

Statement before the House Judiciary Committee
Subcommittee on the Constitution and Civil Justice
Examination of Litigation Abuse

Cy Pres Settlements

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the Manhattan Institute or the Center for Class Action Fairness.

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Thank you, Mr. Chairman, and members of this Subcommittee, for your kind invitation to testify today about abusive *cy pres* settlements.

I serve as an Adjunct Fellow at the Manhattan Institute Center for Legal Policy and as President for the Center for Class Action Fairness,¹ but I am not testifying here on their behalf and the views that I am sharing today are my own. My perspective comes from my legal practice running a non-profit public-interest law firm focusing on litigation in class actions on behalf of class members in cases where their court-appointed attorneys have failed to fairly represent their clients' interests. I was elected to the American Law Institute in 2008, and have published and spoken across the country on topics related to class actions.²

Background: Class Action Settlements

Class actions were designed to provide injured parties with a more efficient means of accessing justice by aggregating claims for violations of individual rights.³ Although most successful class action litigation under Rule 23 is resolved in the form of

¹ I founded the Center for Class Action Fairness in 2009. The Center is a 501(c)(3) public-interest law firm that represents *pro bono* consumers and shareholders objecting to unfair class action settlements that benefit class counsel at the expense of their putative clients. Attorneys with the Center have won several landmark cases expanding the rights of consumers in class action settlements. *E.g.*, *In re Baby Products Antitrust Litigation*, No. 12-1165 (3d Cir. Feb. 19, 2013); *In re Bluetooth Prod. Liab. Lit.*, 654 F.3d 935 (9th Cir. 2011); *Nachshin v. AOL, LLC*, 663 F.3d 1034 (9th Cir. 2011); *Robert F. Booth Trust v. Crowley*, 687 F.3d 314 (7th Cir. 2012); *Dewey v. Volkswagen AG*, 681 F.3d 170 (3d Cir. 2012).

² Portions of this testimony are drawn from Ted Frank, *Class Actions, Arbitration, and Consumer Rights*, Legal Policy Report No. 16 (Manhattan Institute 2013); and Theodore H. Frank, *Cy Pres Settlements*, Class Action Watch (Mar. 2008).

³ See Martin H. Redish, *Class Actions and the Democratic Difficulty: Rethinking the Intersection of Private Litigation and Public Goals*, 2003 U. Chi. Legal F. 71, 77 (2003).

a class settlement, such class settlements frequently provide little or no meaningful compensation to consumers. Indeed, a significant number of consumer class settlements do not provide consumers with any monetary relief whatsoever. This systematic under-compensation is the product of two structural problems in class actions. First, because class attorneys' fees generally come from the same source as the class members' compensation—the defendant—class attorneys settling class claims have a fundamental conflict of interest.⁴ Second, to the extent class attorneys exploit that conflict of interest, judges lack the necessary information or incentive to rectify self-dealing in most cases.

The principal reason for the failure of many class settlements to provide meaningful compensation is obvious: class attorneys have incentives to engage in self-dealing during the negotiation of class settlements.⁵ Because class members, especially those in a small-claims consumer class action, have small stakes in the case and therefore usually do not closely monitor their attorneys' conduct, class attorneys often are able to obtain high fees without obtaining meaningful compensation for class members.⁶

Indeed, all three branches of government have recognized this economic reality. In enacting the Class Action Fairness Act of 2005,⁷ Congress found that “[c]lass members often receive little or no benefit from class actions, and are sometimes harmed,

⁴ *E.g.*, *Mirfasihi v. Fleet Mortgage Corp.*, 356 F.3d 781, 785 (7th Cir. 2004).

⁵ *See, e.g.*, Ted Frank, *Class Actions, Arbitration, and Consumer Rights*, Legal Policy Report No. 16 at 6-11 (Manhattan Institute 2013); Lester Brickman, *Lawyer Barons* 335-72 (Cambridge U. Press 2011); John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 Colum. L. Rev. 1343, 1347-48 (1995); Coffee, 54 U. Chi. L. Rev. at 883-84; Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 7-8 (1991).

⁶ In a now-classic study, Andrew Rosenfeld demonstrated that a class attorney that settles a class action enjoys a “settlement premium” above the average attorney’s fee awarded in a class action that proceeds to judgment. *See An Empirical Test of Class-Action Settlement*, 5 J. Legal Stud. 113, 115-17 (1976). This premium is consistent with the hypothesis that class attorneys will maximize their fees at the expense of the class members’ compensation. *See also, e.g.*, Frank, *Class Actions* 6-11; Coffee, 54 U. Chi. L. Rev. at 883-84.

⁷ CAFA, Pub. L. No. 109-2, § 2, 119 Stat. 4.

such as where . . . counsel are awarded large fees, while leaving class members with coupons or other awards of little or no value.”⁸

Similarly the FTC has recognized that “[e]xcessive class action attorney fee awards represent a substantial source of consumer harm.”⁹

Courts also have recognized the harm to consumer welfare caused by the class attorney’s conflict of interest: “the negotiator on the plaintiffs’ side, that is, the lawyer for the class, is potentially an unreliable agent of his principals” given the possibility that he may trade a small class award for the relatively certainty of a high fee award.¹⁰

One of the leading ways for self-dealing class counsel to benefit themselves at the expense of the class is through what are called *cy pres* settlements.

The Problem of *Cy Pres* Relief.¹¹

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

⁸ See *id.* at 4; see also S. Rep. No. 109-4, at 33.

⁹ R. Ted Cruz, Dir. Office of Policy Planning, FTC, Friend of the Court: The Federal Trade Commission’s Amicus Program, Remarks Before the Antitrust Section of the American Bar Association 13 (Dec. 12, 2002) (“Not infrequently, the interests of a private class action attorney may substantially diverge from the interests of the class.”), available at <http://ftc.gov/speeches/other/tcamicus>; Deborah Platt Majoras, Chairwoman, FTC, *Comments at the FTC Workshop: Protecting Consumer Interests in Class Actions* (Sept. 13, 2004), in 18 *Geo. J. Legal Ethics* 1161, 1162-63 (2005) (class actions may not “truly serve consumers’ interests by providing them appropriate benefits”; encouraging “consumers to carefully scrutinize opt-out notices and class action settlement terms and particularly attorney fee awards that may reduce the total compensation available to consumers”).

¹⁰ *Mars Steel Corp. v. Continental Ill. Nat’l Bank & Trust Co.*, 834 F.2d 677, 681-82 (7th Cir. 1987).

¹¹ For more on *cy pres*, see Frank, *Class Actions* 8-9; Martin Redish *et al.*, *Cy Pres Relief and the Pathologies of the Modern Class Action: A Normative and Empirical Analysis*, 62 *Fla. L. Rev.* 617 (2010); John H. Beisner *et al.*, *Cy Pres: A Not So Charitable Contribution to Class Action Practice* (2010); Theodore H. Frank, *Cy Pres Settlements*, *Class Action Watch* (Mar. 2008).

resulted in the dissolution of the trust because of impossibility or illegality.¹² In a classic 19th-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.¹³ 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.¹⁴ *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.

The problem with *cy pres* is that it exacerbates existing conflicts of interest in the class action settlement context. When a class attorney settles a class action, he or she is not only negotiating class recovery, but is also negotiating his or her own fee. 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

¹² 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)).

¹³ *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).

¹⁴ *State v. Levi Strauss & Co.*, 41 Cal. 3d 460, 715 P.2d 564, 224 Cal. Rptr. 605 (1986).

class and their attorneys. Every dollar going to the attorneys does not go to the class, and vice versa. At the same time, a class action settlement must be approved by the court. Attorneys who do not adhere to their fiduciary responsibility to the class have an incentive to exaggerate class recovery to a court to maximize their fees.

The possibility of *cy pres* awards gives an additional incentive to class action attorneys to breach their fiduciary duties to the class. Every dollar that a class member does not recover can now be spent by the attorney himself to the charity of the attorney's choice. Attorneys essentially get free advertising: witness the existence of websites like "ohiolawyersgiveback.com" where lawyers are using their clients' money to advertise themselves. At best this is unseemly; at worst, it is an unethical breach of the attorneys' fiduciary duty to put the interests of their clients first. If courts permit unfettered *cy pres*, then attorneys have an incentive to make it difficult for their own putative clients to recover, because then they can maximize the amount of money that goes to charity in the attorneys' names. This hurts class members. For example, in a settlement I successfully challenged in the Third Circuit,¹⁵ the parties created substantial burdens, including a five-page claim form with confusing instructions, that successfully deterred class members from making claims on the settlement fund. If my client had not successfully appealed the settlement approval, class members would have received less than \$3 million, while the class counsel would have received about \$15 million to distribute to its favorite charity, plus another \$14 million for itself.

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.¹⁶

¹⁵ *Baby Products, supra*.

¹⁶ *Mirfahisi v. Fleet Mortgage Corp.*, 356 F.3d 781, 784 (7th Cir. 2004).

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 to the beneficiary; 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.¹⁷ The only real expense to Ellison was the \$22 million attorneys' fee. More recently, Facebook settled a suit by establishing a charity run by a Facebook board member, and funding it with \$6.5 million dollars; again, the class did not benefit, and the only expense to Facebook was the \$3.2 million fee paid to the class attorneys. If the charitable contribution is one that the defendant was making anyway, the effect on the defendant is one of a change of accounting entries rather than any cost to the defendant or benefit to the class aside from the attorneys' fees.¹⁸ While federal courts are starting to crack down on such abuses, they are doing so inconsistently, and parties are still trying to get away with such shenanigans.¹⁹

¹⁷ Ted Frank, "Final update: Oracle settlement," Point of Law weblog, <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," MarketWatch, 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?").

¹⁸ For example, Kellogg agreed to class action settlements that required it to donate a few million dollars of products to food-banks—something it was already doing to the tune of tens of millions of dollars a year. *Dennis v. Kellogg*, 697 F.3d 858 (9th Cir. 2012) (rejecting settlement).

¹⁹ Compare *Dennis v. Kellogg*, 697 F.3d 858 (9th Cir. 2012); *Nachshin v. AOL LLC*, 663 F.3d 1034 (9th Cir. 2011); and *Klier v. Elf Atochem N. Am., Inc.*, 658 F.3d 468 (5th Cir. 2011); with *Lane v. Facebook*, 696 F.3d 811 (9th Cir. 2012). In *Lane*, the *cy pres* went to a new charity established by defendant Facebook, who could then direct the money to

Further ethical problems arise if the beneficiary is related to the judge. The *New York Times* has documented the problem of charities soliciting judges for leftover settlement money.²⁰ In one notorious case, a judge directed *cy pres* to an animal-rights group in a class action over a hotel fire.²¹ 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. (Two of the attorneys were eventually convicted, and too few people went to prison over this.)²²

While this is obviously an extreme case, it does illustrate the ethical problems associated with judges choosing or approving charitable destinations for settlement money. In a settlement I objected to, the parties in a nationwide class action proposed a *cy pres* award to a local charity where the judge's husband served as a board member; the judge rubber-stamped the proposed settlement over an objection regarding the appropriateness of the *cy pres* award.²³ The Ninth Circuit reversed on other grounds, but refused to condemn the conflict of interest.²⁴ This appearance of impropriety damages public perceptions of the fairness of the justice system, and appellate courts should be doing more to police it.

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

recipients favorable to Facebook's lobbying interests, a tactic that is being repeated by Facebook in the pending *Fraley v. Facebook* settlement. Roger Parloff, *Google and Facebook's new tactic in the tech wars*, CNN MONEY (Jul. 30, 2012), available at <http://tech.fortune.cnn.com/2012/07/30/google-and-facebooks-new-tactic-in-the-tech-wars/>.

²⁰ Adam Liptak, *Doling Out Other People's Money*, N.Y. TIMES (Nov. 26, 2007).

²¹ *In re San Juan Dupont Plaza Hotel Fire Litigation*, 2010 WL 60955 (D. P.R. Jan. 7, 2010).

²² Ted Frank, "Fen-Phen Zen," American.com (Apr. 4, 2007).

²³ Nathan Koppel, *Proposed Facebook Settlement Comes Under Fire*, WALL STREET JOURNAL (Mar. 2, 2010).

²⁴ *Nachshin v. AOL, LLC*, 663 F.3d 1034 (9th Cir. 2011).

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.

In July 2007, a district court judge 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."²⁵ The lead plaintiffs' attorney was a GWU Law alumnus.²⁶ I represent a client appealing an approval of a settlement of a class action with a national class where over \$2 million of *cy pres* is going to three San Diego universities (including the *alma mater* of class counsel), class counsel is being paid \$8.85 million, but the class will receive only about \$225,000 in cash.²⁷ In another settlement where class counsel was already scheduled to receive \$27 million, *cy pres* was designated to a charity run by the ex-wife of class counsel.²⁸ Such problems go beyond trial lawyers and civil lawsuits; Richard Epstein has criticized a Bush administration 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.²⁹

²⁵ *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.

²⁶ Ashley Roberts, *Law School Gets \$5.1 Million to Fund New Center*, GW Hatchet (Dec. 3, 2007).

²⁷ *In re EasySaver Rewards Litigation*, No. 13-55373 (9th Cir.). I have previously successfully blocked a diversion of \$2.5 million of a settlement fund to third-party charities (including two schools affiliated with class counsel). Alison Frankel, "Legal Activist Ted Frank Cries Conflict of Interest, Forces O'Melveny and Grant & Eisenhofer to Modify Apple Securities Class Action Deal," *American Lawyer Litigation Daily* (Nov. 30, 2010).

²⁸ *In re: Chase Bank USA NA "Check Loan" Contract Litigation*, No. 09-md-02032 (N.D. Cal.). The conflict of interest was not disclosed to the district court, which approved the settlement.

²⁹ Richard A. Epstein, *The Deferred Prosecution Racket*, WALL ST. J. (Nov. 28, 2006).

Certainly, the desire to give money to charity is a good cause. But there are surely more efficient ways to do so than to give *carte blanche* to plaintiffs' attorneys to direct class members' money and then have them take a 25 to 40 percent commission on the donation. In practice, *cy pres* "creates the illusion of class compensation" without actually compensating the class.³⁰ And as Judge Edith Jones has said, "district courts should avoid the legal complications that assuredly arise when judges award surplus settlement funds to charities and civic organizations."³¹

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 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."³² 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.³³ Another possibility is already contemplated by federal law: unclaimed funds escheat to the treasury.

There is still another possible solution. The federal Class Action Fairness Act 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.³⁴ The same principle should apply when cash is involved; at a minimum, money given to *cy pres* should not count dollar for dollar like money given to class members. Contingent-fee attorneys should be rewarded only for benefits going directly to the class. Moreover, if a *cy pres* settlement benefits the attorneys directly or indirectly, that settlement should offset the attorneys' fees. A \$1 million *cy pres* award on behalf of a charity related to class counsel should count as part of the attorneys' fee award, not as a

³⁰ Redish, 62 Fla. L. Rev. at 623.

³¹ *Klier v. Elf Atochem*, 653 F.3d 468, 481-82 (5th Cir. 2011) (Jones, J., concurring).

³² § 3.08. See also *Klier*, *supra*; *Masters v. Wilhelmina Model Agency, Inc.*, 473 F.3d 423 (2d Cir. Jan. 4, 2007); Liptak, *supra* n. 12. But see *Baby Products*, *supra* (suggesting mechanism as possibility, but refusing to require district courts to do this).

³³ *Fears v. Wilhelmina Model Agency, Inc.*, No. 02 Civ 4911 (S.D.N.Y. Jul. 5, 2007).

³⁴ 28 U.S.C. § 1712(e).

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 settlement does not benefit class members, the attorneys should not be realizing disproportionate benefit. Judge Lee Rosenthal correctly recognized the need to structure incentives *ex ante*, and discounts *cy pres* in calculating settlement benefit; this should be standard practice, rather than a rare exception.³⁵

At a minimum, the parties should be required to give notice to the class of who the *cy pres* recipients are, and whether there are relationships between the recipients and the parties, attorneys, and judge. Though this information is plainly material to the fairness of a settlement, courts have generally refused to establish bright-line rules that penalize parties that hide this information from class members.³⁶

I welcome your questions.

³⁵ *In re Heartland Payment Sys.*, 851 F. Supp. 2d 1040, 1076-77 (S.D. Tex. 2012).

³⁶ *Baby Products, supra*; *Nachshin, supra*.