

# CLASS ACTION WATCH

## *Cy Pres* Settlements

by Theodore H. Frank

The idea of *cy pres* (pronounced “see pray” or “sigh pray,” from the French *cy pres comme possible*—“as near as possible”) originated in the trust context, where courts would reinterpret the terms of a charitable trust when literal application of those terms resulted in the dissolution of the trust because of impossibility or illegality.<sup>1</sup> In a classic nineteenth century example, a court repurposed a trust that had been created to abolish slavery in the United States to instead provide charity to poor African-Americans.<sup>2</sup> The California Supreme Court endorsed the use of *cy pres* or “fluid recovery” mechanism in class action settlements in 1986, to distribute proceeds to a “next best” class of consumers, and many other courts have gradually adopted the procedure.<sup>3</sup> *Cy pres* settlements arise in one of three circumstances:

- There is a fixed settlement fund that exceeds the amount paid out because only a few class members have registered to be claimants;
- The court (often at the parties’ behest) decides that administering a settlement by paying class members directly would be too expensive;
- The parties otherwise agree that a case shall be settled by paying a third party.

While original *cy pres* class action settlements provided that left-over money be distributed to a different set of consumers who may or may not coincide with the class, in recent years, left-over or specifically earmarked funds are typically given directly to a third-party charity.

Plaintiffs’ lawyers have recently shown renewed interest in the *cy pres* mechanism in class action settlements.<sup>4</sup> The interest of the class attorney in a class action settlement does not entirely coincide with the interests of the class members. A defendant may be willing to spend a certain amount of money to settle a class action to avoid the expense and risk of litigation, but that money must be divided between the class and their attorneys. At the same time, a class action settlement must be approved by the court. One mechanism often used to maximize attorneys’ fees are “coupons,” which, if structured improperly, act to exaggerate the size of class recovery to maximize the return to plaintiffs’ lawyers at a lower cost to defendants. The parties represent to the court that the value of the settlement to the class is the nominal value of the coupons; in fact, both parties expect the coupons to have a low redemption rate because

*continued page 21*

## THE SUPREME COURT REJECTS “SCHEME LIABILITY” IN SECURITIES CLASS ACTIONS

by Larry Obhof

On January 15, 2008, the Supreme Court issued its decision in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, a case heralded by commentators as the “most important securities case in decades.”<sup>1</sup> The five-to-three *Stoneridge* majority rejected a theory of “scheme liability” that would have greatly expanded the universe of potential class action defendants.

What makes *Stoneridge* so important? In simple terms, the plaintiff sought to expand the scope of Section 10(b) actions beyond the securities markets and into the realm of ordinary

*continued page 9*

MARCH  
2008

INSIDE

The Problem of Class Action Tolling in Mass Tort Personal Injury Litigation

FACTA Truncation: Applicable to the Digital World?

*Silberblatt*: Court Protects Unnamed Class Members

“Reverse Bifurcation” Approach to Punitive Damages Trials in West Virginia

Ninth Circuit Affirms Largest Employment Discrimination Class in History

# Cy Pres Settlements

*Continued from page 1*

for many class members, “the right to receive a discount [or coupon] will be worthless.”<sup>5</sup> The class attorneys then capture the lion’s share of the actual settlement. There are countless examples where the nominal or even the predicted values of the coupons that justified a huge attorneys’ fee far outstripped the actual redemption rate.<sup>6</sup> In a recent settlement (a nationwide Sears class action in Cook County, Illinois), plaintiffs’ attorneys received about \$1 million, while the 1.5-million member class redeemed claims at under a 0.1% rate for a total of \$2,402.<sup>7</sup> Such settlements benefit defendants in the short run by permitting them to pay off class action attorneys cheaply, but hurt defendants in the long run by creating a mechanism by which class action attorneys can profitably bring weak cases.

The Class Action Fairness Act (CAFA), passed in 2005, has drawn de jure<sup>8</sup> and de facto<sup>9</sup> scrutiny to the issue of coupon settlements by requiring attorneys’ fees in coupon settlements to be tied to the actual value of the redeemed coupons. But CAFA does not provide the same scrutiny to cy pres settlements and trial lawyers are shifting to that mechanism to accomplish the same task of maximizing return from weak cases.

Judge Richard Posner has argued that cy pres is a misnomer in the class action context:

[Cy pres] doctrine is based on the idea that the settlor would have preferred a modest alteration in the terms of the trust to having the corpus revert to his residuary legatees. So there is an indirect benefit to the settlor. In the class action context the reason for appealing to cy pres is to prevent the defendant from walking away from the litigation scot-free because of the infeasibility of distributing the proceeds of the settlement (or the judgment, in the rare case in which a class action goes to judgment) to the class members. There is no indirect benefit to the class from the defendant’s giving the money to someone else. In such a case the “cy pres” remedy (badly misnamed, but the alternative term—“fluid recovery”—is no less misleading) is purely punitive.<sup>10</sup>

But sometimes cy pres is less a matter of being punitive and more a matter of disguising the true cost of a settlement to the defendant to maximize the share of the actual recovery received by the plaintiffs’ attorneys. If the beneficiary is related to the defendant, or the defendant otherwise benefits from the payout, then the contingent attorneys’ fee can be exaggerated by claiming that the value to the class is equal to nominal value of the payment

- 63 *Id.* at 1194.
- 64 *Id.*
- 65 *Id.* (quoting *Watson*, 487 U.S. 977, 990, 999 (1988)).
- 66 *Id.*
- 67 *Id.* (quoting *Watson*, 487 U.S. at 992).
- 68 *Id.* at 1194-95.
- 69 *Id.* at 1195-96.
- 70 *Id.* at 1196.
- 71 *Id.*
- 72 *Id.*
- 73 *Id.*
- 74 *Id.*
- 75 *Id.*
- 76 *Id.* at 1197.
- 77 *Id.*
- 78 *Id.*
- 79 *Id.*
- 80 *Id.*
- 81 *Id.* at 1198.
- 82 *Id.*
- 83 *Id.* at 1199 (quoting *Califano v. Yamasaki*, 442 US 682, 700-01 (1979)).
- 84 *Id.*
- 85 *Id.*
- 86 *Id.*
- 87 *Id.*
- 88 *Id.*
- 89 *See, e.g.*, *Gen. Tel. Co. of the Southwest v. Falcon*, 457 U.S. 147, 151 (single facility), 159 n. 15 (wholly subjective decisionmaking process).
- 90 *Dukes I*, 222 F.R.D. at 155.
- 91 *Watson*, 487 U.S. at 992 (plurality op.) (internal quotation marks omitted).
- 92 *Id.*
- 93 *Id.* at 992-93 (internal quotation marks and citations omitted).
- 94 *Id.*
- 95 *Int’l Bhd. of Teamsters v. United States*, 431 U.S. 324, 362 (1977); *see also* *Reeves v. Sanderson Plumbing Prods. Inc.*, 530 U.S. 133, 148 (2000).
- 96 *Dukes II*, 509 F.3d at 1193.
- 97 *See, e.g.*, *Philip Morris USA v. Williams*, 127 S. Ct. 1057, 1063 (2007) (due process requires that a defendant have “an opportunity to present every available defense”).

to the beneficiary; as in the coupon scenario, the defendant is willing to make a larger nominal contribution to settle the case than the actual cost to the defendant. For example, a California state court settlement of a derivative action against Larry Ellison, alleging insider trading, settled when Ellison agreed to pay \$100 million to a charity chosen by Oracle—even though the billionaire has previously stated that his fortune would go to charity.<sup>11</sup> The only real expense to Ellison was the \$22 million attorneys' fee.

Further ethical problems arise if the beneficiary is related to the judge. The *New York Times* recently documented the problem of charities soliciting judges for leftover settlement money.<sup>12</sup> In a mass-tort inventory settlement of fen-phen cases in Kentucky, tens of millions of dollars intended for plaintiffs was diverted to a newly created charity where the judge who approved the settlement and three of the plaintiffs' attorneys sat as board members, each receiving tens of thousands of dollars for their service. The settlement also provided a million dollars to the alma mater of one of the trial lawyers, which then hired the attorney for a \$100,000/year no-show job. (Three of the attorneys are under indictment, and the judge was removed from office.)<sup>13</sup> While this is obviously an extreme case, it does illustrate the ethical problems associated with judges choosing or approving charitable destinations for settlement money.

More frequently, if the beneficiary is related to the plaintiffs' attorneys, or the plaintiffs' attorneys otherwise benefit from the payout, the award rewards trial lawyers twice: first by providing *cy pres* recovery to an organization that supports the agenda or causes of the trial lawyers bringing the case, and then a second time by basing attorneys fees on the first amount. *Cy pres* donations to law schools certainly provide further incentive for those institutions to support continued expansion of class action law; *cy pres* awards also regularly go to "public interest" law firms that provide litigation support for the trial bar.

In July 2007, Judge Colleen Kollar-Kotelly granted a motion to award \$5.1 million of unclaimed antitrust settlement funds to George Washington University to create a "Center for Competition Law" on the grounds that it would "benefit the plaintiff class and similarly situated parties by creating a Center that will help protect them from future antitrust violations and violations of other competition laws."<sup>14</sup> The lead plaintiffs' attorney, Michael Hausfeld, was a GWU Law alumnus.<sup>15</sup> Other beneficiaries included the Naderite Public Citizen<sup>16</sup> and the Impact Fund, a trial lawyer organization that expressly lobbies for such awards.<sup>17</sup> In a Madison County, Illinois settlement where only \$20 million of the \$60 million

award was left unclaimed, plaintiffs' lawyers Korein Tillery negotiated with Pfizer over the distribution of the remaining \$20 million: \$5 million each to the Illinois Institute of Technology (for its law school and biomedical research program), University of Chicago Hospitals and the Centers for Disease Control; \$3 million to the United Way of Metropolitan Chicago; and \$2 million to Lubavitch Chabad of Illinois. Korein Tillery took no discount on its \$20 million attorneys' fee.<sup>18</sup> Such problems go beyond trial lawyers and civil lawsuits; Richard Epstein has criticized a government settlement with Bristol-Myers Squibb requiring them to endow a chair of ethics at the District of New Jersey U.S. Attorney's alma mater, Seton Hall Law School.<sup>19</sup>

There are several possible responses to the issue of unfettered *cy pres* awards, which frequently have too little scrutiny from courts, despite the clear conflicts of interest they present between class members and their attorneys. The American Law Institute's controversial Draft of the Principles of the Law of Aggregate Litigation proposes limiting *cy pres* to "circumstances in which direct distribution to individual class members is not economically feasible, or where funds remain after class members are given a full opportunity to make a claim."<sup>20</sup> This would imply that a settlement distribution should go to class members who have filed a claim, although some courts have rejected such a solution as a windfall to class members, especially when the number of class members filing claims is small relative to the size of the class.<sup>21</sup>

Illinois has passed legislation requiring at least half of any *cy pres* award to go to qualifying "nonprofit charitable organizations that have a principal purpose of promoting or providing access to justice for low income residents."<sup>22</sup> Such a resolution effectively taxes *cy pres* awards, reducing the incentive to divert settlement money into entirely self-serving charities. And while one may question the efficacy of Illinois's choice, better that the legislature be lobbied over the appropriate way to spend *cy pres* funds than the judicial branch.

There is another possible solution that has not received adequate attention, however. CAFA bases fee awards in coupon settlements on the actual redeemed value of the coupons; if coupons are donated to charity, those coupons cannot be used to calculate a fee award.<sup>23</sup> The same principle should apply when cash is involved. Contingent-fee attorneys should be rewarded only for benefits going directly to the class. Moreover, if a *cy pres* settlement benefits the plaintiffs' bar directly or indirectly, that settlement should offset the contingent fees. A \$20 million *cy pres* award to Public Citizen or the Impact

Fund should count as part of the attorneys' fee award, not as a justification for additional attorneys' fees. Such a mechanism would give plaintiffs' attorneys the proper incentive to align their interests with those of the class when devising a settlement: if the class members do not get paid, the attorneys do not get paid.

Some might object that such limits would deter contingent-fee class actions when there is no identifiable class or when it is infeasible to distribute settlement funds in a lawsuit where damages are small. But that objection perhaps identifies an advantage, rather than a disadvantage, of tying fees to actual class recovery. A lawsuit where the cost of litigation is greater than the benefit to the class suggests that the social costs are greater than the social benefits. To the extent there is wrongdoing, it should be a job for public, rather than private, attorneys general. An elected official should at least hypothetically balance costs and benefits to society at large in deciding whether to bring suit and faces (at least potential) political consequences if taxpayer resources are wasted in meaningless suits. This is far from a guarantee of good behavior, but at least there would be checks in the political process; entrepreneurial plaintiffs' lawyers seeking rents through the class action mechanism have no such check, and thus act in the public interest only through occasional fits of serendipity.

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## Endnotes

1 Susan Beth Farmer, *More Lessons From the Laboratories: Cy Pres Distributions in Parens Patriae Antitrust Actions Brought by State Attorneys General*, 68 *FORDHAM L. REV.* 361, 391-93 (1999); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 509-10 (4th ed. 1992); BRYAN A. GARNER, *BLACK'S LAW DICTIONARY* 392 (7th ed. 1999). "Justification for the use of the doctrine [in the middle ages] was laid on the shoulders of the donor, the idea being since the object of the testator in donating the money to charity was to obtain an advantageous position in the kingdom of heaven, he ought not to be frustrated in this desire because of an unexpected or unforeseen failure." *Id.* (quoting EDITH L. FISCH, *THE CY PRES DOCTRINE IN THE UNITED STATES* 4 (1950)).

2 *Jackson v. Phillips*, 96 Mass. 539 (1867). *But see Evans v. Abney*, 396 U.S. 435 (1970) (upholding Georgia Supreme Court's dissolution of trust providing for segregated municipal park).

3 *State v. Levi Strauss & Co.*, 41 Cal. 3d 460, 715 P.2d 564, 224 Cal. Rptr. 605 (1986).

4 *See, e.g.*, Remarks of Michael Hausfeld, "Class Action Fairness Act: Two Years Later," Federalist Society, Washington, D.C. (Feb. 14, 2007).

5 Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 L. & CONTEMP. PROBS. 97, 108 (1997).

6 James Tharin & Brian Blockovich, *Coupons and the Class Action Fairness Act*, 18 *GEO. J. LEGAL ETHICS* 1443 (2005).

7 Ted Frank, "Moody v Sears: Lawyers, \$1M. Class, \$2,402," *Overlawyered* weblog, [http://www.overlawyered.com/2007/05/moody\\_v\\_sears\\_lawyers\\_1m\\_class.html](http://www.overlawyered.com/2007/05/moody_v_sears_lawyers_1m_class.html) (May 5, 2007).

8 28 U.S.C. § 1712.

9 *E.g.*, *Synfuel Technologies, Inc. v. DHL Express (USA), Inc.*, 463 F.3d 646 (7th Cir. 2006) (rejecting coupon settlement, though scrutiny under CAFA not required).

10 *Mirfahisi v. Fleet Mortgage Corp.*, 356 F.3d 781, 784 (7th Cir. 2004).

11 Ted Frank, "Final update: Oracle settlement," *Point of Law* blog, <http://www.pointoflaw.com/archives/001875.php> (Nov. 23, 2005) ("That the plaintiffs are settling for pennies on the dollar with no benefit to the corporation on whose behalf they're ostensibly suing, as well as the fact that a Delaware court has already absolved Ellison of the same charges, suggests that even the plaintiffs recognize the suit as meritless."); Michael Paige, "Judge OKs Ellison's \$122M Settlement," *MARKET WATCH*, Nov. 22, 2005; Peter Branton, *Wealth of Experience*, *IT WEEKLY* (Jul. 9, 2006) ("I think after a certain amount, I'm going to give almost everything I have to charity because what else can you do with it?").

12 Adam Liptak, *Doling Out Other People's Money*, *N.Y. TIMES* (Nov. 26, 2007).

13 Ted Frank, "Fen-Phen Zen," *American.com* (Apr. 4, 2007).

14 *Diamond Chemical Co. v. Akzo Nobel Chemicals B.V.*, No. 01-2118 (May 14, 2007) ("Diamond I"); *Diamond Chemical Co. v. Akzo Nobel Chemicals B.V.*, No. 01-2118 (Jul. 10, 2007); George Washington University press release, July 11, 2007.

15 Ashley Roberts, *Law School Gets \$5.1 Million to Fund New Center*, *GW HATCHET* (Dec. 3, 2007).

16 Bruce Mohl, *Reilly Turns to Private Enforcement of Item Pricing*, *BOSTON GLOBE* (June 27, 2004) (settlement of consumer fraud litigation with \$3.2 million to the private attorneys, \$3.9 million to "an eclectic group of charitable, consumer, and nonprofit groups," and \$425,000 to the Massachusetts Attorney General's Office).

17 *See* <http://www.impactfund.org/New/pages/support/cypres.htm>.

18 Ameet Sachdev, *Charities Reaping Lawsuit Dividends*, *CHI. TRIBUNE* (Sep. 9, 2007).

19 Richard A. Epstein, *The Deferred Prosecution Racket*, *WALL ST. J.* (Nov. 28, 2006).

20 § 3.08. *See also* *Masters v. Wilhelmina Model Agency, Inc.*, 473 F.3d 423 (2d Cir. Jan. 4, 2007); Liptak, *supra* note 12.

21 *Fears v. Wilhelmina Model Agency, Inc.*, No. 02 Civ 4911 (S.D.N.Y. Jul. 5, 2007).

22 Public Act 095-0479, codified at 735 ILCS 5/2-807 (2007).

23 28 U.S.C. § 1712(e).