

ARTICLES

How to Structure Securities Class Action Settlements to Obtain Court Approval and Global Peace

By Niki Mendoza – August 25, 2018

The goals of a securities class action settlement are obtaining a certain and timely recovery (for plaintiffs) and obtaining finality and global peace (for defendants and insurers). Plaintiffs seek the highest settlement amount, in the shortest time frame. Defendants and insurers seek the broadest release and to minimize exposure to opt-outs. These goals are achievable, however, only if the settlement is approved by the court.

Rule 23(e) of the Federal Rules of Civil Procedure requires that federal court actions may be settled on a class-wide basis only if the court finds that the settlement is fair, reasonable, and adequate. In making this determination, courts look to both substantive and procedural fairness. The substantive fairness inquiry looks at the consideration received by the parties, i.e., the amount of the settlement received by the class and the release received by defendants. The procedural fairness inquiry looks at whether the settlement is the result of arm's-length negotiations, such as before a third-party mediator. Courts are required to evaluate the settlement as proposed and may only approve or reject it; they cannot change it. As articulated by the Ninth Circuit in [Hanlon v. Chrysler Corp](#), 150 F.3d 1011 (1998), “[s]ettlement is the offspring of compromise; the question [courts] address is not whether the final product could be prettier, smarter or snazzier, but whether it is fair, adequate and free from collusion.”

With the increased scrutiny courts are applying to class action settlements, along with the proposed amendments to Rule 23 that require courts to more closely review the proposed settlements earlier, the parties should carefully structure the settlement to anticipate and address certain issues that raise court concern. These issues should be addressed as early as possible in the negotiation process, ideally when drafting a settlement term sheet.

Defining the Settlement Class

One of the most critical pieces of a class settlement is the settlement class definition—that is, who is giving the release and, in exchange, is potentially eligible to recover a portion of the settlement fund. Defendants and insurers seek the broadest class definition to include the most class members releasing claims, and plaintiffs seek to avoid overly diluting the recovery of class members on whose behalf the case was brought. All parties need court approval.

If the parties are considering a settlement class definition that is broader than the class definition that was proposed or certified for litigation purposes, they should carefully address whether the change is necessary to achieve the parties' goals. A revision to the class definition will not necessarily lead to court disapproval, but expansions will be viewed with suspicion. The parties, therefore, should be prepared to justify the revision to the court. The Northern District of California's [Procedural Guidance for Class Action Settlements](#) expressly advises that when seeking preliminary approval of a class action settlement, the parties should advise the court of any differences between the settlement class and the class previously proposed or certified. Courts have further advised that, if the class is extended, there should be an adequate plaintiff

and one with standing to present the add-on scope. The settlement dollars should also be sufficient to cover the old scope plus the new scope.

In the securities context, courts have certified settlement classes that extend the class period beyond the proposed or certified litigation class period, that include securities that were not specifically enumerated in the proposed litigation class, or that include investors that could not satisfy for litigation purposes certain elements of the securities claims.

Outlining the Release

Closely related to the settlement class definition (i.e., who will give a release) is the scope of the release itself (i.e., what is being given up). Defendants and insurers seek the broadest release, to reach finality and obtain global peace. Although lead plaintiffs may agree to a broad release, all parties should consider whether the release is overly broad with the potential to jeopardize the deal by drawing objections from class members or court disapproval. Unlike in non-class direct actions where the parties are free to negotiate the broadest general release on behalf of themselves, in the class action context, the parties should consider the legal limitations on the extent of the release that will be given by absent class members.

Courts typically look at a combination of the class definition and the scope of the release and whether all class members are potentially eligible to participate in the recovery. Courts recognize the practical reality that class action settlements will not be reached if the parties cannot set definitive limits on defendants' liability. If, on the other hand, the class is broad *and* the release is broad *and* certain class members would likely receive little or no recovery, there is a greater risk of objections and opt-outs and of court disapproval.

Indeed, courts have denied settlement approval when a release is overly broad. For example, the Northern District of California recently rejected an initial proposed settlement of a Fair Credit Reporting Act (FCRA) class action because it contained an overbroad release of claims for *all* FCRA claims arising out of the class members' consumer reports prepared by the defendant, and the release was not limited to only the FCRA claims that were actually alleged in the complaint. The court had informed the parties in advance of the settlement that the release should be limited to the claims certified for class treatment; that language releasing claims that "could have been brought" is too vague and overbroad; and that class counsel must justify the release as to each claim released, the probability of winning, and its estimated value if fully successful. This is consistent with the Northern District of California's guidance, recommending that the parties address differences between the claims to be released through the settlement and the claims in the complaint.

In the securities class action context, a class action release may extend beyond the claims that were actually asserted in the complaint, to reach, for example, other claims that are based on the identical factual predicate as the claims alleged. Customary release language in securities class actions encompasses claims that the lead plaintiff or any other member of the settlement class (a) asserted in the litigation or (b) could have asserted in any forum; that arise out of, are based on, or in any manner relate to the allegations, transactions, facts, matters, occurrences, statements,

representations, or omissions involved, set forth, or referred to in the complaint; and that relate to the purchase or acquisition of the relevant securities during the class period.

Tethering the release to the allegations in the complaint and to the purchase or acquisition of the relevant securities during the class period will increase the likelihood of satisfying the identical factual predicate requirement.

While it may be appropriate in some negotiations to kick the can down the road and agree only that the parties “will exchange customary mutual releases,” specific release language should be addressed in the term sheet when timing permits.

Evaluating Due Diligence

The parties should also consider whether additional discovery or due diligence will be helpful, either to obtain the necessary approvals of all parties (such as the lead plaintiff) or to obtain court approval. Class counsel is acting as a fiduciary on behalf of absent class members and is required to investigate the strengths and weaknesses of the case before reaching an informed settlement.

Particularly when negotiations occur early in litigation, courts may query whether class counsel has obtained enough information as to the maximum value if recovery was obtained through trial and what are the specific risks to obtaining that recovery in this particular case. If there has been little or no discovery, it is more difficult to justify a substantial discount on the maximum recoverable damages without at least some informal “due diligence” conducted in connection with the negotiation process. Less discovery or due diligence may be acceptable if the settlement is a higher percentage of the maximum recovery at trial. When a settlement is reached early, in particular if negotiations occur very early in the litigation due to ability-to-pay issues, due diligence may be helpful to confirm representations of defendants’ lack of assets.

Informal discovery or due diligence can also be a useful tool for increasing the consideration to the class without additional out-of-pocket funds from defendants or insurers. The form of the cooperation provided may be documentation, information, or interviews or depositions related to any remaining defendants with whom a settlement has not been reached.

Crafting a Blow Provision

A blow provision in a class action settlement allows a party to terminate the settlement under certain circumstances. Typically, if a blow provision is included in a securities class action settlement, the provision allows the defendant to terminate the settlement if a certain portion of the settlement class excludes themselves from the settlement class. The portion that triggers the termination option is frequently a certain percentage of the estimated number of total shares involved in the settlement. This may be expressed in the following term:

Defendant shall have the right to withdraw from and terminate the settlement in its entirety and to render the Stipulation of Settlement null and void if settlement class members who, during the settlement class period, collectively purchased more than [X]\$ of the damaged shares of [X Company] common stock and who are eligible to participate in the settlement (the “Opt-Out Threshold”) validly elect to exclude themselves from the

settlement class in accordance with the requirements for requesting exclusion provided in the notice.

Two issues arise with respect to the blow provision: the amount that triggers the termination option and whether that amount is publicly disclosed. As to the trigger amount, class counsel seeks a high threshold to avoid having the provision easily triggered. Class counsel may contend that too low of a threshold will make the settlement agreement illusory and nonbinding because the defendant could easily terminate the settlement agreement with only a very small portion of opt-outs. Defendants and insurers may seek a low threshold to allow them to terminate the settlement if there are substantial opt-outs that expose them to additional liability.

The second issue is the confidential or public nature of the opt-out threshold. In securities class action settlements, the specific opt-out threshold is often contained in a confidential supplemental agreement. Some courts have allowed the threshold amount to remain confidential to prevent class members from using it for the improper purpose of obstructing the settlement and obtaining higher payouts. Other courts recently have required public disclosure of the supplemental agreement.

In preparing a draft term sheet, parties often agree that the settlement will include a blow provision, but they reserve negotiation until memorializing and finalizing the settlement as to the amount of the threshold or how it can be triggered.

Agreeing on Timing

The parties should include the agreed-upon settlement amount in the finalized term sheet. It is also good practice to specify the timing of when the settlement will be funded, most often into an escrow account. A certain number of days following preliminary approval is common. But there may be reasons to have all or part of the funding occur later, either after certain milestones such as final approval or when the settlement becomes “final” after all appeals have been exhausted, or related to a corporation’s tax year, depending on the needs of defendants and insurers.

Class counsel may also seek to include a “quick-pay” provision that allows class counsel to receive its court-awarded attorney fees from the settlement fund immediately upon approval by the district court, even if an appeal is filed. In return, class counsel will agree to refund the fees that it received in the event the award is reversed or reduced on appeal. The justification for a prompt-payment provision is two-fold: (1) Class counsel has often gone months, and even years, with no payment while investing thousands if not millions of dollars in the litigation; and (2) allowing class counsel to be paid promptly regardless of an objection or appeal may dissuade objectors from seeking to extract payments from class counsel in order to withdraw their objections or appeals merely so that class counsel can be timely paid.

It is important to disclose to the court any such quick-pay agreement—or any agreement at all related to the settlement. Other agreements related to class counsel’s attorney fees, such as free-sailing provisions in which defendants agree not to dispute class counsel’s attorney fee request, will be more closely scrutinized.

Other Terms

Other nonmonetary terms should also be addressed early in the settlement process, such as the following:

- whether the agreement in principle will remain confidential for a certain period of time;
- whether the parties will request a stay of litigation while they document the settlement;
- whether the defendants will timely issue the notice required by the Class Action Fairness Act of 2005;
- what will be the proposed time frame for notice to the class and who will be the proposed claims administrator; and
- whether the term sheet is binding.

And, finally, the parties should address how to resolve disputes that may arise in connection with finalizing the settlement, such as documenting the settlement, and in reaching agreement on or calculating the blow provision. The parties may seek to have the issues presented confidentially before a third-party mediator, rather than to air the issues publicly through court filings.

Conclusion

Structuring a securities class settlement that will be subject to approval by the court requires critical thought and experienced negotiators. Reaching agreement on the settlement amount is a big step. But the steps both before and after agreeing on the settlement amount are also important. The parties should anticipate and address the issues discussed above, preferably as early as drafting the initial term sheet. This will reduce the risks of opt-outs, objections, and court disapproval and put the parties on a clearer path toward ultimately obtaining the certainty, finality, and global peace sought through settlement.

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