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## Third Circuit Scrutinizes Cy Pres Distributions

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A settlement is a settlement. The parties agree on its terms, terminate the litigation, and move on. Right? Not always. Class actions, for example, are different. There, the courts must review the settlement to determine whether it is fair and reasonable. If it is not, the court may reject the settlement and require the parties to craft different settlement terms or resume litigation.

The U.S. Court of Appeals for the Third Circuit recently waded into the murky waters of reviewing class action settlement awards. In *In re Baby Products Antitrust Litigation*, No. 12-1165 (E.D. Pa. 2013), the court reviewed a settlement containing provisions for a "cy pres" distribution. Increasingly common, cy pres distributions — sometimes referred to as a "fluid recovery" — involve the defendant's payment of money to nonparties, usually charities, that were not injured, but that have interests akin to those of the injured parties. Cy pres distributions are made when settlement funds are not exhausted by payments to class members who submitted claims or when it is economically irrational to distribute extremely small payments to a large number of class members.

Although federal appeals courts rarely interfere with settlements approved at the trial level, the Third Circuit bucked the trend, noting the district court's lack of factual basis in approving the class settlement. In reversing the trial court, the Third Circuit also expressed its misgivings with the incentives to class counsel that cy pres awards present — incentives the Third Circuit worried were not adequately aligned with those of the class members.

Courts, of course, generally do not involve themselves in settlements. A settlement is a private contract between two disputing parties. But class actions are different, because they are representative actions. Almost always, class settlements affect a large number of unnamed, or "absent," class members who had no real voice in negotiating the settlement of their case. The named class representative, together with class counsel, did that. Thus, the Federal Rules of Civil Procedure (Rule 23(e)) require the court to hold hearings and review the fairness of class settlements.

Class actions often resolve a large number of small claims — claims that are too small to warrant pursuit by any one claimant. The smallness of these individual claims, coupled with the logistical difficulties involved in distributing the funds, can create problematic side-effects. Sometimes, after the settlement funds are used

to pay attorney fees and costs and are distributed to eligible class members, large sums remain. Class counsel, defendants and courts have struggled with how to dispose of these remaining settlement funds. Among other answers to this question, such parties have proposed distributing the extra money to the known class members on a pro rata basis; allowing the funds to escheat to a state or the United States; or allowing the funds to revert back to the defendants. But these solutions have proved unsatisfactory for the most part. The first solution allows class members to extract damages beyond the amount to which they are entitled; the second serves no compensatory purpose at all; and the third diminishes the deterrent effect of the lawsuit.

### **Enter the cy pres distribution**

The concept of cy pres is not a new one. Derived at common law, the doctrine of cy pres — which, translated from the old Norman French, means "as near as possible" — has been utilized for centuries by courts in the realm of trusts and estates. When presented with a testamentary charitable gift that, by reason of some intervening event, has become impossible to complete, courts have routinely looked at the testator's intent to determine an alternative, and equally suitable, donee. In the early 1970s, a law student writing in the *University of Chicago Law Review* suggested that courts should do the same thing in class action suits — allowing the unclaimed funds resulting from a class action settlement to go to "a next-best class closely approximating the plaintiff class" or, if that is impractical, allocating the funds to be spent for "the public benefit." Modern antitrust settlements now frequently provide for such allocation of undistributed funds to cy pres recipients, which are often charities that, at least in theory, bear some relationship to the underlying harm on which the suit is brought.

District courts have for the most part approved of these distributions, and circuit courts have for the most part affirmed such approval. As one commentator has recently observed, the sporadic circuit court rejection of a district court ratification of a cy pres distribution is an "outlier" in the jurisprudence. Wary of disrupting a private contractual relationship between the class plaintiffs and the settling defendants, and cognizant of the fact that approval of settlements is governed by an "abuse of discretion" standard, circuit courts are generally inclined to limit their oversight of cy pres settlements, effectively endorsing and thus cementing their use.

This year, however, the Third Circuit, in the case of *Baby Products*, added itself to the short list of circuit courts willing to turn a scrutinizing eye on cy pres settlement distributions. That case was a class action alleging antitrust claims against Toys R Us and several manufacturers that allegedly fixed prices for certain baby products. After extensive litigation, the class representatives and the defendants agreed to a settlement of \$35.5 million. Of that amount, one-third, or some \$11.8 million, was designated for plaintiffs' attorney fees. The remainder, after payment of litigation costs, was to be distributed to class members who submitted valid proofs of purchase. Claimants with documentary proof of purchase were to be awarded 20 percent of the estimated retail price of the purchased products. That 20 percent represented the assumed overcharge to plaintiffs. Class members who submitted claims lacking any proof of purchase were to receive nothing more than a nominal award of \$5.

After that distribution, the remaining funds were to be distributed pro rata to the class members with proof of purchase, until each received three times his or her original award. (The antitrust laws allow successful plaintiffs to receive treble damages.) If any funds were still remaining after the "treble damages" distribution, they would be distributed to one or more charitable organizations — the cy pres recipients. Despite objection by an unnamed class member, the district court approved the settlement, noting that "the cy pres allocation will only come into play if all of the claimants in all of the subclasses receive the maximum award legally available to them."

On appeal, the circuit court was aided by information that the district court lacked.

After a lengthy process of claims evaluation, it became apparent that there would be no cy pres distribution under the settlement. Of the \$35 million settlement fund, only about \$14 million was paid to class members. Attorney fees and costs accounted for another \$21 million, leaving only \$4 million for cy pres distribution. This happened largely because most class members could not

documentary proof necessary to receive more than the \$5 nominal award.

The Third Circuit began its review of the district court's decision by noting that, in general, there is nothing per se improper about a settlement that includes a "cy pres component directing the distribution of excess settlement funds to a third party to be used for a purpose related to the class injury." The court was quick to point out, however, that direct compensation to class members will always be "preferred over cy pres distributions." In conducting its review of a cy pres award, the Third Circuit instructed trial courts to consider the same factors of fairness, reasonableness and adequacy that they employ to evaluate all other terms of a class action settlement and also to consider the "degree of direct benefit provided to the class" by the settlement. A cy pres award should "generally represent a small percentage of total settlement funds."

In this case, the Third Circuit was particularly concerned with the fact that the district court did not calculate what portion of settlement funds would go to class members and what portion would go to cy pres recipients. Trial courts should withhold final approval of class settlements until the claims process is sufficiently advanced to enable a reasonably precise calculation of benefits going directly to class members. Without that data, the trial court lacks "the factual basis necessary to determine whether the settlement was fair to the entire class."

Because that data was lacking here, the Third Circuit concluded that the settlement could not yet be approved. It reversed the trial court and remanded, instructing the trial court to "reconsider the fairness of the settlement" and, if necessary, alter its terms "to provide greater direct benefit to the class." The court suggested specific means of so doing, including either lowering the evidentiary threshold necessary for a consumer to be eligible for the full treble-damage award or raising the nominal award to a level above \$5.

The Third Circuit also reviewed the reasonableness of the attorney fees portion of the settlement. The \$11.8 million represented a contingent fee award, representing one-third of the total \$35 million settlement fund. In a statement that echoed its general concerns with the settlement, the Third Circuit voiced its concern that allowing counsel to claim a contingency fee based on the cy pres portion of the settlement may weaken counsel's incentives to advocate for full recovery by the class members. "Class members," the court wrote, "are not indifferent to whether funds are distributed to them or to cy pres recipients, and class counsel should not be either." The trial court was instructed to decrease the contingency award to something below one-third if it concluded that class counsel had not done enough to put settlement dollars into class members' hands.

All in all, the court's holding provides helpful guidance to class, defense and intervening counsel: If a class action settlement contains a cy pres award that is too large relative to the distribution to class plaintiffs, or if a court perceives that class counsel has not worked hard enough to make it easy for class members to receive the damages to which they are entitled, such a settlement may very well be rejected. However, despite the Third Circuit's misgiving, it appears clear that cy pres awards are here to stay. •

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