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REPORT

SETTLEMENTS

JUDICIAL REVIEW

What is the impact on judicial review of class action settlements when there is a change in the law after the parties sign a settlement, and should judges consider such a change when adjudicating the reasonableness of the settlement? In this BNA Insight, attorneys Laurence J. Hutt and Amy B. Levin review pertinent case law, and argue that courts should abide by the law in effect at the time of settlement. Reviewing courts ''should honor parties' bargained-for settlement terms rather than giving effect to the changed law, which would potentially 'undo' the settlement terms,'' the authors say.

Frozen in Time: Evaluating Class Action Settlements in the Face of Changes in Law

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California courts are increasingly scrutinizing the reasonableness, adequacy, and fairness of class action settlements. In two recent decisions, the Court of Appeal reversed judgments affirming proposed class action settlements, cautioning that trial courts need to weigh the merits of the plaintiff's case against the amount offered in settlement carefully to ensure that the interests of absent class members whose claims would be extinguished by the settlement are adequately protected. *Kullar v. Foot Locker Retail, Inc.*, 168 Cal. App. 4th 116, 130 (2008); *Clark v. Am. Residential Servs. LLC*, 175 Cal. App. 4th 785, 799–803 (2009). Federal courts have been actively and closely reviewing class action settlements for some time. *E.g.*, *Ehrheart v.*

Verizon Wireless, 609 F.3d 590, 593 (3d Cir. 2010) (district courts are ''fiduciaries for the absent class members''); *Waters v. Int'l Precious Metals Corp.*, 190 F.3d 1291, 1300 (11th Cir. 1999) (district court has an ''active supervisory role'' when reviewing class action settlements); *Armstrong v. Bd. of Sch. Dirs. of City of Milwaukee*, 616 F.2d 305, 314 (7th Cir. 1980) (the ''most important'' factor in judging the fairness of a class action settlement is ''the strength of the plaintiffs' case on the merits balanced against the settlement offer''), *overruled on other grounds by Felzen v. Andreas*, 134 F.3d 873 (7th Cir. 1998).

An obvious, yet largely unaddressed, question arises from these decisions: *As of what time in the settlement process should trial courts evaluate the ''strength'' of the plaintiff's case?* In most cases, courts need not address, and thus have not addressed, this issue because the law governing the parties' material claims and defenses, and thus the strength of the plaintiff's case, remains unchanged throughout the settlement negotiation and court review process. In some instances, however, there is an arguably material change in the law affecting the matters or claims being settled, such that the parties' allocations of risk as to the merits of their claims and/or defenses at the time they execute the settlement may no longer reflect the actual merits of those claims or defenses at the time the trial court preliminarily or finally approves the proposed settlement or at the time an appeal is considered. In these circumstances, assuming the parties' bargained-for allocations of risk resulted from good faith, arm's length negotiations and there was no collusion, trial courts must make the difficult choice whether to uphold the parties' bargained-for settlement terms *despite the changed law* or to send the parties back to the bargaining table *because of the changed law*.

The few authorities that have addressed this issue suggest—we believe correctly—that proposed settlements should be judged according to the law in effect *at the time the parties negotiate and enter into a settlement*. *E.g.*, *Ehrheart*, 609 F.3d 590; *Sutter Health Uninsured Pricing Cases*, 171 Cal. App. 4th 495 (2009); *Curiale v. Lenox Group Inc.*, 2008 WL 4899474 (E.D. Pa. Nov. 14, 2008); *Shepherd Park Citizens Ass'n v. Gen. Cinema Beverages*, 584 A.2d 20 (D.C. 1990); *Armstrong*, 616 F.2d 305; *Dawson v. Pastrick*, 600 F.2d 70 (7th Cir. 1979); *In re Master Key Antitrust Litig.*, 76 F.R.D. 460 (D. Conn. 1977).[1] That is, the operative time period for judging the strength of the plaintiff's case appears to be at the time the parties agree to their settlement, and any later changes in the law, regardless of when in the settlement process they occur (*i.e.*, before or after preliminary approval, before or after final approval, or before the appeals period has run), do not impact the court's evaluation of the reasonableness, fairness, and adequacy of the settlement. *Curiale*, 2008 WL 4899474, at *6–*8 (change in law before preliminary approval); *Ehrheart*, 609 F.3d at 592, 595 (after preliminary approval); *Dawson*, 600 F.2d at 76 (same day as final approval); *Armstrong*, 616 F.2d at 309–10, 321–22 & n.25 (after final approval); *Sutter Health Uninsured Pricing Cases*, 171 Cal. App. 4th at 506–07 (after final approval); *Shepherd Park Citizens Ass'n*, 584 A.2d at 22–24 (when motion for reconsideration of final approval order was pending); *In re Master Key Antitrust Litig.*, 76 F.R.D. at 462, 464–65 (after final judgment). As these courts recognized, were it otherwise—if courts could undo settlements based on future changes in the law that the parties had no way of predicting at the time of settlement—this would seriously undermine important motivations for settling and the well-established law favoring settlement of complex disputes, including class actions.

Indeed, the Third Circuit has gone so far as to suggest—at least implicitly—that, as a matter of law, district courts must preserve and enforce valid settlements despite post-settlement changes in the law that may be material to the settled claims. In reversing a district court decision vacating preliminary approval of a class settlement, the court made clear that district courts do *not* have discretion to consider post-settlement changes in the law when reviewing proposed class action settlements: ''[C]hanges in the law after settlement do not affect the validity of the agreement and do not provide a legitimate basis for rescinding the settlement.'' *Ehrheart*, 609 F.3d at 593. The court emphasized the binding nature of settlements and the ''strong public policy,'' ''which is particularly muscular in class action suits favoring settlement of disputes, finality of judgments and the termination of litigation.'' *Id.*

Courts Should Honor Parties' Informed and Good Faith Reasons for Settling

Parties often opt to settle class action lawsuits for two important reasons: (1) to achieve final resolution of their disputes more quickly, certainly, efficiently, and cost effectively; and (2) to avoid the risks associated with unsettled law affecting the elements of their claims and/or defenses at the time of settlement.

First, parties often settle to avoid protracted litigation. If these same parties were able to back out of reasonable, bargained-for settlements, or if objectors could nullify settlements, on the basis of future changes or clarifications in the law, no settlement would ever be truly ''final'' and this important incentive to settle would be lost or severely eroded. *Ehrheart*, 609 F.3d at 596 (''It is essential that the parties to a class action settlement have complete assurance that a settlement agreement is binding once it is reached.''); *Shepherd Park*, 584 A.2d at 24 (''It would be a positive disincentive to settlements if litigants knew an accord were vulnerable to ordinary changes in the law occurring after

[1] The Second Circuit's decision in *Newman v. Stein*, a shareholder derivative suit, is an apparent exception to these authorities. 464 F.2d 689, 696 (2d Cir. 1972). In that case, the Second Circuit stated, without any substantive analysis, that ''evaluation of the propriety of a settlement requires realistic consideration of facts which affect the ultimate likelihood of success, and it would be inappropriate for a reviewing court to freeze matters as of the moment at which the parties entered into an agreement and ignore subsequent developments which either reinforce or undermine the original decision to settle.'' *Id.* at 696. Although a few courts have considered post-settlement changes in the law in evaluating the fairness of proposed settlements, in strict accordance with the plain language of this decision—*In re Chemtura Corp.*, 439 B.R. 561, 600 (Bankr. S.D.N.Y. 2010); *In re Lee Way Holding Co.*, 120 B.R. 881, 892 n.15 (Bankr. S.D. Ohio 1990)—most courts appear to reject this language from *Newman*. *In re Trism Inc.*, 286 B.R. 744, 749–50 (Bankr. W.D. Mo. 2002); *In re Erickson*, 82 B.R. 97, 101–02 (D. Minn. 1987).

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the agreement. . . .''); *Dawson*, 600 F.2d at 76 (''To allow post-approval changes or clarifications in the law to upset a settlement would be contrary to the established policy of encouraging settlements and frequently would allow a party to back out of a bargained-for position after agreement had been reached.''). Parties presumably would be more reluctant to settle if there were a risk that their efforts could unravel at the drop of a hat, and they would then have to negotiate a new and possibly worse deal, or they may not end up reaching a settlement at all.

Settlement of complex disputes, in particular multi-party class actions, conserves judicial resources and enables parties to avoid the costs and risks associated with prolonged litigation.

Second, when the operative law governing the parties' claims and/or defenses is in flux, parties often settle to avoid an uncertain, unpredictable, and potentially damaging outcome. *Armstrong*, 616 F.2d at 322 n.25 (''[A] large incentive for settlement in many cases . . . is the desire by both parties to avoid the risks created by uncertainty in the legal standards applicable to the litigation.''). Indeed, potential unfavorable changes in the law are a contingency the parties are ''free to compromise by way of settlement.'' *In re Master Key Antitrust Litig.*, 76 F.R.D. at 464; *Shepherd Park*, 584 A.2d at 24. If parties' informed and negotiated allocations of risk—which necessarily can be based only on their *present* understanding of the law and their own assessment at that time of the future direction of the law regarding unsettled issues—were undermined by *future* changes in the law, an important incentive for settling would be lost. *Ehrheart*, 609 F.3d at 594 (''In negotiating this agreement, Verizon bet on the certainty of settlement instead of gambling on the uncertainties of future legislative action. Verizon lost, and the District Court erred by letting it replay its hand.''); *Curiale*, 2008 WL 4899474, at *8 (''The Settlement Agreement simply hedged the parties' bets, reflecting their choice of 'the certainty of settlement [over] the gamble' of legislative action. That Congress ultimately enacted the legislation does not allow Defendant to avoid the Settlement Agreement it executed in good faith with Plaintiff.'') (alteration in original); *Armstrong*, 616 F.2d at 322 n.25 (''To allow reevaluation of a settlement on the basis of decisions reached after its approval would undercut'' . . . ''the desire by both parties to avoid the risks created by uncertainty in the legal standards applicable to the litigation,'' which is ''a large incentive for settlement in many cases[.]''); *In re Master Key Antitrust Litig.*, 76 F.R.D. at 465 (''The decision to settle was a result of defendants' free, open and unfettered choice. It reflected their views and those of their counsel of the risks of jury verdicts on liability and damages and the possibility of success on appeal. *No one is endowed with the ability to predict the future, ... but it is precisely this uncertainty that produces settlements.* The agreement is fully enforceable.'') (emphasis added).[2]

The Law Favors Settlement of Complex Litigation

Settlement of complex disputes, in particular multiparty class actions, conserves judicial resources and enables parties to avoid the costs and risks associated with prolonged litigation. ''Settlement of the complex disputes often involved in class actions minimizes the litigation expenses of both parties and also reduces the strain such litigation imposes upon already scarce judicial resources.'' *Armstrong*, 616 F.2d at 312; *see also Curiale*, 2008 WL 4899474, at *5 (' 'The law favors settlement particularly in class actions and other complex cases where substantial judicial resources can be conserved by avoiding formal litigation.' '). If courts were to send parties back to the negotiating table every time a new case was decided or statute passed that potentially implicated the terms of a settlement, this would inevitably lead to more litigation and less conservation of resources.

Settlements Should Be Evaluated According to Law in Effect at Time of Deal

In most of the cases cited above, the law changed in the *defendants'* favor. *E.g.*, *Ehrheart*, 609 F.3d 590; *Sutter Health Uninsured Pricing Cases*, 171 Cal. App. 4th 495; *Curiale*, 2008 WL 4899474; *Armstrong*, 616 F.2d 305; *Dawson*, 600 F.2d 70; *In re Master Key Antitrust Litig.*, 76 F.R.D. 460. Because the plaintiffs' claims would not have been as strong, or even viable at all, under the changed law, they presumably benefited from settling rather than continuing to litigate, and the interests of absentee class members presumably were protected as well. *Kullar*, 168 Cal. App. 4th at 129 (' 'The court has a fiduciary responsibility as guardians (sic) of the rights of the absentee class members when deciding whether to approve a settlement agreement.' ') (citation omitted).

[2] Courts in various non-class action cases similarly have rejected the notion that material changes in the law post-settlement are grounds for rescission of a settlement on the basis of mistake of law. They reason that potential favorable or unfavorable changes in the law are a risk the parties take when deciding to settle, and thus any future changes should not operate to undo the terms of the previously-negotiated settlement agreements. *See, e.g.*, *In re Napolitano*, 2008 WL 5401541 at *4–*5 (Bankr. E.D.N.Y. Dec. 23, 2008); *Krantz v. Univ. of Kansas*, 21 P.3d 561, 567 (Kan. 2001) (''A subsequent change in the law will not justify rescission of a settlement agreement or contract on the basis of 'mistake of the law.' ''); *Bd. of Trs. of the Sheet Metal Workers Local Union No. 137 Ins. Annuity & Apprenticeship Training Funds v. Vic Constr. Corp.*, 825 F. Supp. 463, 467 (E.D.N.Y. 1993) (''This case involves not so much a mistake of settled law as a failure to determine or predict a controlling interpretation of a statute.''); *Anita Founds. Inc. v. ILGWU Nat'l Ret. Fund*, 902 F.2d 185, 190 (2d Cir. 1990) (''The uncertainty of a legal position and the desire to avoid the risk of a lawsuit are the impetus for many out-of-court settlements. It simply is inappropriate to equate these settlement agreements with agreements premised upon the misapplication of settled legal principles.''); *Sentry Indem. Co. v. Peoples*, 800 F.2d 1547, 1553 (11th Cir.1986).

One might wonder, however, whether trial courts would rule the same way when the law changes in the *plaintiffs'* favor. Under this scenario, the plaintiffs may have achieved a more favorable outcome had they continued to litigate rather than settling, and absentee class members who were not part of the negotiation process therefore would be bound by a settlement that may not be in their best interests at the time it is consummated.

The case law presenting this type of situation is sparse, but to the extent it gives guidance, it suggests that settlements nonetheless should be upheld because plaintiffs and defendants bear the risks of settling equally. *In re Master Key Antitrust Litig.*, 76 F.R.D. at 464 (''If a party makes a conscious and informed choice of litigation strategy, he cannot seek extraordinary relief merely because his assessment of the consequences was incorrect.''). Thus, neither party should be able to undo a settlement based on subsequent changes in the law that improve that party's respective claims or prospects for relief. *Id.* at 464–65 (''If *Illinois Brick* had been decided in favor of the indirect purchasers, plaintiffs could not complain that they settled too cheaply. Defendants are in a similar position. Both sides were at risk; they got exactly what they bargained for.''); *see also Shepherd Park*, 584 A.2d at 23–24 (in antitrust case brought by the District of Columbia as *parens patriae* against two soft drink bottling companies, in which there was a change in law favorable to the District, the court chose to ''give effect to the parties' evaluation of the risk at the time it was made,'' and thus affirmed the denial of the objectors' request for reconsideration of the final order approving settlement). This result is consistent with the important policy considerations underlying parties' decisions to settle—ensuring the finality of settlements and respecting parties' carefully bargained-for allocations of risk at the time of settlement.

The result is also consistent with due process. In approving a class settlement, the court must find that the named plaintiff is an adequate representative of and shares common claims with the class, and that class counsel is competent and has no conflicts vis-à-vis the class. Such a showing, along with the right of class members to opt out of the settlement after notice, is sufficient to satisfy the due process requirements underlying representative actions. When these requirements have been satisfied, the class is properly bound to the settlement in the same fashion as another party-litigant would be bound. The named plaintiff *and* the class, therefore, equally should bear the risk that the law may change in their favor post-settlement.

Conclusion

The existing state of the law favors settlement of complex cases, including class actions, because courts view the settlements reached by parties and their counsel implicitly, if not expressly, to reflect the respective sides' careful and informed considerations at the time of settlement of how uncertainties in the law will be resolved, and thus of the likely outcomes of their cases. Courts respect and uphold the parties' allocations of risk at the time of settlement, even when the law governing the claims and defenses being settled materially changes prior to final court approval, so as not to undermine the important incentives to settling and the law favoring settlement of complex disputes.

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