests.

(*Eubank v. Pella Corp., 753 F.3d 718, 720 (7th Cir. 2014)* (noting the $11 million fee award was "inequitable - even scandalous") (citations omitted).)

Determining Reasonable Attorneys' Fees, Conflicts of Interest

Other courts are in accord:

> Collusion may not always be evident on the face of a settlement, and courts therefore must be particularly vigilant not only for explicit collusion, but also for more subtle signs that class counsel have allowed pursuit of their own self-interests and that of certain class members to infect the negotiations

(*In re Bluetooth Headset Prods. Liab. Litig., 654 F.3d 935, 947 (9th Cir. 2011)*.)

> The relief that this settlement provides to unnamed class members is illusory. But one fact about this settlement is concrete and indisputable: $2.73 million [in attorney's fees] is $2.73 million.

(*In re Dry Max Pampers Litig., 724 F.3d 713, 721 (6th Cir. 2013)*.)

> [C]ourts [reviewing class action settlement agreements] are left pretty much at sea, aided however by the principles that (1) the Court is a fiduciary for the class members who ultimately pay any fee, (2) the class lawyers' interests at this stage diverge sharply from those of the class members, (3) it is the lawyers who bear the burden of justifying the size of the award they seek at their clients' expense, and (4) the risk of non-persuasion is with those lawyers.

(*In re Weatherford Int'l Sec. Litig., No. 11-cv-1646, 2015 WL 127847, at *1 (S.D.N.Y. Jan. 5, 2015)*.)

Determining Reasonable Attorneys' Fees, Conflicts of Interest

The district judge made significant modifications in the settlement, but not enough. The settlement, a selfish deal between class counsel and the defendant, disserves the class.

(*Pearson, 772 F.3d at 787*.)

Attorneys' fees don't ride an escalator called risk into the financial stratosphere.

(*Redman v. RadioShack Corp., 768 F.3d 622, 633 (7th Cir. 2014)*, cert denied, *135 S.Ct. 1429 (2015)*.)

Attorneys' Fees, Other Concerns

- "Clear sailing" or "kicker" agreements, in which a class action defendant agrees not to contest the class lawyer's petition for attorneys' fees.
  - This type of agreement may be view as evidence of a conflict or collusion.
- Fee motion timing. Some courts view it as improper to request fees after the deadline for objecting has passed.

Determining Reasonable Attorneys' Fees, Practical Considerations

When submitting requests for attorneys' fees in connection with a class action settlement agreement, counsel should:

- Not negotiate fees while negotiating class relief.
- Emphasize the lawyers' skills and any "innovative" terms of settlement.
- Compare awards in similar cases.
- If possible, emphasize the absence (or near absence) of objecting class members.

Cy Pres Distributions

- *Cy pres* provisions in class action settlement agreements generally allow for leftover funds to be directed to charitable organizations.
- Generally used in two scenarios:
  - Residual class settlement funds.
  - Distribution to the class is infeasible, for example where:
    - Award per class member is *de minimus*;
    - Each class member's recovery would be so small as to make an individual distribution economically impracticable (e.g., cost of paying claims exceeds amount to be distributed); or
    - Class members are difficult to identify or changing constantly (e.g., class members declined to file claims, have died, etc.).

Cy Pres Distributions, Criticisms

Although these provisions are permissible, they have come under attack recently.

> [*Cy pres*] distributions 'have been controversial in the courts of appeals.' . . . Indeed, many of our sister circuits have criticized and severely restricted the practice.

(*In re BankAmerica Corp. Sec. Litig., 775 F.3d 1060, 1063 (8th Cir. 2015)* (collecting cases).)

> A *cy pres* award is supposed to be limited to money that can't feasibly be awarded to the intended beneficiaries, here consisting of the class members . . . [this] has not been demonstrated.

(*Pearson, 772 F.3d at 784.*)

> *Cy pres* distributions also present a potential conflict of interest between class counsel and their clients because the inclusion of a *cy pres* distribution may increase a settlement fund, and with it attorneys' fees, without increasing the direct benefit to the class.

(*In re Baby Prods. Antitrust Litig., 708 F.3d 163, 173 (3d Cir. 2013).*)

Cy Pres Distributions, Criticisms

- The Supreme Court also has weighed in.
- In a statement issued in connection with the denial of *certiorari* in *Lane v. Facebook, Inc.*, Chief Judge Roberts noted:
  - The "disconcerting" features of the settlement, which provided no money to the class, but allocated $6.5 million to a newly established charity dedicated to online privacy.
  - The "fundamental concerns surrounding the use of [cy pres] remedies in class action litigation."
  - In "a suitable case," the Court may need to "clarify the limits on the use of" *cy pres* practice.

(*134 S. Ct. 8 (2013).*)

- This issue is ripe for review.

Cy Pres, Ethical Concerns

- ✓ Attorneys have an ethical obligation to ensure that the *cy pres* funds are earmarked to beneficiaries with a proper nexus to the class.
- ✓ Counsel should make an honest effort to locate absent class members, rather than just earmarking a *cy pres* distribution to end the case.
  - ➢ *Cy pres* creates an incentive to reach settlement quickly and avoid the costly process of searching for absent class members.
- ✓ Counsel should think creatively about how to structure *cy pres* funds to best serve the interests of absent class members.
- ✓ A *cy pres* remedy potentially blurs the line between attorney as "advocate" and attorney as "entrepreneur."
- ✓ Counsel should avoid any conflict of interest when fees potentially increase as a result of a *cy pres* distribution without any increase in the benefits to the class.

Cy Pres, Potential Rule Change

- In it’s Report, the Rule 23 Subcommittee noted that concern has been expressed "in several quarters" about the questionable use of *cy pres* provisions and the courts' role in approving these arrangements.
- A proposed revision to FRCP 23(e) would allow courts to approve settlements including a *cy pres* remedy by applying certain criteria to determine whether the remedy is appropriate.

Objectors, Common Grounds

- Class members may object to a proposed settlement (*FRCP 23(e)(5)*).
- An objector may appeal a district court's approval of a settlement agreement.
- Objectors can play an important role in the approval process by serving as a check on the fairness of the agreement.
- After a settlement has been reached, objectors can ensure that the approval process passes muster under our adversarial system. These are "good objectors."
- However, "bad objectors" also exist and object to "hold up" the settlement process merely to extort more money.

Objectors

- At the time the 2003 amendments to FRCP 23 were being developed, there was discussion regarding the tension between:
  - Ensuring that “good” objectors could properly test the fairness of the settlement.
  - Preventing “bad” objectors from using the objection process as a way to extract money from the settling parties or hold up the settlement.
- FRCP 23(e)(5) was amended in 2003 to direct that objections, once they have been made, could only be withdrawn with the permission of the district court.
- The problem with this solution is that it did not apply once the objector had taken an appeal. This created an incentive for objectors to appeal district court decisions approving a class action settlement.

Objectors, Settlement

- How can “objector blackmail” be avoided?
  - Requiring posting of an appellate bond.
  - Accelerate payment of fees to class counsel.
  - Sanction frivolous objections.
- Issues with these proposed solutions include that “good” objectors may be chilled from proceeding.

Objectors, Strategies

There are a few strategies to dealing with objectors:

- Resolve issues with objectors before appeal, which requires district court approval. But this may be easier said than done under the current rules.
- Potential amendments to federal rules being discussed:
  - The Rule 23 Subcommittee noted several possible changes to FRCP 23(e)(5) including:
    - A reporting obligation requiring a party seeking to withdraw an objection to notify the court of any "side agreements" that influenced the decision to withdraw.
    - Language authorizing sanctions should the court determine that objections were unfounded.
  - Amend Federal Rule of Appellate Procedure 42 to require appellate permission for a class member to withdraw.

Questions

Relevant Practical Law Resources Available with a *Free Trial* to Practical Law

- Class Action Toolkit
- Settling Class Actions: Process and Procedure
- Potential Changes to FRCP 23
- To come: What's Market: Class Action Settlement Agreements

About the Speakers

Deborah H. Renner, Partner, *BakerHostetler*

Deborah Renner leads BakerHostetler's class action practice in New York and is a founder and former editor of BakerHostetler's Class Action Lawsuit Defense blog. She also serves as the Pro Bono Coordinator for the New York office, and is on the firm's Diversity Committee.

Deborah focuses her practice on complex commercial litigation, including the defense of consumer fraud, data breach, ERISA, and securities class actions. Deborah has successfully defended numerous companies in nationwide, multidistrict and state class actions. She has defeated class certification in courts around the country and has won the dismissal of class claims at the outset of numerous actions. Deborah frequently advises companies on class action defense and regulatory inquiries. Among her areas of knowledge and experience, Deborah is certified in information privacy.

Deborah was recently elected a member of the American Law Institute.

About the Speakers

Paul G. Karlsgodt, Partner, *BakerHostetler*

Paul Karlsgodt is the leader of BakerHostetler's national Class Action Defense practice team. He knows and understands the intricacies of the class action process and is strategic in his work, looking at a case from all angles but also knowing which aspects require his most complete focus and attention. Clients turn to Paul for representation and advice, trusting his experience and knowing he will be a strong advocate who will keep their long term business goals in mind.

Paul was named a Fellow of the American Bar Foundation in 2011 and is the Denver office Litigation group coordinator. He is the editor of and primary contributor to www.ClassActionBlawg.com, which covers global and national class action-related issues such as decisions, trends, best practices, news and reform.

About the Speakers

Karl Fanter, Partner, *BakerHostetler*

Karl Fanter concentrates his practice on complex commercial litigation, with particular emphasis on class action defense and appeals. Karl crafts creative-yet-practical solutions for his clients' most important cases.

Representative Experience:

- Represented a senior government official in Iqbal v. Ashcroft, which involved challenges to detention policies after the September 11 terrorist attacks. Matter was litigated to the United States Supreme Court and resulted in favorable defense ruling on pleading standards required to bring actions in federal court.
- After seeing its market share decline over time, a non-profit hospital in Northeast Ohio learned that a larger rival—which happened to be the biggest employer in the county—had converted hundreds of local employers to its captive insurance subsidiary by making secret payments to the independent insurance brokers who represented those employers. Member of team that crafted a claim under Ohio's version of RICO based on a criminal statute outlawing improper payments to service providers of employee benefit plans. After a nine-week trial, team won an unprecedented jury verdict under this theory. Case was argued on appeal, which resulted in the judgment being affirmed.
- Member of team representing federally insured bank in matter involving novel banking product being offered to consumers. Represents bank in five parallel putative nationwide class action lawsuits initially filed in federal courts, now consolidated in single action.

About the Speakers

David McMillan, Associate, *BakerHostetler*

David McMillan is an Associate in the firm's litigation group whose practice centers on class action defense, securities litigation, and bankruptcy litigation matters. He has worked on a number of high profile fraud cases involving the financial industry, including representation of the Securities Investor Protection Act Trustee for the liquidation of Bernard L. Madoff Investment Securities LLC. He also defends clients in significant securities-related government investigations and securities fraud class actions. David frequently speaks on panels discussing cutting edge issues in class action law, and contributes regularly to the firm's class action defense blog.

About the Speakers

Sarah Heckman Yardeni, Editor, *Practical Law Litigation*

Sarah Heckman Yardeni joined Practical Law from Skadden, Arps, Slate, Meagher & Flom LLP, where she was a senior litigation associate representing clients on a wide range of matters. Prior to joining Skadden, she clerked for the Honorable Debra Freeman in the Southern District of New York. Before that, she was a litigation associate at Moses & Singer LLP. She is also an Adjunct Professor of Legal Writing at Fordham Law School.