

# Client Alert

National Class Action Practice Group

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## ***In re Baby Products Antitrust Litigation:*** **Third Circuit Issues Game-Changing Decision Affecting Cy Pres Funds in Claims-Made Class Action Settlements**

On February 19, 2013, the United States Court of Appeals for the Third Circuit vacated a district court order approving a class action settlement, holding that a district court must specifically determine that a claims-made settlement incorporating a *cy pres* fund provides sufficient direct compensation to class members before granting final approval. *See In re Baby Prods. Antitrust Litig.*, Nos. 12-1165, 12-1166, and 12-1167, – F.3d –, 2013 WL 599662, *rev'g* 834 F. Supp. 2d 329 (E.D. Pa. 2011). To make such a determination, the Third Circuit reasoned, a district court typically must find that the portion of the settlement distributed *cy pres* represents only a “small percentage of total settlement funds.” *Id.* at \*5.

The Third Circuit’s opinion is notable for a number of reasons, including because it represents a growing trend of circuit courts expressing skepticism about *cy pres* funds in class settlements. But the most significant aspect of the opinion is its practical effect on parties negotiating such settlements on a claims-made basis. By holding that the fairness of claims-made settlements depends on the value of the benefits actually claimed by class members, the Third Circuit created substantial challenges to class action defendants seeking to resolve disputes on favorable terms.

### **The Proposed Settlement and District Court Approval**

In *Baby Products*, a consolidated putative antitrust class action, the plaintiffs alleged that Babies “R” Us and a number of baby product manufacturers conspired to restrict competition in violation of the Sherman Antitrust Act, allegedly causing the plaintiffs to pay inflated prices. After several years of litigation, the parties agreed to settle the case on a classwide basis.

Under the settlement, the defendants agreed to deposit \$35.5 million into a common fund, with \$14 million allocated to attorneys’ fees and expenses, and the remainder reserved for distribution to the settlement class, which was divided into eight subclasses. Depending on the proof of purchase submitted, each claimant would be eligible for one of three benefits:

1. Claimants who provided “valid documentary proof of purchase and of the actual price paid for a product” would

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receive 20% of the actual purchase price of each product purchased;

2. Claimants who provided valid proof of purchase but not “documentary proof of the actual purchase price” would receive 20% of the estimated retail price of each product purchased; and
3. Claimants who provided no proof of purchase would receive a payment of \$5.

If the claims for any subclass failed to exhaust the settlement funds allocated for that subclass, claimants in that subclass who fell within one of the top two compensation categories (*i.e.*, claimants who had submitted at least some proof of purchase) would become eligible for a *pro rata* enhancement of up to three times their baseline awards. Any funds remaining after the *pro rata* enhancements would be distributed to one or more *cy pres* recipients. Notably, the parties did not agree to the potential *cy pres* recipients in the settlement agreement. Instead, they agreed that each party would recommend up to two not-for-profit organizations to receive *cy pres* awards, and the district court would make the final decision regarding the beneficiaries.

In January 2011, the district court preliminarily approved the settlement and established a schedule governing the claims process. In the preliminary approval order, the court scheduled the final approval hearing for July 6, 2011 and set the claims deadline for August 1, 2011. The parties then notified the class members of the settlement. After conducting the fairness hearing on July 6, 2011, the court ultimately granted final approval in December 2011, approximately four months after the claims deadline. In considering the fairness of the settlement, the court did not know the number of claims submitted or the amount of benefits allocated to the settlement class members through the claims process.

## The Third Circuit Decision

One of the class members who objected to the settlement in the district court appealed the district court’s final approval order to the Third Circuit, arguing that the settlement was unfair to the class members because it “resulted in a troubling and . . . surprising allocation of the settlement fund.” 2013 WL 599662, at \*1. In particular, the objector was concerned because, after the conclusion of the claims process, only \$3 million of the \$35,500,000 that the defendants paid into the settlement fund was allocated to class members, while the plaintiffs’ attorneys received approximately \$14 million and the remaining \$21.5 million was allocated to unnamed *cy pres* beneficiaries. The vast majority of the class members who submitted claims had not provided proof of purchase and were eligible only for the lowest category of settlement benefit—\$5.

The Third Circuit shared the objector’s concern and vacated the district court’s final approval order. In doing so, the court held that in addition to applying the traditional test to determine whether a proposed class settlement is fair to the class members, district courts must also make factual findings as to “the degree of direct benefit provided to the class,” keeping in mind that “[b]arring sufficient justification, *cy pres* awards should generally represent a small percentage of total settlement funds.” *Id.* at \*5. Conducting this inquiry, the Third Circuit explained, could require district courts to “withhold final approval of a settlement until the actual distribution of funds can be estimated with reasonable accuracy” or, alternatively, “urge parties to implement a settlement structure that attempts to maintain an appropriate balance between payments to the class and *cy pres* awards.” *Id.* at \*6.

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Applying this reasoning, the Third Circuit held that the district court in *Baby Products* erred in approving the settlement because it did not know—and thus did not consider—the allocation of the settlement fund after the conclusion of the claims process. As a result, the district court lacked the information necessary to assess whether sufficient funds were distributed directly to the class, rather than to *cy pres* recipients.

As a corollary, the Third Circuit also vacated the district court’s orders approving approximately \$11.8 million in attorneys’ fees, which represented about one-third of the \$35.5 million settlement amount, because of the disproportionate amount of the settlement fund allocated to *cy pres* beneficiaries instead of class members. While the court declined the objector’s request to “impose . . . a rule requiring district courts to discount attorneys’ fees when a portion of an award will be distributed *cy pres*,” the court expressed concern that *cy pres* settlements could overcompensate class counsel without directly benefiting class members. *Id.* at \*10. Accordingly, the court noted that district courts are permitted to “decrease attorneys’ fees where a portion of a fund w[ould] be distributed *cy pres*” and further stated that evaluating the appropriateness of attorneys’ fees in *cy pres* settlements could require a district court “to delay a final assessment of the fee award to withhold all or a substantial part of the fee until the distribution process is complete.” *Id.* at \*11.

## Why Does This Issue Matter to Class Action Defendants?

Despite its myriad reservations about the settlement in *Baby Products*, the Third Circuit did not reject wholesale the use of *cy pres* funds in class settlements. To the contrary, the court expressly held, as a matter of first impression, that “a district court does not abuse its discretion by approving a class action settlement agreement that includes a *cy pres* component. . . .” *Id.* at \*4. The court, however, joined the growing chorus of circuit courts of appeals expressing concern about the use of *cy pres* in class settlements, particularly when the parties defer to the district court to select the beneficiaries. (For further discussion of this issue, see David L. Balser, *et al.*, *Are Cy Pres Settlements Really Faux Settlements? Analyzing Recent Criticism of Cy Pres Funds in Class Settlements*, BNA Class Action Litigation Report, 13 CLASS 1080 (Sept. 28, 2012)).

Given that only \$3 million of the \$35.5 million total settlement amount was allocated to class members, the settlement in *Baby Products* may raise legitimate concerns. The Third Circuit’s decision, however, exemplifies the familiar maxim that “bad facts make bad law.” See *Pazden v. Maurer*, 424 F.3d 303, 319 (3d Cir. 2005) (Rendell, J., dissenting). Most importantly, the decision presents substantial challenges to reaching claims-made settlements in class actions because the decision injects heightened uncertainty into settlement negotiations. Based on the Third Circuit’s reasoning, final approval of a settlement should be contingent on the value of the claims class members ultimately make—a factor the parties can neither control nor reliably predict during negotiations. As a result, parties are left to negotiate the value of per-class member benefits (and, ultimately, attorneys’ fees) in a vacuum. Moreover, settlement agreements resulting from time-consuming negotiations could easily be rejected, despite the parties’ best efforts to compensate class members reasonably.

Moreover, the Third Circuit’s unmistakable suggestion that *cy pres* awards are less valuable than direct class benefits for purposes of calculating attorneys’ fees disincentivizes plaintiffs’ attorneys from incorporating *cy pres* funds into settlements. This, in turn, could lead plaintiffs’ attorneys to insist that defendants pay higher per-member class benefits, further decreasing the prospects of settlement or making it more difficult for defendants to reach settlements on favorable terms.

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In short, while the decision in *Baby Products* implicates some of the same legitimate issues with *cy pres* class settlements that other courts have identified, it likely creates another stumbling block for class defendants trying to reach reasonable settlements in cases in which the real value is not to the class members, but to the plaintiffs' lawyers driving the litigation.

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