What Every Judge Should Know about a Rule 23 Settlement
(But Probably Isn't Told)

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For the past 50 years, Rule 23 of the Federal Rules of Civil Procedure has required district court judges to scrutinize proposed class settlements. Judges are told their duty to absent class members is akin to a fiduciary duty. We are reminded that district judges must "exercise the highest degree of vigilance in scrutinizing proposed settlements of class actions." *Reynolds v. Beneficial Nat'l Bank*, 288 F.3d 277, 279–80 (7th Cir. 2002). In its present form, Rule 23(e) permits approval only when, after a hearing, the court finds the settlement "fair, reasonable, and adequate."

The judicial gloss on this rule is that there's lots for the district court to do. In one widely accepted formulation, the district court must weigh the following:

> (1) the strength of the plaintiffs' 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 views of counsel; (7) the presence of a governmental participant; and (8) the reaction of the class members to the proposed settlement.

Churchill Vill., L.L.C. v. Gen. Elec., 361 F.3d 566, 575 (9th Cir. 2004).

Unfortunately, the dynamics of the Rule 23 settlement process do not favor the judge. While class counsel is generally the movant, plaintiff and defendant share a community of interest in seeing the settlement approved. And in the absence of an objector, the court has no adverse party questioning the settlement. Rather, the burden of ferreting out problems falls wholly on the court.

Yet, too often, the court doesn't get the information the judge needs. Here is what the district court should know but too often isn't told.

Insurance Coverage

The amount of insurance (less amounts expended for costs of defense) is a crucial driver of settlements. If the insurance is meager, a lower settlement may be justified, particularly with a defendant of relatively modest means. *See, e.g.*, *In re Advanced Battery Techs., Inc. Secs. Litig.*, 298 F.R.D. 171, 178 (S.D.N.Y. 2014) (in approving settlement, court considered that defendants had minimal insurance coverage for lead plaintiffs' claims and that any judgment against defendants would likely be uncollectible). Second, even large companies are extremely reluctant to pay their own funds in settlement. Thus, even when there's lots of insurance, it usually marks the outer edge of potential settlement. *See, e.g.*, *In re Rent-Way Secs. Litig.*, 305 F. Supp. 2d 491, 507–8 (W.D. Pa. 2003) (in approving settlement where class

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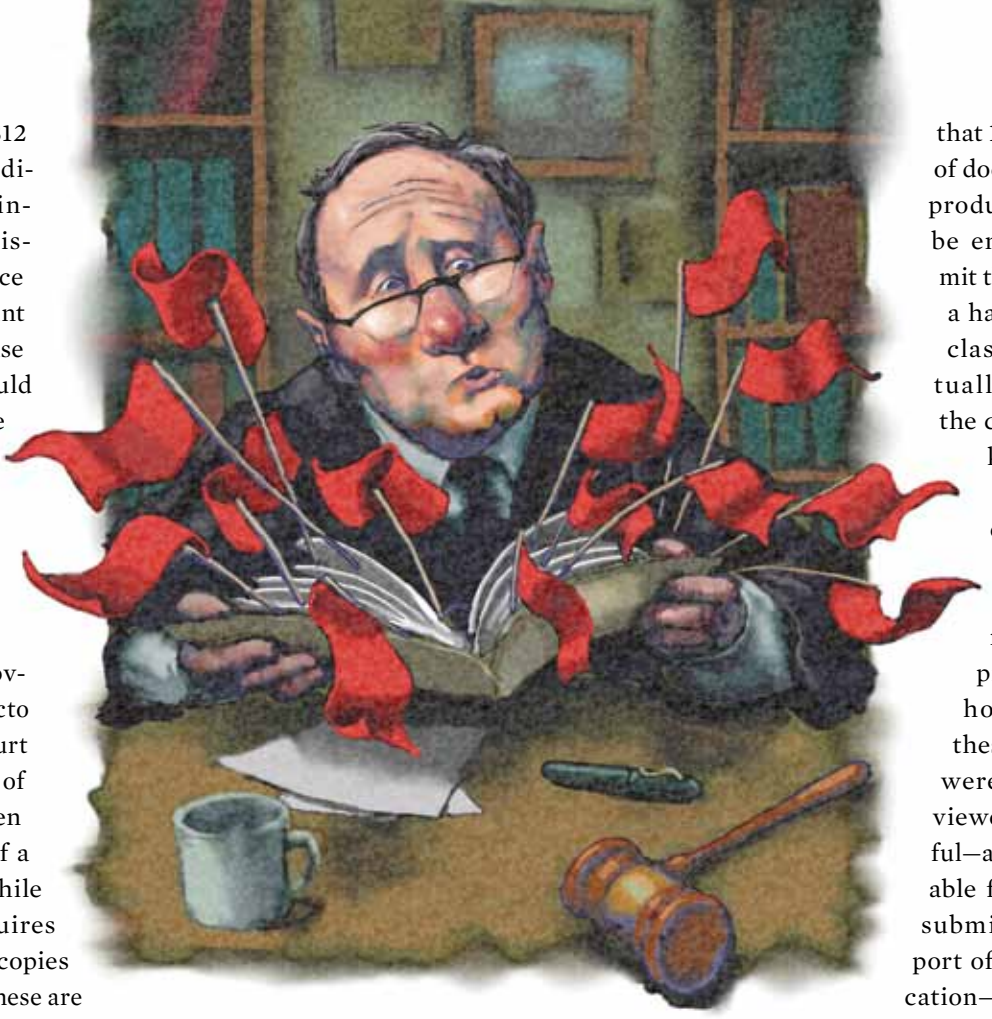

obtained $11 million of $12 million available under directors' and officers' insurance policy, court discussed potential insurance coverage including amount of proceeds spent in defense and whether insurer could exclude coverage or argue for rescission). The real negotiations are often not between class counsel and defendants' attorneys but between class counsel and the insurer.

Because insurance coverage often acts as a de facto cap on class recovery, a court should know the amount of insurance available when assessing the fairness of a settlement. However, while Rule 26(a)(1)(A)(iv) requires the parties to exchange copies of all insurance policies, these are not filed with the court or otherwise available. And too often the amount of available coverage is not disclosed to the court in the parties' Rule 23(e) filings.

Thus, except in the rare case of a limited, determinable fund, the court has no reliable measure of the potential recovery against which to evaluate the class settlement. Requiring disclosure of available insurance in the settlement approval filings goes a long way toward providing the needed metric in determining the fairness and adequacy of the settlement.

Discovery

The extent of discovery is a crucial determinant as to how thorough a job class counsel has done. But too often the settlement papers say little more than "x depositions were taken" and "y documents were produced." More disclosure is needed. First, the identity of each person deposed by class counsel should be listed, as well as depositions noticed but not taken. *See, e.g., In re Lupron Mktg. & Sales Practices Litig.*, 228 F.R.D. 75, 96–97 (D. Mass. 2005) (approving settlement where 26 depositions had been taken, specifically including those of defendant's senior management); *Kreuzfeld A.G. v. Carnehammar*, 138 F.R.D. 594, 607 (S.D. Fla. 1991) (following class certification, court compelled deposition of one of the individual defendants, stating that his deposition was crucial to preparing for trial). Second, a mere statement that 100,000 pages of documents were produced may not be enough to permit the court to get a handle on what class counsel actually did. What the court needs to know is who produced the documents, what categories of documents were produced, and how many of these documents were actually reviewed. Also helpful—and easily available from the data submitted in support of the fee application—is how many hours were spent by class counsel, contract attorneys, and paralegals in this review.

The court should also be told when the discovery was taken. So-called confirmatory discovery—discovery taken after a settlement in principle is reached—is too often a sham, undertaken to inflate the lodestar rather than assist in the prosecution of the claim. Thus, any discovery taken after the settlement is reached should be identified and treated separately.

Other Pending Actions

Usually, releases in class settlements are all-encompassing and may compromise claims asserted in pending litigation elsewhere. "Broad class action settlements are common, since defendants and their cohorts would otherwise face nearly limitless liability from related lawsuits in jurisdictions throughout the country." *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 396 F.3d 96, 106 (2d Cir. 2005). For example, the defendant in *Sandler Associates, L.P. v. Bellsouth Corp.* obtained summary judgment on federal law claims because a state court had approved a class action settlement involving similar allegations and releasing all related claims. 818 F. Supp. 695, 700–01 (D. Del. 1993), *aff'd*, 26 F.3d 123 (3d Cir. 1994). Given the breadth of most settlements, it is incumbent on the parties to disclose this other litigation in their motion for

Illustration by Doug Thompson

preliminary approval. Obviously, the defendant is fully aware of it. If these other actions are strong, their termination must be taken into account in evaluating the proposed settlement. Under the guise of a general release, the defendant may be buying its peace from litigation that is only tangentially—or not at all—related to the class litigation before the court.

At a minimum, then, the court should be apprised of all actions arguably released by the pending settlement. And because the notice of a settlement usually goes only to the client, his or her lawyer in the other pending actions may not learn of the settlement in a timely fashion. Actual notice must be given to counsel in these other actions, which, of course, the defendant has ready access to.

Claims Rates and Pro Rata Share

The settlement papers commonly stress the dollar size of the settlement. After all, a large number is presented as the result of substantial efforts by class counsel capped by a wonderful result. But dollars alone are not the full story. Rather, the expected recovery per dollar loss is what class members—and the court—need to know.

The expected average recovery is a function of the settlement dollars (after deduction of fees and expenses) divided by the estimated claims made. For example, suppose class members are shareholders of a particular company. Then assume (1) the net settlement amount is $1 million, (2) investors purchased 2 million shares of the company's stock during the class period, and (3) the estimated claims rate is only 25 percent. In that case, the expected average recovery per share is $1 million/ (2 million shares x 25 percent), or $2.00 per share. Too often the court is told little or nothing about the second and third elements: class size and expected claims rate.

As part of class discovery or even settlement negotiations, the parties gain a good idea of the size of the class. Though limited, there is also literature on expected claims rates in a number of kinds of actions. *See, e.g.*, Francis E. McGovern, *Distribution of Funds in Class Actions—Claims Administration*, 35 J. Corp. L. 123 (2009). Also, experienced class counsel can advise the court of claims rates in their own experience. To the extent possible, the settlement papers should set out both the per-unit pro rata share—net settlement dollars divided by relevant units—and the expected claims rate.

Claims Process

The best settlement is worthless if the claims process is too onerous. Conscientious plaintiffs' counsel should insist on the least difficult claim form that is actually necessary to determine whether a claimant is entitled to recover part of the fund. A form that asks for more than is necessary may well be evidence that the attorneys are not putting the best interests of the class at the forefront of their negotiations. An extreme example is described in *Eubank v. Pella Corp.*, 753 F.3d 718 (7th Cir. 2014), in which Judge Posner criticized the 12-page claim form that class counsel agreed to for a "simple" claim for defective new windows, with a ceiling of $750 per home. And many others, while fewer than 12 pages, are not only too onerous for the amount at stake but often unrelated to what is necessary. Indeed, as the Federal Judicial Center and various cases have noted, there is often no justification for any claims process at all because the persons entitled to recovery are known and the amounts can be determined by information known to counsel and the defendant. *See, e.g.*, *De Leon v. Bank of Am.*, 2012 U.S. Dist. LEXIS 91124, at *20 (M.D. Fla. 2012); Fed. Judicial Ctr., Judges' Class Action Notice and Claims Process Checklist and Plain Language Guide (2010).

Some cases do justify a claims process, but it should not be any more difficult than actually necessary to determine eligibility for class participation and the level of recovery, where appropriate. Thus, a court should look very carefully at a process that requires claimants to submit records, especially detailed ones or documents stretching back over time. Similarly, a process that asks claimants to determine particular dates on which, for example, they rented a car or used a credit card will almost surely result in a minuscule number of claims. *See, e.g.*, *Pearson v. NBTY, Inc.*, 2014 U.S. App. LEXIS 21874, at *4 (7th Cir. 2014). In *Pearson*, a consumer class action involving nutritional supplements, Judge Posner harshly criticized a claims form that required not only a sworn statement of claim, which he would have found sufficient, but also attachment of receipts for the supplements. *See id.* at *5. This sort of burden might be justified if the amount to be recovered is very large and the defendant lacks the information. So too with requirements that claims forms be sworn.

A judge weighing the fairness of a settlement must balance the claim requirements proposed against the value of the benefit to class members. A settlement to which few will make claims, or in which the claims process is unrealistic, is not one with much value for the defined class. An example is *In re Baby Products Antitrust Litigation*, in which the Third Circuit overturned a settlement in which most claimants had accepted a $5 award because they did not have the documentation to prove exactly what products they had purchased, which would have entitled them to a higher award. *See* 708 F.3d 163, 176 (3d Cir. 2013). The court doubted that "a settlement with such a restrictive claims process was in the best interest of the class." The same was true in *Pearson*, in which the Seventh Circuit held that the amount actually received by the class—not the potential sum, assuming a 100 percent claims rate—is the proper basis for valuation. *See* 2014 U.S. App. LEXIS 21874, at *2–4.

In another baby products case, a district court approved a settlement in which the only monetary payment to class members

was a box of Pampers—and to receive that, claimants had to send in an original receipt from a prior purchase and a code found only on the box. The court of appeals agreed with the objector that no one keeps old boxes of diapers, let alone for years. Thus, no one would qualify for even the minimal benefit. *In re Dry Max Pampers Litig.*, 724 F.3d 713 (6th Cir. 2013). The settlement was, as the Sixth Circuit held, "illusory." *Id.* at 271.

Reversion of Undistributed Funds to Defendants and Cy Pres Awards

A court should look doubly hard at a settlement that allows unclaimed funds to revert to the defendants, rather than being redistributed to the plaintiff class. In *Laguna v. Coverall North America, Inc.*, Judge Chen noted in dissent that the supposed $918,750 value of a settlement really had a value of, at most, $82,025, and probably less, because the unclaimed funds went back to the defendants and the real value of the settlement was so small that few claims were made. *See* 753 F.3d 918, 934 (9th Cir. 2014). Judge Chen was surely right in arguing that the combination of a claims process that appeared to be unnecessary (because the defendant had the names, addresses, and other information of the franchisee class) and reversion of unclaimed class funds presented serious questions of potential collusion.

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Another red flag is a settlement allowing unclaimed funds to be paid to charities. Cy pres awards of residual amounts following distribution to class members are common in consumer class action settlements. But courts need to be wary of settlements that include these awards. First, they need to know that there is a valid reason for the cy pres award. Usually, it will be because the real damage that individual claimants have is too small to justify documentation or because the cost of a redistribution after claims are paid would be too high to justify a second payout. Then courts approve a substitute payment to a nonprofit organization so long as the group is really a substitute for the injured plaintiffs. There must be "a driving nexus between the plaintiff class and the cy pres beneficiaries." *Dennis v. Kellogg Co.*, 697 F.3d 858, 865 (9th Cir. 2012). To see if this is true, a court should insist on detailed information about the proposed recipient. The court cannot determine that a settlement is fair and reasonable if part of the proceeds are earmarked for an organization "to be determined at a later time." The nexus must be to the claim made. Thus, in *Dennis*, the Ninth Circuit held that a future distribution of Kellogg's cereal products to charities that feed the indigent was unrelated to claims that Kellogg misled consumers when it claimed that Frosted Mini-Wheats would improve children's attentiveness in school by 20 percent. The cy pres distribution was not going to benefit the class.

The second potential problem with inclusion of cy pres awards as part of a class action settlement is that the award may be valued by counsel as part of the total benefit to the class and thus the amount by which counsel's fee is calculated. If that is ever to be justified, there is a particular need for scrutiny of the alleged value of the award both to the class and the defendant, who may be obtaining tax benefits or is already committed to making the same distribution.

Class Notice

Finally, courts must look carefully at the proposed notice to absent class members, both in substance and with an eye toward how it will be disseminated. Notice in federal cases is governed by Federal Rule of Civil Procedure 23(c)(2). That rule requires that class members receive "the best notice that is practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort." In general, if the defendant's records identify class members, they must be sent individual notice. *See, e.g.*, *Larson v. AT&T Mobility LLC*, 687 F.3d 109 (3d Cir. 2012). Counsel often propose a "summary notice," which directs class members to a website on which they may obtain more information. But this kind of notification in any case certified under Rule 23(b)(3) must still comply with the requirements of subsection (c)(2), including that it plainly inform the class of the nature of the action, the class definition, and claims and defenses. *See De Leon v. Bank of Am.*, 2012 U.S. Dist. LEXIS 91124 (M.D. Fla. 2012). Class members must also be told that they may file an appearance by an attorney, that they may opt out of the class, and that the action will be binding on them.

Because the adversary element is lacking in the process of preliminarily approving class actions, the court must be alert to what it is not being told as well as to what it is told. Notice, insurance coverage, discovery, claims issues, settlement value, and the defendant's continuing stake are just some of the areas where the court should be on guard. At least that much is owed to absent class members. ■

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