Risk Mitigation And Settlement Strategies For Class Action Lawsuits

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Commentary

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During the past decade American businesses have seen a surge in consumer-driven advertising class actions. Although one can speculate as to the reason for this increase, it is likely due to a confluence of factors, including the economic downturn, a glut of attorneys, increased regulatory advertising enforcement, and a target-rich modern marketplace. Even businesses engaged in the most benign marketing and promotional practices can find themselves in the crosshairs of a consumer with an axe to grind. Given the prevalence of class actions, it is more important now than ever to be vigilant in monitoring your business’s advertising and promotional practices to avoid unnecessary exposure. At the same time, because the early days of a class action lawsuit are the most critical, it is equally important for your business to be prepared to react swiftly and effectively should it ever find itself the subject of a class action challenge. There are a number of practical considerations for businesses looking to minimize their risks of being sued while implementing effective procedures for responding to a class action complaint should it ever become necessary.

Likewise, if a class action cannot be avoided or dismissed quickly, it is important to weigh the high cost of protracted litigation, concomitant distraction from business pursuits, and the risk of exposure, against the cost of a reasonable settlement. There are a number of options for settlement and also pitfalls to avoid. Also available is post-suit class action insurance with a number of benefits that may be attractive in the right circumstances.

Initial Consideration & Defenses To Class Action Lawsuits

When it comes to class actions, the time-honored maxim that “the best offense is a good defense” is especially cogent. A company can take many steps to reduce its risk and exposure to class action litigation, including the following:

Implementing Good Advertising Practices. Perhaps the most crucial effort a business can make to avoid class action litigation is to carefully review and substantiate its advertising and promotions prior to disseminating them publicly. Hiring experienced advertising counsel is probably the most effective way to ensure that advertising complies with the complex legal requirements of the various agencies and states.

Remaining Mindful of Class Action Litigations Involving Competitors. It
is no surprise that competitors often mimic each other’s successful advertising and promotional practices. A company should likewise monitor and avoid the unsuccessful marketing practices of its competitors, including the ones that draw class action scrutiny. A company should consider setting up a service to notify it when its competitors are sued so that it can learn from and avoid similar problems down the road. For instance, in the context of gift card sales and promotions, a recent rash of consumer class actions brought under state law and common law theories have recently been filed, seeking large sums of money and sometimes leading to large settlements. See, e.g., In re Groupon Marketing and Sales Practices Litigation, No. 11-md-02238 (S.D. Cal. Mar. 29, 2012) (involving allegations that the expiration dates on Groupon’s vouchers violated the Electronic Funds Transfer Act and that Groupon failed to disclose necessary terms, resulting in an $8.5 million settlement); Johnson v. Apple, Inc., No. 1-09-CV-146501 (Cal. Super. Ct. Feb. 10, 2012) (alleging that Apple sold iTunes gift cards that falsely promised that all songs bought using the cards would cost only 99 cents, resulting in a potential settlement payout of over $50 million).

Monitoring the Enforcement Efforts of Government Agencies and Self-Regulatory Bodies. The breeding grounds for class action litigation are the public pronouncements of federal regulatory agencies like the FTC and FDA, and self-regulatory bodies like the National Advertising Division (“NAD”) and Children’s Advertising Review Unit (“CARU”). Class action plaintiffs’ attorneys monitor these entities and often piggy-back on their complaints and findings to bring substantively identical private class action lawsuits. It is crucially important for a business to keep abreast of FTC and NAD developments that it can conform its own advertising practices and avoid similar troubles.

Carefully Administering Business Practices that Could Lead to the Potential for Class Claims. Those aspects of a business that interact directly with consumers are the most frequent targets of class action litigants. When a company is forced to deal with consumers in a uniform yet large-scale manner, it is almost inevitably that the business will inadvertently generate ill-will among some small portion of consumers. For this reason, it is crucial for a business to be especially vigilant with its billing, marketing, product fulfillment, and customer service practices so as to avoid any unnecessary strife. Similarly, unforeseeable lapses such as data breaches and billing errors, though often due to completely unpredictable circumstances, are ripe targets for class action challenge. It is therefore wise for a business to take whatever steps are possible to minimize the chances of such events occurring.

Once a class action complaint is filed and served, the clock begins to tick on time for responding – whether by answer, dispositive motion, or settlement. Following are some practical, procedural considerations that should come to the fore.

Should the Case be Removed to Federal Court? Once your company is served, it should consider whether to remove the case to federal court if the complaint was originally filed in state court. Removal to federal court is appropriate where the district court had “original jurisdiction” over the matter, such as where there is diversity of citizenship, a federal question, or the Class Action Fairness Act (“CAFA”) applies. If your company is the proponent of federal jurisdiction, it has the burden of establishing that removal is appropriate. A company should carefully weigh the pros and cons of removing a case to
federal court. Litigation in federal courts tends to move more quickly than state court litigation, and some believe federal judges are more scrutinizing. At the same time, if the plaintiff is a resident of the state in which he filed the lawsuit, removal to federal court may provide a more neutral venue and more streamlined discovery procedures.

Is there CAFA Jurisdiction? If the plaintiff filed his or her complaint in federal court, then you should consider whether the plaintiff has alleged a proper basis for federal jurisdiction. Most often consumer plaintiffs will rely on the Class Action Fairness Act as the basis for federal jurisdiction. The CAFA allows individuals to file putative class actions alleging state law claims in federal court, even absent a federal question or complete diversity of citizenship, where three requirements are satisfied: (1) the amount in controversy exceeds the sum or value of $5 million; (2) the aggregate number of proposed plaintiffs is 100 or greater; and (3) “minimal” diversity exists between the plaintiffs and defendants (i.e., any member of the plaintiff class is a citizen of a state different from any defendant). See Lowdermilk v. U.S. Bank N.A., 479 F.3d 994, 997 (9th Cir. 2007). If the plaintiff has failed to allege any of these requirements, a motion to dismiss for lack of subject matter jurisdiction may be one way to force the plaintiff back to state court.

Does an Arbitration Agreement or Class Action Waiver Control? The Supreme Court’s recent ruling in AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011), held that arbitration provisions and class action waivers in contracts are enforceable, barring would-be class action plaintiffs from filing lawsuits, regardless of state law to the contrary. As such, if a consumer purchase agreement underlies the lawsuit and contains a mandatory arbitration provision or class action waiver, a motion to compel arbitration might be appropriate. Engaging in arbitration is significantly less expensive than litigating a nationwide class action.

Are there Grounds for Moving to Strike Class Allegations? If it is evident from the pleadings that a proposed class will fail to satisfy any of the Rule 23(a) requirements, a motion to strike class allegations at the pleading stage may effectively neuter a class action from the outset. Although motions to strike class allegations are still relatively uncommon, they are worth considering where it is clear that no amount of discovery will enable the plaintiff to cure the deficiencies in its class allegations. As one court explained, “[w]here the dispute is factual and discovery is needed to determine whether a class should be certified, it may be premature to strike class allegations[,] ... [b]ut when the defendant advances a legal argument based on the pleadings, discovery is not necessary for the court to evaluate whether a class action may be maintained. Wright v. Family Dollar, Inc., No. 10-cv-4410, 2010 WL 4962838, at *1 (N.D. Ill. Nov. 30, 2010). Put differently, if the face of the complaint reveals, for example, that individual issues such as affirmative defenses, reliance, damages, or causation predominate over class-wide issues, a motion to strike the class allegations may be appropriate.

Is the Plaintiff’s Claim Preempted by Federal Law? Often the law of advertising will intersect with the laws and regulations that govern federally-regulated industries such as pharmaceuticals, agriculture, and the environment. When this happens, a private, state-law advertising challenge is sometimes preempted by federal law because the statute says so or state law challenges would interfere too greatly with the relevant federal agency’s oversight of the regulated
industry. The law of federal preemption is vast and complex, so it is important for a business to understand in advance which of its advertising practices are subject to a preemption defense.

After surmising initial procedural defenses, you should next consider whether the complaint suffers from any substantive pleading errors that could form the basis for a motion to dismiss under Rule 12(b)(6). In this regard, the Supreme Court has opened a very wide door for class action defendants to challenge complaints in its landmark decisions in Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007), and Ashcroft v. Iqbal, 556 U.S. 662 (2009). The Twombly and Iqbal rulings displaced the former permissive Conley pleading standard, which held that dismissal was not appropriate unless the plaintiff could prove “no set of facts” that would entitle him to relief. Conley v. Gibson, 355 U.S. 41, 45-46 (1957). In its place, the Court installed a more stringent pleading standard that requires a complaint to set forth “sufficient factual matter” to state “a claim to relief that is plausible on its face” in order to survive dismissal. Iqbal, 556 U.S. at 678. Under this new “facial plausibility” standard, a plaintiff must allege “factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” Id. By invoking the Twombly/Iqbal standards, class action defendants have successfully persuaded courts to dismiss complaints for, inter alia, failure to allege a false or misleading representation, causation, reliance, or ascertainable loss.

Likewise, an emerging doctrine in the Third Circuit requires plaintiffs to identify an administratively feasible method for identifying members of the proposed class has led to class actions being dismissed on ascertainability grounds. The Third Circuit explained that ascertainability is an “essential prerequisite” of class certification that requires the class plaintiff to establish, by preponderance of the evidence, a reliable and administratively feasible method for objectively identifying persons belonging to the proposed class. In the context of mass-marketed retail products, a class plaintiff cannot establish ascertainability by simply relying on affidavits of absent class members or on retail records that fail to link individual purchasers to specific purchases. Where “individualized fact-finding or mini-trials will be required to prove class membership,” the proposed class is not “administratively feasible” and class treatment is inappropriate. The Third Circuit decision in Carrera v. Bayer Corp., No. 12-2621, 2013 WL 4437225 (3d Cir. Aug. 21, 2013) holds that in consumer fraud class actions, class certification should be precluded on ascertainability grounds where members of the proposed class are unlikely to have documentary proof of purchase (e.g., packaging or receipts) and no record of specific retail purchases exists. Id. at *5-8. See also, Hayes v. Wal-Mart Stores, Inc., 2013 WL 3957757 (3d Cir. Aug. 2, 2013) (Class certification is not appropriate “if the only proof of class membership is the say-so of putative class members or if ascertaining the class requires extensive and individualized fact-finding.”); Marcus v. BMW of North America, LLC, 687 F.3d 583 (3d Cir. Aug. 7, 2012).

**Sometimes Settlement Is The Best Option**

Companies settle class action litigation for a variety of reasons: dispose of contingent liability; stop financial hemorrhaging from fees and costs; clean up the balance sheet in advance of a merger, sale, acquisition, or financing arrangement; and/or cap the existential risk posed by the merits of the underlying case.

Given the risk of a claims-made settlement going viral – the quagmire created by the cy pres (or “next best use”) doctrine, and Generally Accepted Accounting Principles, or GAAP, that require booking the entire amount of a claims-made fund as a liability on the company’s balance sheet — structuring an effective settlement can feel like trying to solve the Rubik’s Cube® in the dark. However, there are some bright spots where companies can design a settlement structure that mitigates risk and provides a meaningful class benefit by using new concepts, such as class action settlement insurance, to assist with resolution.

**Traditional Common Fund.** Class counsel often starts negotiation with a demand for a common fund wherein the entire settlement is paid out to the class (or cy pres beneficiary). For several reasons, the defendant has no practical benefit using this settlement structure. First, 100% of the fund is expended; there will be no unclaimed money returning to the defendant. Second, class members who file claims receive a windfall as their pro-rata claim is increased to achieve the goal of paying
out the entire fund. Third, the use of cy pres as a residual beneficiary has killed many settlements making that option unpalatable. Fourth, since 100% will be paid out, the defendant seeks to minimize the size of the fund, which can create problems getting a settlement approved. All in all, the common fund is the least attractive option to a class action defendant.

**Claims-Made Settlement Fund.** Most class action practitioners and defendants prefer a claims-made settlement structure, which allows class members to submit claims and obtain a negotiated benefit. Using this approach comes with its share of landmines, so proceed with caution when designing and implementing a claims-made settlement fund.

**Bridging The Divide.** A claims-made settlement is often the only way to bridge the gap between what a defendant is willing to pay and what the plaintiffs are willing to accept. Unlike an agreement to pay 100% of a common fund settlement, a claims-made settlement obligates the defendant to pay only an agreed amount per claim submitted and validated through an agreed process, up to a maximum cap on liability created by the settlement. Using this approach requires a balancing of interests.

For a settling defendant who ultimately will be held accountable for all of those qualifying claims, the response rate (how many claims will be submitted) is usually the most important variable to consider. Experienced class action attorneys agree that predicting response rates is anything but an exact science. The response rate to a claims-made settlement can vary depending on the makeup of the class, the geographic scope of the settlement, and numerous other factors, including: the type of case being settled, the amount and nature of any media coverage of the case and settlement, the type and value of benefits provided by the settlement, the nature of the notice provided to the class of the settlement, and the design of the claim process. In short, claims-filing rates will never be entirely predictable. But in exchange for not requiring that the entire fund be expended and accepting the response rate risk, the settlement will typically make a larger benefit available for the class. On balance, if more class members have the ability to obtain the benefit and be compensated, then the settlement is more likely to be approved and withstand scrutiny by the court and potential objectors.

**Settlements Gone Viral.** Predicting the take rate, and thus the likely cost of a settlement, is particularly difficult in today’s environment. With online settlement promotion sites like www.topclassactions.com, (which will even provide claim forms), claim aggregators (which charge a contingent fee to submit claims), and social media coupled with a broader public awareness of class settlements, the risk of a settlement going viral is greater than ever. This new reality adds a fresh layer of complexity and uncertainty to deciding how to structure the class settlement.

Here are examples of cases where claims made exceeded the available settlement fund.

**Airborne®**

**Case:** Wilson v. Airborne, Inc., Case No. EDC V07-770 VAP (0Px), in the United States District Court for the Central District of California.

**Class:** Purchasers of Airborne-branded products (including Airborne Effervescent Health Formula, Airborne On-the-Go, Airborne Power Pixies, Airborne Nighttime, Airborne Jr., Airborne Gummies, and Airborne Seasonal Relief) made between May 1, 2001 and November 29, 2007.

**Notice:** $1.7M spent on the media campaign, which resulted in reaching 80.4%
of Adults 18+ with an estimated average frequency of 2.6 times.

**Claims:** 702,323 claims for relief received, with an aggregate face value of $36,529,796 on the $23.25M initial settlement fund.

**Skechers**

**Case:** Grabowski v. Skechers U.S.A., Inc., Case No. 3:10-01300, in the United States District Court for the Southern District of California.

**Class:** Purchasers of Skechers footwear known as Shape-ups, Tone-ups, Skechers Resistance Runner, and Shape-ups Toners.

**Notice:** $879K spent reaching 89% of class members, who were women 18 to 44 years of age, and 84% of all adults 18 to 44 years of age, with an estimated average frequency of 5 times.

**Claims:** 520,000 claims for relief received. The settlement fund oversubscribed (see chart) the initial settlement fund of $40 million.

<table>
<thead>
<tr>
<th>Shoes</th>
<th>Initial Amount</th>
<th>Maximum Amount</th>
<th>Pro-rata Payout</th>
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<tbody>
<tr>
<td>Shape-ups</td>
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<td>$80.00</td>
<td>$34.00</td>
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<td>Padded Sole Shoes</td>
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<td>Tone-ups</td>
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<tr>
<td>Resistance Runners</td>
<td>$42.00</td>
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<td>$36.00</td>
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**Fogel v. Farmers**

**Case:** Fogel v. Farmers Group, Inc., et al., Case No. BC300142, Superior Court of the State of California for the County of Los Angeles.

**Class:** All persons or entities who were subscribers to one or more of the Exchanges at any time during the Class Period, or were named insureds on any Exchange insurance or reinsurance policy issued or in effect at any time during the Class Period.

**Notice:** Notice program reached 97% of the class through Direct Notice and Publication Notice.

**Claims:** 210,710 claims for relief received, representing 974,126 jars with a claim value of $4, totaling an aggregate face value of $3.9M on the $2.5M settlement fund.

These defendants were probably not expecting 100% of the fund would be claimed, but likely were hoping for a considerably smaller take rate. That is the real risk with any class action settlement. There are several hedging and risk mitigation strategies below that can lessen the binary risk that a particular class action case could be the next one that goes viral.

**The World According To GAAP**

Significantly, there can be substantial financial reporting consequences for a settling company as a result of entering into a claims-made settlement. According to GAAP, a defendant entering into a claims-made settlement is generally required to take a charge on its financial statements for the entire amount of the
settlement (even though the defendant hopes to and, indeed may, ultimately pay less). In other words, GAAP essentially requires the company to assume that 100% of the class will submit qualifying claims. Since settlements can go viral, GAAP will likely require that the entire liability be booked because any “anticipated” or “estimated” take rate of less than 100% is ultimately nothing but a guess — a hopeful and optimistic guess.

A settling defendant will likely also have to disclose the settlement in other ways. For example, the defendant may well be obligated to report the settlement agreement on SEC Form 8-K. Again, the settling defendant may have to disclose the full amount that could theoretically be paid (assuming all class members received the maximum relief possible and not some smaller amount the defendant expects to pay) based on the actual response rate.

Making such accounting and reporting problems far worse is the fact a claims-made settlement can remain pending for quite some time. Even in the best-case scenario, the process of notifying class members, receiving claim forms, processing the claims, and then paying qualifying claims will likely take several months at a minimum. Furthermore, in the real world, there can be and are often considerable delays caused by objectors to the settlement. For example, if an objector appeals a settlement in federal court, it takes on average almost a full year for a case to move from filing a notice of appeal to a final disposition by the court of appeals. Just as the lawsuit can continue for months or even years after the settlement is reached, the settling defendant’s obligation to disclose the settlement can also linger. A settling defendant could end up having a negative impact from a class action settlement disclosed over several quarters or years.

Cutting ’Coupon Settlements’

In coupon settlements, class members are sent coupons or vouchers for free or discounted products or services from the defendant. Similar to a claims-made settlement, the settling defendant ultimately “pays” only for those coupons that are actually redeemed. In this regard, a coupon settlement shares some of the risks and advantages of a claims-made settlement. However, new state and federal legislation—combined with increased scrutiny from trial courts—have effectively decreased the ability to resolve class actions with coupons.

In the federal Class Action Fairness Act of 2005 (“CAFA”), Congress included several provisions that regulate coupon settlements. Some of these provisions effectively serve to discourage class action plaintiff’s attorneys from agreeing to accept a coupon settlement. If a settlement is for coupons, the attorney’s fees awarded for representing the class are based on the value of only coupons that are actually redeemed by class members. Thus, the Ninth Circuit has recently held that, under CAFA, attorney fees for class counsel may not be calculated under the lodestar method in cases based solely on coupon relief and, instead, the district court is required to calculate the redemption value of coupons awarded to class before awarding attorney fees. States are also specifically addressing attorney’s fees for coupon settlements.

Some courts have found that the CAFA provisions regarding coupon settlements combine to require that a court apply “heightened scrutiny” when considering whether to approve a coupon settlement. Furthermore, both before and without regard to CAFA, many courts have been increasingly skeptical of coupon settlements, especially when the proposed coupons fail to address the injury at issue and are not redeemable for cash. In rejecting a proposed coupon settlement in Schwartz v. Dallas Cowboys Football Club, Ltd., the district court explained:

[T]he use of “coupons” as a means of resolving a dispute in a class action context is unsatisfactory when the coupons do not redress the wrongs alleged in the complaint and when the value of the coupons is illusory due to their inability to be converted into cash. [...] First, and most importantly, the coupons do nothing to ameliorate the alleged antitrust violation asserted by the plaintiffs against the defendants. [...] Second, the real value of the coupons is questionable since the coupons, while transferable, are not redeemable for cash. Third, the
period of time permitted to use the coupons is relatively short, with all coupons expiring [in only about four months]. Given these infirmities, the court concludes that the coupons in this case are simply a sales promotion for the defendants’ products which the class members neither have sought nor are likely to benefit from their use.10

Whether a case is pending in state or federal court, courts are far more likely to approve coupon settlements that impose no use restrictions, or only very limited ones, on the coupons. For example, coupons that are freely transferable, do not have aggregation limits, have longer redemption periods, and are not limited to particular products or services are more likely to be approved by a court. Coupon settlements that avoid restrictions on use and transferability or that include enhancements, in-kind compensation, and/or cash components are also less likely to draw opt-outs and objectors which can, in turn, make approval more likely and the whole process move more quickly.

**Cy Pres: No Good Deed Goes Unpunished**

_Cy pres_ is a distribution method in which an attempt is made to distribute monetary or in-kind contributions to the “next best” recipients, typically a charitable organization. In theory, these _cy pres_ awards can be appropriate when direct payments to the class members may be impractical because, for example, the class is so large compared to amount of money available. Such awards can also be made in addition to a direct payment to some or all class members. Like a traditional common fund settlement, the defendant pays the full amount involved.

The use of _cy pres_ distribution to resolve class actions faces widespread criticism from both business and consumer groups as well as increasingly strict scrutiny from the courts.11 Various legislative reforms are being proposed in numerous states and the U.S. House Judiciary Committee has heard testimony on multiple occasions suggesting that _cy pres_ settlements are an “abuse” of class action litigation.12 The courts, for their part, have refused to approve several class action settlements due to assorted concerns with the use of _cy pres_.13

To the extent a _cy pres_ distribution might be appropriate in a given case, courts require that the _cy pres_ recipients are carefully chosen to account for the nature of the lawsuit, the objectives of underlying statutes and the interests of absent class members, including their geographic diversity.14 For example, the Ninth Circuit rejected a _cy pres_ settlement because it determined the _cy pres_ distribution failed to sufficiently “(1) address the objectives of the underlying statutes, (2) target the plaintiff class, or (3) provide reasonable certainty that any member will be benefitted.”15

Vague and evolving legal standards regarding the use of _cy pres_ to resolve class actions makes such settlements a prime target for objections and appeals that increase costs and delay resolution. Consider _Lane v. Facebook, Inc_. The district court approved a _cy pres_ settlement in March of 2010.16 Objectors appealed, challenging the use of _cy pres_, and the Ninth Circuit affirmed almost two years later in September 2012.17 However, the appellants sought rehearing _en banc_. Although that request was eventually denied in February 2013,18 a petition for certiorari was filed with the Supreme Court.19 As 2014 approaches, the 2010 _cy pres_ settlement is still in limbo. Because determining whether a _cy pres_ distribution sufficiently addresses the nature of a particular class action is a nebulous inquiry that can be readily challenged, settling parties should expect objections and appeals to follow a _cy pres_ settlement.

The increased scrutiny of _cy pres_ settlements also means that a settling defendant will not be able to somehow use the device for its own benefit. Critics of _cy pres_ imagine hypotheticals such as “a settlement against Microsoft settling for Microsoft giving money to the Gates Foundation.”20 In reality, it is extremely unlikely that any such settlement would be approved.

From the defendant’s point of view, a _cy pres_ settlement is ultimately much like a traditional common fund settlement because the defendant will be obligated to pay 100% of the amount allocated to _cy pres_ distribution. Furthermore, because a _cy pres_ distribution benefits class members indirectly at best, courts are likely to require a larger dollar amount from a _cy pres_ settlement than might have been required to approve a settlement providing direct payment.21 Generally speaking, _cy pres_ provides no particular advantage for a settling defendant.
Transferring The Risk
Settling a case is that equilibrium achieved when the unstoppable force collides with the immovable object. Class counsel seeks to have the largest benefit available for the most people providing the most complete compensation. The Court wants to ensure that the rights of absent class members are protected and approve settlements after the best notice and relief are available to compensate class members. Defendants want to pay the least amount possible to end the litigation, stop bleeding costs, mop up contingent claims and obtain peace. The defendant is pushing for the smallest capped fund with a minimal benefit and thus will inevitably be confronted with the reality that a settlement, assuming one is reached with Class Counsel, still may not obtain trial court approval or withstand appellate scrutiny.

There is an alternative approach to resolution which allows both sides to obtain the necessary components of resolution: class action settlement insurance. This is a specialty product which allows a class action defendant to transfer the risk of loss or claims from the class action settlement to a third-party insurer.

The most obvious benefit of such “settlement insurance” appears to be that a settling defendant can substitute a known amount (the cost of the policy premium) for an unknown amount (the total cost of qualifying claims that ultimately will be submitted by class members). The insurance company — not the settling defendant — bears the risk that the total payout will be greater than predicted. With class action settlement insurance, the defendant is not concerned that the settlement will catch fire and burn down the company. The wild fire is now contained.

However, in addition to allowing a defendant to lock in its cost for a claims-made settlement, there could be other substantial benefits to such insurance. As noted above, when a defendant enters into a claims-made settlement, GAAP generally requires the defendant to take a charge on its financial statements for the entire amount of the settlement until the settlement administration is finalized — which will take months and can even take years if, for example, a class member objects and appeals. Further, the defendant may also have to report information regarding the lawsuit and settlement in disclosures such as SEC Form 8-K. Class action settlement insurance could potentially help a defendant facing such reporting obligations. If the risk of paying for a class action settlement has been transferred to an insurer, the net impact on the settling defendant’s income statement simply could be a charge for the cost of the insurance — drastically different than a charge for the entire potential amount of the settlement.

Additionally, it seems that the cost of acquiring such insurance is often going to be deductible as a business expense for the settling defendant. Indeed, in some circumstances, a defendant might even end up deducting the cost of purchasing insurance to pay the claims being settled when the defendant would not have been able to deduct the amounts of direct payments to the class members. In this regard, the IRS has sometimes ruled that amounts paid to resolve claims are not deductible expenses. Internal Revenue Code Section 162(a) generally allows a deduction for all the ordinary and necessary expenses incurred in carrying on a business. However, Section 162(f), one of many exceptions to the general rule, prohibits a deduction for any fine or penalty paid to a government for the violation of any law. Whenever a payment is made to resolve claims against a company, a question can arise as to whether the payment comes within the prohibition on deducting fines and penalties.

In some instances, payments to resolve claims have been found to constitute fines and penalties for which no deduction was allowed even though the money was not paid to a government. For example, in Allied–Signal, Inc. v. Commissioner, T.C.Memo. 1992–204, aff’d 54 F.3d 767 (3d Cir. 1995) (table), the taxpayer was not allowed to deduct an $8 million contribution to an environmental fund since the payment reduced the criminal fine that would otherwise have been assessed for the underlying conduct. In that case, the Tax Court stated:

In Waldman, we addressed the issue of when a taxpayer’s “fine or similar penalty” was “paid to a government.” As stated therein, “We do not believe that a Government must actually ‘pocket’ the fine or penalty to satisfy the ‘paid to a government’ requirement of section 162(f).” Waldman v. Commissioner, 88 T.C. at 1389. One of the sentencing judge’s goals in sentencing petitioner
was to ensure that the citizens of the Commonwealth of Virginia received or benefited from a portion of the criminal fine.


In order to evaluate the characterization of a settlement payment for purposes of § 162(f), it is necessary to look to the origin and character of the liability giving rise to the payment. In ascertaining the nature of a payment as punitive or compensatory, courts analyze the purpose of the statute requiring the payment or forming the basis of claims that are settled. If the law is designed to be punitive or to deter the type of conduct committed by the taxpayer, then the payment is likely covered by § 162(f).

**Champagne Settlements On A Beer Budget**

As any practitioner knows, not all settlements and structures are created equal. There are some additional tactical strategies which can be used to mitigate risk, validate claims, and cap exposure:

**Cash/Coupon Combination.** In cases where the defendant can offer a coupon or voucher for services can create an added benefit at a lower cost. Structured the right way, this is not a coupon settlement. Instead, it is an alternative benefit structure which gives class members a choice. Our recommendation is that the benefit be structured where the class members are offered a cash benefit of X and a noncash voucher of 2x. This provides a choice for class members. If fees are based upon the cash component, then there is no objection under CAFA. For the settling defendant, it is likely that the voucher – even at 2x – will have a lower cost than cash payments. So all in all – this is a winning strategy.

**Cash Tail.** The defendant can provide a voucher which is good for the purchase of goods or services over a specified period of time. In the event that the class member elects, he can turn the voucher in for cash after the agreed upon time frame. Make this benefit transferable and redeemable for cash and the company can structure a deal which has a lower cost than straight cash refund yet does not run afoul of the CAFA restrictions.

**Pro Rata.** In cases where the settlement fund is smaller than the potential exposure (example: $1,000,000 capped fund where 100,000 class members could each claim $100 which represents $10M in exposure), then consider building in an internal sliding scale payout. This way, if certain claim thresholds are met, then the benefit is reduced in a pre-negotiated sliding scale. This reduces the risk and ensures that more people will be able to obtain the benefit within the negotiated cap. Since all settlements involve compromise, this would be an adjustment which can be used to stretch dollars further in order to achieve resolution.

**Claims Validation.** Internal validation of claims is an overlooked risk factor. Ensuring appropriate internal controls are in place to catch waste, fraud, and abuse is an important component. For example, if you have a class list, companies may want to assign each class member an identifier to be used to download the claim form. This is an initial validation to prevent viral spread of claims by people seeking free money rather than those who are actually class members seeking their benefit. Additionally, having the administrator audit suspect claims under an agreed upon criteria is an important internal control. By stopping leakage, companies can reduce financial risk. In *Airborne*, the administrator had rejected over $6.8M in claims based upon fraud. Thus, reducing fraud reduces risk and cost – much like apprehending shoplifters.

**Conclusion**

With the advent of Class Action Settlement Insurance, companies can move beyond the uncertain and unpredictable costs of settlement fund. They can create a
larger and more robust settlement fund which makes greater relief available for the class while keeping the liability off of their books. The benefits to the parties are tremendous:

- Removes uncertainty and unpredictability;
- Mitigates the GAAP accounting requirements that the defendant has to book the entire fund as a liability;
- Allows the parties to negotiate a bigger and better fund thereby making a larger benefit available to more class members;
- Leads to a better settlement, so objectors have less basis to file or appeal;
- Increases relief available to the class, so courts are more likely to grant final approval of a better settlement;
- Creates more pathways to a settlement and final approval.

Endnotes


2. See, gen., Brian T. Fitzpatrick, The End of Objector Blackmail, 62 Vand. L. Rev. 1623, 1666 (2009) ("courts and commentators have been concerned with the ability of class action objectors to blackmail class counsel by filing meritless appeals that could delay the final resolution of settlements for months or years."). (emphasis added); see also id. at pp. 1633-1640, citing Principles Of The Law Of Aggregate Litigation § 3.08 cmt. b (Proposed Final Draft, Apr. 1, 2009) ("A baseless objection, followed by an appeal after the objection is rejected, can delay the finalization of a settlement for months or even years."); Edward Brunet, Class Action Objectors: Extortionist Free Riders or Fairness Guarantors, 2003 U. Chi. Legal F. 403, 429 ("The ability to appeal after filing an objection in the district court—now firmly established after Devlin—slows down the class action’s progress considerably."); Geoffrey P. Miller & Lori S. Singer, Nonpecuniary Class Action Settlements, 60 Law & Contemp. Probs. 97, 120 n.64 (1997) (explaining that objectors "can appeal


4. See 28 USC §§ 1332(d), 1453, and 1711-1715.

5. 28 USC § 1711(a) provides:If a proposed settlement in a class action provides for a recovery of coupons to a class member, the portion of any attorney’s fee award to class counsel that is attributable to the award of the coupons shall be based on the value to class members of the coupons that are redeemed.


7. In Texas, for example, “if any portion of the benefits recovered for the class are in the form of coupons or other noncash common benefits, the attorney fees awarded in the action must be in cash and noncash amounts in the same proportion as they recover for the class.” Texas Rule of Civil Procedure 42(j)(2).

8. See, e.g., In re HP Inkjet Printer Litigation, — F.3d ——, 2013 WL 1986396 (9th Cir. May 15, 2013) (noting that CAFA “invites increased judicial scrutiny of coupon settlements generally”); True v. Amer. Honda Motor Co., 749 F. Supp. 2d 1052, 1069 (C.D. Cal. 2010) (“several courts have interpreted section 1712(e) as imposing a heightened level of scrutiny in reviewing [coupon] settlements”); Figueroa v. Sharper Image Corp., 517 F.Supp.2d 1292, 1321 (S.D.Fla. 2007) (“the undersigned interprets the statutory directive to imply the application of a greater level of scrutiny to the existing criteria than existed pre-CAFA”); Synfuel Techs., Inc. v. DHL Express (USA), Inc., 463 F.3d 646, 654 (7th Cir. 2006) (expressing, in dicta, that with CAFA, “Congress required heightened judicial scrutiny of coupon-based settlements”).

9. See, e.g., Synfuel Techs., Inc. v. DHL Express (USA), Inc., 463 F.3d 646, 653 (7th Cir.2006) (noting that for many consumers, “the right to receive a discount
[or coupon] will be worthless”) (quoting Geoffrey P. Miller & Lori S. Singer, Nonpecuniary Class Action Settlements, 60 LAW & CONTEMP. PROBS. 97, 108 (1997)); In re Compact Disc Minimum Advertised Price Antitrust Litig., 216 F.R.D. 197, 221 (D.Me.2003) (“[A] settlement is not fair where all the cash goes to expenses and lawyers, and the members receive only discounts of dubious value.”); see also J. Brendan Day, My Lawyer Went to Court and All I got Was This Lousy Coupon - The Class Action Fairness Act’s Inadequate Provision for Judicial Scrutiny over Proposed Coupon Settlements 38 SETON HALL L. REV. 1085 (2008).

10. Schwartz v. Dallas Cowboys Football Club, Ltd., 157 F.Supp.2d 561 (E.D.Pa. 2001), citing In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation, 55 F.3d 768 (3d Cir. 1995) (rejecting proposed settlement that would have provided $1,000 coupons redeemable toward the purchase of a new truck from the defendant).

11. See, e.g., In re Thornburg Mortg., Inc. Sec. Litig., 885 F.Supp.2d 1097, 1111 (D.N.M) (2012) (“The Court believes, however, the cy pres awards are a bad idea and inappropriate, because they inject a third party into the litigation, do not adequately reflect the best interests of absent class members, create an appearance of impropriety, and are not the best use of the Court’s time and resources.”); See also gen., Jennifer Johnston, Cy Pres Comme Possible to Anything is Possible: How Cy Pres Creates Improper Incentives in Class Action Settlements, 9 JL ECON. & POL’Y 9 277 (2013; Martin H. Redish, Peter Julian, and Samantha Zyontz, Cy Pres Relief and the Pathologies of the Modern Class Action: A Normative and Empirical Analysis, 62 FLA. L. REV. 617 (2010); Sam Yospe, Cy Pres Distributions in Class Action Settlements, 2009.3 COLUMBIA BUSINESS LAW REVIEW 1014 (2009).

12. See, e.g., Frank, Theodore H., Statement to the House, Committee on the Judiciary, Subcommittee on the Constitution and Civil Justice, Examination of Litigation Abuse, Hearing, March 13, 2013 (Serial 113-8).


14. See, gen., In re Baby Prods. Antitrust Litig., 708 F.3d 163, 172 (3d Cir 2013) (cy pres distributions are inferior and must be specifically justified); In re Lupron Mktg. & Sales Pract. Litig., 677 F.3d 21, 33 (1st Cir. 2012) (when feasible, interests of cy pres recipients should reasonably approximate those being pursued by class); Ira Holtzman, C.P.A. v. Turza, — F.3d ——, 2013 WL 4506176 (7th Cir. August 26, 2013) (“Money not claimed by class members should be used for the class’s benefit to the extent that is feasible” and determining cy pres recipient requires “adversarial presentation”); In re Airline Ticket Comm’n Antitrust Litig., 307 F.3d 679, 682 (8th Cir. 2002) (emphasizing importance of tailoring cy pres distribution to nature of underlying suit); Nachshin v. AOL, LLC, 663 F.3d 1034, 1036-1040 (9th Cir. 2011) (cy pres distribution must target plaintiff class; must be “driving nexus” between cy pres beneficiaries and class).

15. Nachshin v. AOL, LLC, 663 F.3d 1034, 1040 (9th Cir 2011).

16. Lane v. Facebook, Inc., 2010 WL 9013059 (N.D.Cal. Mar 17, 2010).

17. Lane v. Facebook, Inc., 696 F.3d 811 (9th Cir. 2012).

18. Lane v. Facebook, Inc., 709 F.3d 791 (9th Cir. 2013).


20. See, e.g., Frank, Theodore H., Statement to the House, Committee on the Judiciary, Subcommittee on the Constitution and Civil Justice, Examination of Litigation Abuse, Hearing, March 13, 2013 (Serial 113-8).

21. In a class action regarding Facebook’s so-called “Sponsored Stories” program, the district court first rejected a proposed cy pres settlement for $10 million.
Fraley v. Facebook, Inc., No. C 11–1726, 2012 WL 5838198 (N.D.Cal. August 17, 2012). A year later, a revised settlement was approved. Fraley v. Facebook, Inc., No. C 11–1726, — F.Supp.2d ——, 2013 WL 4516819 (N.D.Cal. August 26, 2013). In approving the revised settlement, the court noted that the determining factor was not an added provision for some form of limited direct payment but that the defendant would now be paying much more, $20 million, and class counsel would be requesting less in fees. Id.; see, also gen., In re Heartland Payment Sys., Inc. Customer Data Sec. Breach Litig., 851 F.Supp.2d 1040, 1077 (S.D.Tex.2012) (“The class benefit conferred by cy pres payments is indirect and attenuated. That makes it inappropriate to value cy pres on a dollar-for-dollar basis.”).