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Recommended Citation

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http://lsr.nellco.org/nyu_lewp/104

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Judicial Review of Class Action Settlements

Jonathan R. Macey¹ and Geoffrey P. Miller²

Judicial scrutiny over settlements is the most important safeguard against inadequate or conflicted representation by class counsel.³ Yet the standards for performing this responsibility appear confused. Courts promote and discourage early settlements;⁴ pronounce that the scrutiny required for settlement proposals is exacting and deferential;⁵ esteem and denigrate the role of class counsel.⁶ Review of class action settlements takes the form of a list of factors uncertain in scope, ambiguous in meaning and undefined in

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³ Settlements of class actions require judicial approval before they can become effective. See Federal Rule of Civil Procedure 23(e). Similar requirements for judicial review of class action and derivative litigation settlements are contained in state class action rules.

⁴ Compare *Ressler v. Jacobson*, 822 F.Supp. 1551, 1554-55 (M.D.Fla. 1992) (“early settlements are to be encouraged”) and *In re M.D.C. Holdings Securities Litigation*, 1990 WL 454747, at *7 (S.D.Calif. 1990) (“[e]arly settlements [of class actions] benefit everyone involved”) with *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation*, 55 F.3d 768, 814 (3d Cir. 1995) (court should be wary before approving a settlement of a class action in its early stages) and *Luevano v. Campbell*, 93 F.R.D. 68, 86 (D.D.C. 1981) (“it is important to consider whether the settlement was reached after extensive factual development, so that counsel on both sides would have had information sufficient to make a reasonable assessment of their risks”).

⁵ See text accompanying notes ____, *infra*.

⁶ Compare *Austin v. Pennsylvania Dept. of Corrections*, 876 F.Supp. 1437, 1472 (E.D.Pa.1995) (recommendation of counsel is entitled to great weight) with *Mirfasihi v. Fleet Mortgage Corp.*, 356 F.3d 781, 785 (7th Cir. 2004) (class actions are rife with potential conflicts between class counsel and class members).

weight.⁷ Given that so many class cases settle,⁸ it would appear desirable to improve the clarity and efficacy of applicable rules.⁹

This article proposes a simple approach to judicial review of class action settlements. The key is to recognize that courts should apply different degrees of scrutiny for different issues depending on the respective competence of the court and class counsel. For questions going to the adequacy of the settlement, where no warning signals of

⁷ See text accompanying notes ____, *infra*.

⁸ See Thomas E. Willging et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 *New York University Law Review* 74, 143 (1996) (percentage of certified class actions resulting in settlement in the data set ranged from 62% to 100%). Settlement rather than trial is the norm in litigation generally. See National Center for State Courts, *Examining the Work of State Courts, 1999-2000: A National Perspective from the Court Statistics Project* 29 (Brian J. Ostrom et al. eds., 2001) (settlement rate about 96%); Leonidas Ralph Mecham, *Judicial Business of the United States Courts: 2001 Annual Report of the Director* 154 (2001) (approximately 98% of federal civil cases resolved short of trial).

⁹ Commentators have addressed aspects of class action settlements. Some criticize the process as insufficiently protecting absent class members. See, e.g., Susan Koniak & George Cohen, *Under Cloak of Settlement*, 82 *Virginia Law Review* 1051 (1996) (highlighting risks of intra-class conflicts and collusive settlements); Debra Lynn Bassett, *When Reform Is Not Enough: Assuring More Than Merely "Adequate" Representation in Class Actions*, 38 *Georgia Law Review* 927 (2004) (calling on courts to exercise more stringent review of adequacy of representation both at the certification and the settlement stages); Linda S. Mullenix, *Taking Adequacy Seriously: The Inadequate Assessment of Adequacy in Litigation and Settlement Classes*, 57 *Vanderbilt Law Review* 1687 (2004) (arguing that courts do an inadequate job of policing the adequacy of class representation when evaluating settlements); Howard M. Downs, *Federal Class Actions: Diminished Protection for the Class and the Case for Reform*, 73 *Nebraska Law Review* 646, 648 (1994) (criticizing judicial laxity in review of settlements). Proposals to upgrade the effectiveness of fairness hearings are found in Richard A. Nagareda, *Administering Adequacy in Class Representation*, 82 *Texas Law Review* 287, 348 (2003) (urging reviewing courts to require a "a reasoned explanation by the settling counsel of the choices made in the class settlement design"); William B. Rubenstein, *The Fairness Hearing: Adversarial and Regulatory Approaches*, 53 *UCLA Law Review* 1435 (2006) (outlining mechanisms to improve the accuracy of review at fairness hearings). Proposals to authorize the judge to transfer lead counsel rights to successful objectors are found in Richard A. Nagareda, *Administering Adequacy in Class Representation*, 82 *Texas Law Review* 287, 352 (2003) and Geoffrey P. Miller, *Competing Bids in Class Action Settlements*, 31 *Hofstra Law Review* 633-650 (2003). Problems of conflict of interest among class members in settlements are addressed in Nancy Morawetz, *Bargaining, Class Representation, and Fairness*, 54 *Ohio State Law Journal* 1 (1993) (calling for enhanced judicial scrutiny of allocation issues); Geoffrey P. Miller, *Conflicts of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard*, 2003 *University of Chicago Legal Forum* 581 (2003) (recommending use of a "veil of ignorance" perspective for intra-class conflict problems); David A. Dana, *Adequacy of Representation After Stephenson: A Rawlsian/Behavioral Economics Approach to Class Action Settlements*, 55 *Emory Law Journal* 279 (2006) (also employing a veil-of-ignorance perspective). A cost-benefit analysis of judicial review of settlements in several contexts, including class action litigation, is found in Sanford I. Weisburst, *Judicial Review of Settlements and Consent Decrees: An Economic Analysis*, 28 *Journal of Legal Studies* 55, 82-87 (1999). Guidelines for the review of settlements in mass tort actions are offered in Carrie Menkel-Meadow, *Ethics and the Settlements of Mass Torts: When the Rules Meet the Road*, 80 *Cornell Law Review* 1159 (1995); William Schwarzer, *Settlement of Mass Tort Class Actions: Order out of Chaos*, 80 *Cornell Law Review* 837 (1995);

collusion or inadequate bargaining leverage are found, the court should employ lenient scrutiny and approve the settlement if it has a rational basis. An intermediate level of scrutiny should apply to issues implicating the fairness of the settlement, including the allocation of settlement proceeds among subgroups in the class, the presence of coupon-type relief, “shotgun” settlements occurring very early in the litigation, and settlements in overlapping class actions. Here, if the initial inquiry raises concerns, the court should demand a well-reasoned explanation for the choices made. For the issue of attorneys’ fees and other questions presenting a direct conflict between the interests of class counsel and those of the class, courts should employ exacting scrutiny and require convincing evidence that the proposal is reasonable.

I. Existing Law

Appeals courts provide four types of instructions to trial courts in reviewing class action settlements. Some courts of appeal instruct their lower courts to use a basic standard. Others provide for the use of one of a number of “factor tests.” Still others articulate more simplified standards. In addition, courts sometimes also instruct the trial courts about the level of scrutiny to employ when reviewing settlements in class actions.

A. Basic Standard

The task of a trial court under Rule 23(e) is to assess whether the proposed settlement is “fair, reasonable and adequate.”¹⁰ Although the mantra “fair, reasonable and adequate” is often recited as an indivisible requirement, each word conveys information. “Reasonable” implies that the settlement should be a product of considered judgment and

and Richard A. Nagareda, *Turning from Tort to Administration*, 94 Michigan Law Review 899, 976-81 (1996).

not arbitrary. “Adequate” implies that the settlement should provide relief to the class sufficient in magnitude and rationally related to the harm alleged. “Fair” implies that the settlement should not discriminate between similarly-situated class members, and also suggests that the bargaining process must be at arm’s length.¹¹

B. Factor Tests

Beyond these general criteria, the “fair, reasonable and adequate” standard doesn’t provide much guidance. In the absence of instructions from the Supreme Court,¹² appeals courts have elaborated factor tests – laundry lists of items that the trial courts should evaluate. The Third Circuit’s nineteen-item approach is the most elaborate,¹³ but other courts employ variants similar in nature if less ramified in scope.¹⁴ Typically included are matters such as the complexity, expense and likely duration of the litigation, the risks of establishing liability and damages, the probability of collecting a judgment, the expected judgment if the case is successful, the value of the settlement, the reaction of the class to

¹⁰ FRCP 23(e)(1)(C). This language, adopted as part of the 2003 amendments to Rule 23, is a codification of case law interpreting the former rule, which required that “[a] class action shall not be dismissed or compromised without the approval of the court.”

¹¹ See *In re Jiffy Lube Securities Litigation*, 927 F.2d 155 (4th Cir. 1991). Some courts accomplish the same result with a non-statutory requirement that the settlement not be the “product of collusion.” E.g., *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.* 396 F.3d 96, 116 (2d Cir. 2005); *Reynolds v. Beneficial National Bank*, 288 F.3d 277, 279 (7th Cir. 2002).

¹² The closest the Supreme Court has come to interpreting the basic standard may be an offhand remark, that courts “judge the fairness of a proposed compromise by weighing the plaintiff’s likelihood of success on the merits against the amount and form of the relief offered in the settlement.” *Carson v. American Brands, Inc.*, 450 U.S. 78, 88 n.14 (1981). A description of judicial litigation appraisal outside the class action context is found in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424-25 (1968). The Supreme Court required that in considering a proposed reorganization plan involving compromises of claims against the debtor the bankruptcy judge should consider “all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated. Further, the judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. Basic to this process in every instance, of course, is the need to compare the terms of the compromise with the likely rewards of litigation.”

¹³ *In re Prudential Insurance Company of America*, 148 F.3d 283, 323 (3d Cir. 1998); *Girsh v. Jepson*, 521 F.2d 153, 157 (3d Cir. 1975).

the proposal, and the opinion of class counsel.¹⁵ The Advisory Committee on Civil Rules considered (but ultimately rejected) the idea of adding an explicit list of factors under Rule 23(e).¹⁶ Although a factor analysis is not contained in the rule, the Advisory Committee's notes recommend this approach as a form of best practice.¹⁷

¹⁴ Factor tests applicable in the federal circuits and selected states are outlined in the Appendix. A 15-factor test, together with 13 additional considerations, is outlined in the *Manual for Complex Litigation (Fourth)*, § 21.62 (Federal Judicial Center 2004).

¹⁵ Factor tests are also articulated as guides to awards of attorneys' fees; these typically include matters such as the time expended and skill displayed by counsel, the magnitude and complexity of the litigation, the risk of the case, and the size of the fund created. For example, the Third Circuit instructs trial courts to consider the following when deciding on an award of fees: (1) the size of the fund created and the number of persons benefited; (2) the presence or absence of substantial objections by members of the class to the settlement terms and/or fees requested by counsel; (3) the skill and efficiency of the attorneys involved; (4) the complexity and duration of the litigation; (5) the risk of nonpayment; (6) the amount of time devoted to the case by plaintiffs' counsel; (7) awards in similar cases; (8) the value of benefits accruing to class members attributable to the efforts of class counsel as opposed to the efforts of other groups, such as government agencies conducting investigations; (9) the percentage fee that would have been negotiated had the case been subject to a private contingent fee agreement at the time counsel was retained; (10) any innovative terms of settlement; and (11) other relevant factors. *Gunter v. Ridgewood Energy Corp.*, 223 F.3d 190, 195 n.1 (3d Cir. 2000); *In re Prudential Insurance Company of America*, 148 F.3d 283, 338-40 (3d Cir. 1998). In the Second Circuit, the relevant factors include: (1) the time and labor expended by counsel; (2) the magnitude and complexities of the litigation; (3) the risk of the litigation; (4) the quality of representation; (5) the requested fee in relation to the settlement; and (6) public policy considerations. *Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 50 (2d Cir. 2000). Factor tests for attorneys' fees are also found in applicable rules of attorney ethics. See, e.g., ABA Model Rule of Professional Conduct 1.5(a) (setting forth eight factors bearing on the reasonableness of a fee).

¹⁶ During the consultative process leading up to the 2003 amendments to Rule 23, the advisory committee considered a draft Rule 23(e)(5) which set forth an extensive list of factors for courts to consider. See Edward Cooper, *Class Action Advice in the Form of Questions*, 11 *Duke Journal of Comparative and International Law* 215 (2001); Minutes, Civil Rules Advisory Committee, October 16-17, 2000, p.6 (available at <http://www.uscourts.gov/rules/Minutes/CRACMOOO.pdf>). The committee report ended up omitting the factor approach from the proposed rule but did include the following list of factors in a comment on recommended practices:

- (A) a comparison of the proposed settlement with the probable outcome of a trial on the merits of liability and damages as to the claims, issues, or defenses of the class and individual class members;
- (B) the probable time, duration, and cost of trial;
- (C) the probability that the class claims, issues, or defenses could be maintained through trial on a class basis;
- (D) the maturity of the underlying substantive issues, as measured by the information and experience gained through adjudicating individual actions, the development of scientific knowledge, and other facts that bear on the ability to assess the probable outcome of a trial on the merits of liability and individual damages as to the claims, issues, or defenses of the class and individual class members;
- (E) the extent of participation in the settlement negotiations by class members or class representative, a judge, a magistrate judge, or a special master;
- (F) the number and force of objections by class members;
- (G) the probable resources and ability of the parties to pay, collect, or enforce the settlement compared with enforcement of the probable judgment predicted under (A);

Factor tests offer significant advantages. They helpfully signal that the trial court should consider all elements of the proposed deal, that the required investigation is fact-intensive, and that the court must exercise discretion in performing this task. They suggest issues that should be briefed by counsel and lines of inquiry for the court to pursue. Factor tests also reflect a sensible response to the limited role that courts of appeals can play in evaluating class action settlements.¹⁸

On the other hand, factor tests also suffer from shortcomings. These tests grow by accretion. They are commodious closets into which the residues of past cases can be deposited – closets that never need to be reorganized or cleaned out because the tests are suggestive only. Like the strategy of a general who fought the previous war, the factor tests created by judges generally fit past cases far better than future cases. Moreover, appeals

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- (H) the existence and probable outcome of claims by other classes and subclasses;
 - (I) the comparison between the results achieved for individual class or subclass members by the settlement or compromise and the results achieved – or likely to be achieved – for other claimants;
 - (J) whether class or subclass members, or the class adversary are accorded the right to opt out of the settlement;
 - (K) the reasonableness of any provisions for attorney fees, including agreements with respect to the division of fees among attorneys and the terms of any agreements affecting the fees to be charged for representing individual claimants or objectors;
 - (L) whether the procedure for processing individual claims under the settlement is fair and reasonable;
 - (M) whether another court has rejected a substantially similar settlement for a similar class; and
 - (N) the apparent intrinsic fairness of the settlement terms.

Report of the Civil Rules Advisory Committee, May 14, 2001, as revised July 31, 2001, pp. 57-58.

¹⁷ See Advisory Committee on the Federal Rules of Civil Procedure, notes to 2003 revisions of Rule 23 (praising the Third Circuit’s “helpful review” of the “many factors that deserve consideration”). Participants in the rulemaking process had an opportunity to revisit the issue in the wake of the Class Action Fairness Act, which required the Judicial Conference to report on “the best practices that courts can use to ensure that proposed class action settlements are fair to the class members.” Class Action Fairness Act of 2005, § 6, Pub. L. 109-2. The Judicial Conference declined the invitation, however, arguing that the rule already incorporates best practices. Report of the Judicial Conference of the United States on Class Action Settlements, February 2006.

¹⁸ If the settlement is rejected, the parties cannot appeal as of right (although a discretionary appeal may be permitted under 28 U.S.C. § 1292(b)). Interveners and objectors can appeal if the settlement is approved. See *Devlin v. Scardelletti*, 536 U.S. 1 (2002) (recognizing right of objectors to appeal). But dissenting parties will often find the effort inadvisable given the deferential “abuse of discretion” standard applicable on appeal.

courts never need to consider whether a factor test should be overruled. Over time, despite the good intentions that motivated their creation, they become unwieldy and disorganized, recalling the list of animals famously attributed to a Chinese encyclopedia in Borges' *The Analytical Language of John Wilkins*.¹⁹

The sheer number of factors is a problem. A trial judge could hardly be blamed for feeling a sense of foreboding when contemplating the nineteen items on the Third Circuit's checklist. Running through them all seems a dreary task. Courts applying these tests often recite the litany and engage in pro forma analyses, but their hearts are not in it.²⁰

Factor tests are also underinclusive. Important factors may be omitted from any list, no matter how ramified.²¹ The problem goes beyond mere exclusion of factors. Because the trial court must review the settlement as a whole, as a form of *gestalt*, even a complete specification of factors might not capture the full scope of the judicial task.

Factor tests are over-inclusive. General in scope, they may identify considerations extraneous to any given case.²² In consequence, courts might be misled into concluding that all factors are relevant to all cases, resulting in distorted analysis and unnecessary

See, e.g., *In re Pacific Enterprises Sec. Litig.*, 47 F.3d 373, 377 (9th Cir. 1995) (district court's determination to approve a settlement should be reversed only upon a strong showing of clear abuse of discretion).

¹⁹ Borges' list included animals (1) that belong to the Emperor, (2) embalmed ones, (3) those that are trained, (4) suckling pigs, (5) mermaids, (6) fabulous ones, (7) stray dogs, (8) those included in the present classification, (9) those that tremble as if they were mad, (10) innumerable ones, (11) those drawn with a very fine camelhair brush, (12) others, (13) those that have just broken a flower vase, and (14) those that from a long way off look like flies. Jorge Luis Borges, *The Analytical Language of John Wilkins* (El idioma analítico de John Wilkins) in Jorge Luis Borges, *Other Inquisitions* 101 (1964).

²⁰ This is one reason why the advisory committee decided not to recommend including an explicit factor test in the revised Rule 23. As the committee minutes explained, "the list itself obviously raises the question whether it is wise to encumber the rule with so many factors." See Minutes, Civil Rules Advisory Committee, October 16-17, 2000, p.7 (available at <http://www.uscourts.gov/rules/Minutes/CRACMOOO.pdf>).

²¹ The advisory committee recognized that the inherently open-textured nature of judicial inquiry implies that any list of factors will be incomplete: excluded matters "may, in a particular case, be more important than any matter offered as an example." Report of the Civil Rules Advisory Committee, May 14, 2001, as revised July 31, 2001, p.57.

²² See Report of the Civil Rules Advisory Committee, May 14, 2001, as revised July 31, 2001, p. 57 (noting that factors that may be important in some cases would be irrelevant in others).

effort.²³ These problems might be mitigated if the list contained meta-instructions for identifying when factors are or are not relevant; but no such instructions are provided.

Factors overlap. Consider the risk considerations articulated in some opinions – the risks of establishing liability, establishing damages, maintaining a class action through the trial, or enforcing a judgment.²⁴ These seem perfectly sensible. But what about the apparently independent factor of the reasonableness of the settlement compared to a possible recovery in light of the risks of litigation?²⁵ This reasonableness factor seems little more than a requirement that the court compare the proposed settlement recovery against the expected class recovery, as weighted by risks already included in other factors. Like the problem of over-inclusiveness discussed above, the overlapping of imbedded considerations may lead to distorted analysis and unnecessary effort.

Factor tests can inhibit the scope of judicial inquiry because courts may not take omitted factors seriously.²⁶ Factor tests may also inhibit original thinking. Provided with a simple framework, courts can simply run the checklist rather than engage in a coherent analysis of the settlement as a whole. The process can become mechanical.

Like all factor tests, the considerations do not always point in the same direction with the same force (if they did, the court could save time by looking at only one). A weighting is required. Should the courts assign equal weights to all the factors? The items are too diverse to make this plausible. But which factors should get more weight and

²³ See Minutes, Civil Rules Advisory Committee, October 16-17, 2000, p.7 (available at <http://www.uscourts.gov/rules/Minutes/CRACMOOO.pdf>) (a court “may feel obliged to consider and make findings” with respect to irrelevant factors).

²⁴ See *In re Prudential Insurance Company of America*, 148 F.3d 283, 323 (3d Cir. 1998).

²⁵ See *In re Prudential Insurance Company of America*, 148 F.3d 283, 323 (3d Cir. 1998).

²⁶ This was another reason why the advisory committee decided not to include a factor test in the proposed revision of Rule 23: because omitted factors may be taken less seriously, the codification of factors creates the risk that “practice may be frozen around the list.” See Minutes, Civil Rules Advisory Committee, October 16-17, 2000, p.7 (available at <http://www.uscourts.gov/rules/Minutes/CRACMOOO.pdf>).

which less? The courts of appeals don't provide much enlightenment. Some opinions indicate that the most important factor is the value of the settlement compared with what the class could expect from continued litigation.²⁷ This may be interpreted as weighting one consideration over others, but it leaves open how much weight is demanded and how other factors should be assessed. This lack of clarity may be typical of factor tests²⁸ but it is not an outcome that lends much predictability or certainty to the law.

For these reasons factor tests are problematic. Offering confusion as well as enlightenment, they sometimes appear to do little more than create a regime of untrammelled discretion: "the capacity to exercise official power as one chooses, by reference to such considerations as one wants to consider, weighted as one wants to weight them."²⁹

C. Simplified Tests

Implicitly recognizing the uncertainty of factor tests, courts have developed simplified approaches. These are not advanced as substitutes for factor tests, but rather as interpretations, clarifications, or strategies for implementation.

Simplifying approaches can be found in the area of merits review. An example is *Lachance v. Harrington*,³⁰ where the district court reduced the Third Circuit's test to a formula: maximum recoverable damages multiplied by the likelihood of recovering maximum damages in the event liability is established.³¹ The judge claimed that this

²⁷ See, e.g., *Petrovic v. Amoco Oil Co.*, 200 F.3d 1140, 1150 (8th Cir.1999) (the most important consideration in deciding whether a settlement is fair, reasonable, and adequate is "the strength of the case for plaintiffs on the merits, balanced against the amount offered in settlement.").

²⁸ See Cass Sunstein, *The Problem with Rules*, 83 Cal. L. Rev. 953, 999 (1995).

²⁹ Cass Sunstein, *The Problem with Rules*, 83 Cal. L. Rev. 953, 959 (1995).

³⁰ 965 F.Supp. 630 (E.D.Pa. 1997).

³¹ *Id.* at 638.

restated prevailing law.³² But when a nineteen factor test is reduced to an equation with two variables there can be little doubt something has changed.

Simplifying approaches have had most success in the area of attorneys' fees. Here, factor tests lend an aura of seriousness to the enterprise but contribute little of substance. Throughout the country the factor approach to attorneys' fees has been effectively been replaced by simplified modes of calculation: the lodestar approach, which multiplies counsel's reasonable hours times reasonable hourly rate times an adjustment factor, and the percentage approach, which awards fees as a reasonable percentage of the settlement value.³³

Simplified tests offer advantages as compared with factor tests. They are less burdensome for the courts and the parties. They focus attention on the most pertinent matters and reduce the risk that the court will overweight minor ones. They require the court to think through the settlement. On the other hand simplified approaches risk being too truncated. Even simplified approaches to attorneys' fees, successful as they have been, recognize that courts cannot apply them mechanically but must take account of the facts and circumstances of each case.³⁴

D. Level of Scrutiny

Appellate courts also instruct the trial courts about the level of scrutiny to employ. Sometimes the opinions speak of a highly demanding standard. Stressing that the burden of proof is on the proponents of the settlement,³⁵ these opinions require careful and

³² Id. at 638.

³³ See, e.g., *Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 53 (2d Cir. 2000) (endorsing use of either lodestar or percentage approach at the trial court's discretion).

³⁴ See, e.g., *Camden I Condominium Association, Inc. v. Dunkle*, 946 F.2d 768 (11th Cir. 1991) (setting forth a "benchmark" fee of 25% which could be adjusted up or down as circumstances require).

³⁵ See, e.g., *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation*, 55 F.3d 768, 785 (3d Cir. 1995).

comprehensive scrutiny of the settlement terms.³⁶ Some even cast the trial courts in the role of fiduciaries of the class³⁷ and demand that they exercise the highest degree of vigilance in protecting class interests.³⁸

But courts also speak in much more lenient terms. We find references to the limited role courts can play in evaluating settlements,³⁹ the danger of judicial tinkering with private bargains,⁴⁰ the virtue of settlement in class cases,⁴¹ the value of class counsel's judgment,⁴² and the fact that settlements, being practical compromises, require a forgiving attitude towards perceived imperfections.⁴³ Judges, in this view, are potential bulls in the china shop of class action litigation, threatening, albeit with good intentions, to shatter compromises delicately crafted by experienced counsel.⁴⁴ According to this deferential view, courts should presume that class action settlements are proper absent a strong showing to the contrary.⁴⁵

³⁶ In re Community Bank of Northern Virginia, 418 F.3d 277, 319 (3d Cir. 2005).

³⁷ See, e.g., Synfuel Technologies, Inc. v. DHL Express (USA), Inc., 463 F.3d 646 (7th Cir. 2006); Reynolds v. Beneficial National Bank, 288 F.3d 277, 280 (7th Cir. 2002); In re Cendant Corp. Litigation, 264 F.3d 201, 231 (3d Cir. 2001); In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation, 55 F.3d 768, 805 (3d Cir. 1995); In re Wireless Telephone Federal Cost Recovery Fees Litigation, 396 F.3d 922, 932 (8th Cir. 2005).

³⁸ Mirfasihi v. Fleet Mortgage Corp., 450 F.3d 745, 748 (7th Cir. 2006); Reynolds v. Beneficial National Bank, 288 F.3d 277, 280 (7th Cir. 2002).

³⁹ In re National Student Marketing Litigation, 68 F.R.D. 151, 155 (D.D.C.1974) (courts assume a "limited role" when reviewing a proposed class action settlement).

⁴⁰ Hanlon v. Chrysler Corp., 150 F.3d 1011, 1027 (9th Cir. 1998).

⁴¹ See, e.g., In re PaineWebber Limited Partnerships Litigation, 147 F.3d 132, 138 (2d Cir.1998) ("strong judicial policy in favor of settlements, particularly in the class action context"); Murillo v. Texas A&M University System, 921 F.Supp. 443 (S.D. Tex. 1996) (settlements in class action cases are "encouraged" and "favored").

⁴² Cotton v. Hinton, 559 F.2d 1326, 1330 (5th Cir.1977) (absent fraud, the trial court "should be hesitant to substitute its own judgment for that of counsel"); Flinn v. FMC Corporation, 528 F.2d 1169 (4th Cir. 1975); Lachance v. Harrington, 965 F.Supp. 630, 638 (E.D.Pa. 1997); Austin v. Pennsylvania Department of Corrections, 876 F. Supp. 1437, 1472 (E.D. Pa. 1995); In re Lloyd's American Trust Fund Litigation, 2002 WL 31663577 (S.D.N.Y. 2002).

⁴³ In re Vitamins Antitrust Litigation, 2000 WL 1737867, at *2 (D.D.C. Mar. 31, 2000) ("[t]he test is whether the settlement is adequate and reasonable and not whether a better settlement is conceivable").

⁴⁴ See Granada Investments, Inc. v. DWG Corp., 962 F.2d 1203, 1205 (6th Cir. 1992) (absent evidence of fraud or collusion, class action settlements are "not to be trifled with.")

⁴⁵ See e.g., City Partnership Co. v. Atlantic Acquisition Limited Partnership, 100 F.3d 1041, 1043 (1st Cir. 1996); In re Lloyd's American Trust Fund Litigation, 2002 WL 31663577 (S.D.N.Y. 2002); Chatelain v.

Instructions as to the appropriate level of scrutiny focus the court's and litigants' attention on the important issues, conserve on the resources of the court and the parties, avoid the potentially stultifying effects of factor analysis, require attention to the overall features of the settlement, and recognize the inherent and inevitable scope of trial court discretion in this area. On the other hand, the instructions as to level of scrutiny in the existing case law appear contradictory and confusing. They are like traffic lights signaling red and green at the same time.

II. Optimal Scrutiny

Given that existing standards for review of class action settlements display uncertainty and confusion, it may be advisable to seek a more coherent approach to the issue. The optimal strategy would consider three costs: the costs of approving bad settlements, the costs of rejecting good ones, and the costs of the review procedure itself.

One tradeoff is between types of judicial error. A demanding approach would weed out bad settlements but would also reject good settlements. Conversely, a lenient approach would allow good settlements to go forward but would also approve bad ones. Holding other factors constant, the optimal level of scrutiny would minimize the costs of both types of error.⁴⁶

Another tradeoff is between accuracy of result and cost of procedure. If a judge engages in extensive scrutiny of class settlements – conducts week-long settlement hearings, hears testimony from fact and expert witnesses, demands production of documents, permits objectors to conduct discovery and present an adversarial case – the

Prudential-Bache Securities, 805 F.Supp. 209, 212 (S.D.N.Y.1992); San Antonio Hispanic Police Officers' Organization, Inc. v. City of San Antonio, 188 F.R.D. 433, 453 (W.D. Tex. 1999).

⁴⁶ Ex ante effects would also need to be considered since the chosen level of scrutiny will influence the mix of cases presented to the court for review.

result might increase the accuracy of decisions. However, these procedures are costly. At the limit the hearing would be little different than a trial on the merits, thus obviating the efficiencies inherent in settlement. If on the other hand the court simply decided the approval question arbitrarily or on the basis of a few minutes leafing through the parties' submissions, the effect would conserve on litigation costs, but at the expense of increased error.

It is impossible to solve this problem perfectly. The best that can be accomplished is to derive a rough approximation based on realistic assumptions about the relevant parameters. The analysis is simplified, however, by the fact that the court is not itself crafting the settlement; the judge's only function is to approve or disapprove the deal as presented.⁴⁷ In this setting the tradeoff can be reframed as an analysis of comparative competence: as between the court and class counsel, whose judgment is more reliable? If the court's judgment is better, stringent (or de novo) review would be indicated; if counsel's judgment is better, the appropriate standard would be much more deferential.

Two considerations bear on the analysis of relative competence: information and interest.

III. Tiered Scrutiny

_____ Given that existing standards for review of class action settlements display uncertainty and engender confusion, it seems wise to seek a more coherent approach. As an alternative to the current farrago of overwhelming and often conflicting lists of factors and instructions, we propose a simple three-tiered approach, where each tier represents a level of judicial scrutiny. Under our proposal, considerations in the settlement are afforded

⁴⁷ See, e.g., *In re Chambers Development Securities Litigation*, 912 F.Supp. 822, 843 (W.D.Pa. 1995); *Ingram v. The Coca-Cola Co.*, 200 F.R.D. 685, 692 (N.D.Ga. 2001).

one of three levels of scrutiny based upon (1) the magnitude of the informational advantages of class counsel relative to the court and (2) the impartiality of the class counsel. Settlement considerations characterized by a large informational advantage for class counsel and little concerns with partiality are accorded the first tier of scrutiny, where courts employ the most lenient review requiring only a rational basis. Settlement considerations marked by a large informational disparity and moderate concerns of partiality are subject to the second tier of scrutiny, where courts employ an intermediate review, requiring a well-reasoned explanation. Finally, settlement considerations involving little informational disparity but a more pressing concern with impartiality justify a third, more exacting level of scrutiny, where the court demands convincing evidence supporting the determination.

This three-tier structure of deference based on informational advantages and partiality can be applied to any of the myriad questions courts confront in reviewing settlement proposals. To illustrate the analysis, we examine three paradigmatic questions faced by courts in this context: (A) the adequacy of the settlement; (B) issues of fairness among class members; (C) attorneys' fees. This analytical framework provides a cogent justification for differing levels of scrutiny and, in fact, serves to explain the differing levels of scrutiny applied in the reported cases.

A. Lenient Scrutiny: Adequacy

The adequacy of the settlement is the most important question facing the court in the review process, for it regards whether the class as a whole is getting a fair deal.. But the importance of the question does not translate into exacting scrutiny any more than the importance of good corporate management requires stringent enforcement of the duty of

care for directors.⁴⁸ The appropriate level of deference should turn on the two factors just mentioned: information and interest.

Consider the information issue. Courts have limited capacity to value what the class is receiving in the settlement. Many class action settlements require class members to file claims before receiving a recovery. But some class members do not make claims (even institutional investors leave money on the table).⁴⁹ In such cases the defendant may wind up paying less than the face value of the settlement.⁵⁰ More serious problems are presented by settlements that include coupons, vouchers, or other forms of non-pecuniary relief which may be difficult to value because of uncertainties about the take-up rate.⁵¹ Courts have no particular ability to estimate claim rates. Judicial competence is further strained in the case of settlements that require the defendant to cease or modify allegedly offensive conduct. These changes in the defendant's behavior may be as important as the cash component of the settlement,⁵² but judicial ability to appraise such forward-looking relief is suspect.

Attorneys for the class also face difficulties in valuing settlements involving non-cash consideration or unknown take-up rates. But counsel's knowledge will generally be superior to that of the court. Counsel will have participated in the design of the claim form and the claiming process, and will ordinarily have selected the settlement administrator

⁴⁸ See Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *Fordham Law Review* 437 (1993).

⁴⁹ See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 *Stanford Law Review* 411 (2005).

⁵⁰ Even so, in apparent recognition of the limits of judicial competence in the area, the Supreme Court has indicated that for purpose of setting attorneys' fees the courts may assess such settlements at face value. *Boeing Co. v. Van Gemert*, 440 U.S. 472 (1980).

⁵¹ See Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 *Law and Contemporary Problems* 97 (1997).

who will review submitted claims. Counsel will have negotiated the settlement and therefore will have a basis on which to assess the value of injunctive relief. Counsel will have been in contact with the representative plaintiff and possibly other class members whose input can provide information about class preferences. Counsel may also have retained experts to assist in structuring the non-pecuniary aspects of the settlement; the advice of such experts, provided candidly during settlement negotiations, may be useful in teasing out value for the class. Some of this information can be presented to the court at the fairness hearing, but the court's ability to understand, evaluate and process this information is limited.

Judges also lack competence in analyzing the value of the release being provided to the defendant. Because the case by definition will not have gone to trial, the judge may have little or no prior knowledge of the facts. He or she may have gleaned something through pretrial motions or discovery disputes, but this exposure will inevitably be sporadic. The judge's competence to evaluate the facts may also be suspect. Some class actions involve complex scientific or technical issues which the judge is unlikely to understand in any depth.⁵³ Class counsel, on the other hand, is likely to be versed in the facts. A preliminary investigation is required even before the complaint is filed.⁵⁴ Counsel will have consulted with the representative plaintiff. When technical or scientific issues are

⁵² Cf. *Blanchard v. Bergeron*, 489 U.S. 87, 95 (1989) (highlighting importance of injunctive relief in civil rights litigation).

⁵³ See, e.g., *Shaw v. Toshiba America Information Systems, Inc.*, 91 F.Supp. 2d 942 (E.D. Tex. 2000) (challenge to defect in computer memory technology).

⁵⁴ See FRCP 11(b)(3)-(4) (by presenting a pleading to the court, an attorney certifies "to the best of [his or her] knowledge, information, and belief, formed after an inquiry reasonable under the circumstances," that at factual allegations and denials have or are likely to have evidentiary support). Even greater pre-filing investigation is required in private securities fraud litigation. See Securities and Exchange Act of 1934 § 21D(b)(2) (complaint must specify each false statement or misleading omission and explain why the omission was misleading); *id.* § 21D(b)(2) (complaint must state "with particularity" facts giving rise to a "strong inference" that the defendant acted with the scienter required for the cause of action).

involved, counsel will ordinarily have researched the issues and consulted with technical experts. Counsel may also have taken the depositions of key defense witnesses and reviewed documents produced in response to discovery requests. The attorney may even have specialized training in the field.

There is less disparity between judge and counsel when it comes to the strength of legal claims and defenses. Judges are obviously skilled in the art of deciding legal issues, and the trial judge, in particular, can predict how he or she would rule. Yet the judge's information is imperfect. He or she will be evaluating legal questions without the benefit of briefing or argument and without the sort of deliberation that would ordinarily attend rulings on questions of law.⁵⁵ These problems are exacerbated when the issue involved is a mixed question of fact and law. Class counsel is also competent to evaluate issues of law. Although counsel can't read the judge's mind, he or she has presumably researched and thought through the legal issues more thoroughly than the court. Counsel is also likely to have superior capacities to assess the impact of legal rulings on the value of the case. Plaintiffs' lawyers are expert in pricing litigation risk, they do so, at least implicitly, every time they accept a case on a contingent-fee basis.⁵⁶

Judges have information about future litigation costs. If a judge intends to grant a pending motion to dismiss, for example, he or she has a good idea of the duration of the case if the settlement had not been reached – not long. The judge can also impose a scheduling order that sets time frames for the case, and thus may be able to predict what such an order would require. This knowledge would give the judge information pertinent

⁵⁵ For this reason, judges reviewing class action settlements refrain from deciding disputed questions of law. *Carson v. American Brands, Inc.*, 450 U.S. 79, 88 n.14 (1981).

⁵⁶ See Richard A. Nagareda, *Aggregation and its Discontents: Class Settlement Pressure, Class-Wide Arbitration, and CAFA*, 106 *Columbia Law Review* 1872, 1905-06 (2006).

to the class' future litigation costs. But the judge's control over timing is limited. The parties may come back with good reasons for seeking a continuance. The judge has no influence over what happens after verdict or settlement: the case may continue indefinitely as a result of appeals. Above all, the judge can influence, but cannot control, the parties' settlement behavior. The judge cannot know whether the parties, if they had not settled when they did, would have done so in a matter of weeks or gone all the way to trial. Class counsel, in contrast, lacks the information possessed by the judge about certain elements of timing, such as the judge's intentions regarding a scheduling order. But attorneys for the class can estimate the future expenses of the case and the effort that would be required to take the case to trial, and have superior ability to predict the probability and timing of settlement.

The respective competence of judge and class counsel is also affected by problems of hindsight bias. When the settlement is presented to the judge, the natural inclination is to ask why the attorneys did not press some apparently fruitful avenue of attack or push harder to obtain some element of relief. If objectors come forward to challenge the settlement, their filings and arguments will play into this all-too-human tendency.⁵⁷ The result could be an unfavorable attitude towards settlement terms that were reasonable when negotiated. Class attorneys, on the other hand, are not subject to hindsight bias: by definition, they negotiated the proposed settlement at a time when hindsight was not available.

Judges also face disadvantages in evaluating the settlement bargaining. The defendant's financial position, business strategy, and attitude toward settlement are all

⁵⁷ See Chris Guthrie et al., *Inside the Judicial Mind*, 80 *Cornell L. Rev.* 777, 802-03 (2001) (finding that judges are subject to hindsight bias).

potentially significant considerations, as are defense counsel's skills, connections and influence. The judge has no basis on which to evaluate these matters. Similarly, the judge is not present at the bargaining table, and so will not be able to assess the complex elements of bluff, threat, and deception that go into counsel's calculations. On this score counsel's competence is overwhelmingly superior to that of the judge.

Judges, dealing only with the cases that come before them, also have limited capacities to compare the settlement with settlements reached in other cases presenting similar or analogous facts. Class attorneys, in contrast, are likely to follow other class action litigation and to know, at least in general, the terms of other settlements, including ones not reported in official reporters. As between the attorneys and the judge, the attorneys have a superior ability to compare the terms of the settlement with settlements obtained in other cases.

The judge can, of course, attempt to reduce the disparity in competence by enhancing the degree of attention he or she gives to the issue. The judge can delve into the facts at the fairness hearing or can explore the give-and-take of the bargaining history. But this exercise may not uncover much. No matter how much the judge investigates, he is unlikely to obtain the sort of information that class counsel had available at the time the settlement was negotiated. Enhanced fairness hearings are also costly: at the limit they threaten to convert the proceeding into a mini-trial on the merits. So while an adequate fairness hearing is necessary, an elaborate one may not be cost-effective.

All these considerations add up to the conclusion that compared with class counsel, judges are not well-equipped to compare the value of the class claims being released with the value of the relief obtained. If information were the only relevant consideration, the

analysis would suggest a rule of deference similar to that displayed in constitutional law under the rubric of rational basis scrutiny: the court would conclude that the settlement was adequate unless no reasonable explanation for counsel's choices could be imagined.

However, the question of interest must also be considered. Judges, we may assume, are impartial when it comes to assessing the adequacy of the settlement. Attorneys for the class are not: their interest is to advocate for approval, and thus they will present the settlement in a favorable light.⁵⁸ Still this problem may be manageable so long as class counsel had appropriate incentives at the time the settlement was negotiated. Although counsel's incentives can never be perfectly aligned with those of the class,⁵⁹ the divergence of interest is relatively slight when it comes to the issue of adequacy. The attorney's ethical responsibility is to act as a vigorous advocate for the class.⁶⁰ Bigger recoveries enhance the lawyer's reputation and improve bargaining leverage. Most importantly, the attorneys' fees increase with class recoveries.⁶¹ Overall the disparity in partiality between judge and class counsel should not cause undue concern.

⁵⁸ See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 *University of Chicago Law Review* 1, 46-47 (1991) (fairness hearings are "pep rallies" in favor of approval).

⁵⁹ Neither of the practical alternatives – the lodestar and the percentage fee – accomplishes this result. The lodestar approach rewards attorneys for the hours expended rather than the result obtained (so long as the case generates some sort of a recovery for the class). The percentage approach offers a better alignment of incentives, but not a perfect one. Counsel has an incentive to maximize class recovery, but may also have an incentive to settle early for an amount below what the class could obtain from further litigation, in order to maximize the return to hours invested. This incentive is due to presumed declining marginal returns to effort in litigation. For an argument that the misalignment of interests between attorneys and the class could be eliminated by selling the class claims to the attorney, see Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 *University of Chicago Law Review* 1, 106-116 (1991) (outlining proposal for auctioning of class claims as potential solution to agency problems between class counsel and the class).

⁶⁰ See ABA Model Rules of Professional Conduct Preamble Comment [2] ("[a]s advocate, a lawyer zealously asserts the client's position under the rules of the adversary system").

⁶¹ Empirical evidence supports the conclusion that the courts' approach to fee awards constrains counsel's incentive to settle the case for too little. Regardless of the fee methodology used, the overwhelmingly significant determinant of the fee is simply the amount of the class recovery. See Theodore Eisenberg and Geoffrey Miller, *Attorneys' Fees in Class Action Settlements: An Empirical Study*, 1 *Journal of Empirical Legal Studies* 27 (2004).

When considerations of information and interest are combined, it appears that courts should exercise lenient scrutiny over the adequacy of proposed settlements. Unless indicators of fraud or collusion exist, the courts should not ordinarily substitute their judgment for that of class counsel. It should be incumbent on counsel to describe the strengths and weaknesses of the case and to account for why the proposal makes sense for the class in light of these attributes. Testimony of expert witnesses, mediators, and other professionals may be relevant in this regard.⁶² In general, as long as counsel offers an adequate explanation for the choices made, courts should defer to counsel's judgment.

This is a good description of what judges in fact do. When courts articulate a deferential approach to review of class action settlements, their focus is on the adequacy question.⁶³ The concern is that "parties represented by competent counsel are better positioned than courts to produce a settlement that fairly reflects each party's expected outcome in litigation."⁶⁴ For this reason, courts consistently appreciate that when "sufficient discovery has been provided and the parties have bargained at arms-length, there is a presumption in favor of the settlement."⁶⁵ Courts recognize that class action settlements involve imponderables⁶⁶ that judges are ill-equipped to evaluate:

⁶² See e.g., *Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 396 F.3d 96, 117 (2d Cir. 2005) (relying on mediator's testimony as to the adequacy of the settlement).

⁶³ See, e.g., *In re Agent Orange Prod. Liab. Litig.*, 818 F.2d 145, 171 (2d Cir. 1987), *Clark Equipment Co. v. Int'l Union, Allied Industrial Workers*, 803 F.2d 878, 880 (6th Cir. 1986), *Officers for Justice v. Civil Service Comm'n*, 688 F.2d 615, 625 (9th Cir. 1982) ("the court's intrusion upon what is otherwise a private consensual agreement negotiated between the parties to a lawsuit must be limited to the extent necessary to reach a reasoned judgment that the agreement is not the product of fraud or overreaching by, or collusion between, the negotiating parties, and that the settlement, taken as a whole, is fair, reasonable and adequate to all concerned.").

⁶⁴ *In Re: Pacific Enterprises Securities Litigation*, 47 F.3d 373 (9th Cir. 1994).

⁶⁵ *City P'Ship Co. v. Atlantic Acquisition Ltd. P'ship.*, 100 F.3d 1041, 1044 (1st Cir. 1996). See also *In re GMC Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 796 (3d Cir. 1995) ("[The] court determines whether negotiations were conducted at arms' length by experienced counsel after adequate discovery, in which case there is a presumption that the results of the process adequately vindicate the interests of the absentees."), *New York by Vacco v. Reebok Int'l*, 903 F. Supp. 532, 535 (S.D.N.Y. 1995),

[R]eview of the substantive terms of a [settlement] is often not productive. Courts cannot know the strength of ex ante legal claims and so are not privy to the relative strengths of the parties at the bargaining table. Nor can courts judge with confidence the value of the terms of a settlement agreement, especially one [involving] injunctive relief.⁶⁷

It is also in this light that we should understand the idea that the views of counsel should be given weight in the analysis of proposed settlements.⁶⁸ This factor appears mysterious given that counsel always recommends that the settlement be approved.⁶⁹ References to the weight to be accorded to counsel's views make sense, however, when they are directed to counsel's views on the overall value of the settlement.

In the rare cases where judges do reject a settlement on purported adequacy grounds three factors are typically present: (1) unmistakable indications of inadequacy; (2) failure to provide a reasoned explanation for the choices made, and (3) indications of unfairness in the settlement bargaining such as possible collusion or lack of bargaining power on the part of class counsel. Judge Scheindlin's opinion in *Polar International Brokerage Corp.*⁷⁰ provides an example. This securities class action resulted in a settlement where the only value for the class was "reassurance" that their rights had not been violated – a benefit that the court properly described as "virtually worthless."⁷¹ Although the case itself lacked

aff'd on the merits, 96 F.3d 44 (2d Cir. 1996), *Nat'l Rural Telecoms. Coop. v. DIRECTV, Inc.*, 221 F.R.D. 523, 528 (C.D. Cal. 2004).

⁶⁶ See, e.g., *Mars Steel Corp. v. Continental Illinois Nat. Bank and Trust Co. of Chicago* 834 F.2d 677, 682 (7th Cir. 1987) (evaluation of settlements involves "imponderables.");

⁶⁷ *Staton v. Boeing Co.*, 313 F.3d 447, 468 (9th Cir. 2002).

⁶⁸ See, e.g., *Luevano v. Campbell*, 93 F.R.D. 68, 88 (D.D.C. 1981) (counsel's professional judgment is "entitled to considerable weight in the court's determination of the overall adequacy of the settlement"); *National Treasury Employees Union v. United States*, 54 Fed.Cl. 791, 797 (Fed.Cl. 2002) (same); *Churchill Village, L.L.C. v. General Electric*, 361 F.3d 566, 576 (9th Cir. 2004); *Parker v. Anderson*, 667 F.2d 1204, 1210 (5th Cir. 1982).

⁶⁹ See, e.g., *In re Oracle Securities Litigation*, 136 F.R.D. 639, 645 (N.D.Cal.1991) ("[c]lass counsel's fee application is presented to the court with the enthusiastic endorsement, or at least acquiescence, of the lawyers on both sides of the litigation, a situation virtually designed to conceal any problems with the settlement not in the interests of the lawyers to disclose.")

⁷⁰ *Polar International Brokerage Corp. v. Reeve*, 187 F.R.D. 108 (S.D.N.Y. 1999).

⁷¹ *Polar International Brokerage Corp. v. Reeve*, 187 F.R.D. 108, 114 (S.D.N.Y. 1999).

merit, so that a small recovery for the class might have been justified,⁷² the lack of any tangible benefit for the class justified the court's refusal to endorse the settlement. In addition, counsel had failed to provide a reasoned explanation for the choices made, failed to specify the maximum possible recovery and vacillated between claiming that the defendant had done wrong and conceding that it had not. Other factors raised suspicion about counsel's motives: the rapidity of the settlement, the lack of investigation into the substantive merits, and counsel's apparently pusillanimous endorsement of the defendant's conduct, all suggested that the settlement bargaining might not have been conducted at arm's length.⁷³

*Reynolds v. Beneficial National Bank*⁷⁴ is another example of the conditions that must be present for a court to reject a settlement. In rejecting the trial court's approval of a nationwide settlement, Judge Posner pointed to unmistakable indications of inadequacy, such as the fact that the proposal would have released for no consideration claims of certain class members that might be worth \$20 million.⁷⁵ Counsel failed to provide a reasoned explanation for these and other dubious features. Plaintiffs' counsel may have lacked bargaining power because of the presence of a "reverse auction" in which the defendant played competing teams of plaintiffs' attorneys off against one another.⁷⁶ And the history of settlement bargaining raised suspicions of a collusive deal between counsel and

⁷² Judge Scheindlin eventually dismissed the case with prejudice, 108 F.Supp.2d 225 (S.D.N.Y. 2000), and sanctioned class counsel for bringing frivolous claims, 196 F.R.D. 13 (S.D.N.Y. 2000).

⁷³ 187 F.R.D. at 118 ("this settlement has earmarks of a non-arm's length, 'politely' collusive settlement: one providing a nonpecuniary benefit of very little value to shareholders and a fairly substantial award of attorney's fees to plaintiff's counsel for a modest amount of work.").

⁷⁴ 288 F.3d 277 (7th Cir. 2002).

⁷⁵ *Reynolds v. Beneficial National Bank*, 288 F.3d 277, 284 (7th Cir. 2002).

⁷⁶ On reverse auctions, see John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 Colum. L. Rev. 1343 (1995); Susan P. Koniak, *Feasting While the Widow Weeps: Georgine v. Amchem Products, Inc.*, 80 Cornell Law Review 1045 (1995).

defendant.⁷⁷ Given the obvious inadequacy of the relief for some class members, counsel's failure to provide a reasoned explanation for the choices made, counsel's lack of bargaining leverage, and the indicators of possible collusion between class counsel and the defendant, the court properly rejected the settlement.⁷⁸

Overall, the pronounced tendency of courts is to exercise lenient scrutiny of counsel's choices as to the adequacy of the settlement as a whole. In the absence of indications of fraud, collusion, or lack of arm's length bargaining, courts demand only that the advocates of the settlement demonstrate that the settlement as a whole is not irrational. This approach is appropriate and reasonable in light of the analysis presented above of the respective institutional competences of the courts and class counsel on the adequacy issue.

B. Intermediate Scrutiny: Fairness

⁷⁷ See *Reynolds v. Beneficial National Bank*, 288 F.3d 277, 284 (7th Cir. 2002) (noting "suspicious circumstances" of settlement negotiations).

Other Seventh Circuit cases rejecting trial court approval settlement proposals display similar features. For example, in *Mirfasihi v. Fleet Mortgage Corp.*, 450 F.3d 745 (7th Cir. 2006), the claims of certain class members were settled out for zero consideration, without a reasoned explanation being provided for this default. And the deal had the odor of collusion: as the court noted in rejecting an earlier version of the same deal, "[w]ould it be too cynical to speculate that what may be going on here is that class counsel wanted a settlement that would give them a generous fee and Fleet wanted a settlement that would extinguish 1.4 million claims against it at no cost to itself? The settlement . . . sold these 1.4 million claimants down the river." *Mirfasihi v. Fleet Mortg. Corp.*, 356 F.3d 781, 785 (7th Cir. 2004).

In *Synfuel Technologies, Inc. v. DHL Express (USA), Inc.*, 463 F.3d 646 (7th Cir. 2006), the Seventh Circuit reversed a trial court's approval of a consumer class action settlement involving alleged overcharges for package delivery services. Again, the basis for the court's disapproval represented far more than a disagreement with class counsel about the adequacy of the settlement. The settlement in question discriminated among class members by providing a regressive recovery scheduled based on number of items shipped, and involved a substantial element of non-pecuniary relief (in the form of credits against future service). The trial court had failed to demand a sufficient explanation for these features of the settlement. Also playing behind the scenes was the fact that counsel was seeking a fee based on a percentage of the estimated value of non-pecuniary relief, a circumstances presenting obvious concerns about conflicts of interest. See Brief for Cross-Appellant, 2005 WL 3736206 (appeal by law firm seeking award of fees on a percentage-of-recovery basis).

⁷⁸ See also *Molski v. Gleich*, 318 F.3d 937, 954 (9th Cir. 2003) ("In sum, the class members received nothing; the named plaintiff and class counsel received compensation for his injury and their time; and the defendant escaped paying any punitive or almost any compensatory damages. . . . This outcome is particularly problematic because only a minimal amount of discovery occurred in this case, and the primary components of the agreement were reached prior to filing of the class action.").

A different calculus applies when we move from the adequacy of the class consideration to issues of fairness. Two considerations are implicated by the requirement that a settlement be “fair” to the class: the allocation of the settlement among class members, and the process of settlement negotiation between class counsel and the defendant. The concepts of information and interest can be employed to derive an appropriate level of judicial scrutiny on these questions.

Consider allocation . Counsel usually has excellent information about the claims of different sub-groups in the class. But judges also are competent in this area. Ranking the relief to class members on an ordinal scale is easy compared with the task of assigning values to the overall features of the settlement.⁷⁹ Moreover, when the issue is a difference in recovery for subgroups in the class, the inquiry into the justification for the difference is different than the free-floating, complex analysis characteristic of the adequacy analysis. The question of allocation will typically involve one or only a few dimensions of comparison – for example, whether a potential statute of limitations defense justifies a lower recovery for class members with older claims. This task is one that courts are competent to perform. Thus, while counsel has an informational advantage with respect to judgments about allocation, the level of disparity is far lower than in the case of the overall adequacy of the settlement. The level of deference to counsel’s judgment should, in this respect, therefore be correspondingly lower.

⁷⁹ It was not difficult, for example, for the judge in to recognize that subgroups in the class were receiving different compensation when the settlement provided a schedule under which class members with 1-3 claims received one unit of relief, 4-7 claims received two units, 8-12 claims received 3 units, and over 12 claims received four units. See *Synfuel Technologies, Inc. v. DHL Express (USA), Inc.*, 463 F.3d 646, 649 (7th Cir. 2006) (recognizing that the settlement contained a regressive schedule of relief under which class members with more claims received less relief per claim than class members with fewer claims).

On the other hand, when we move from questions of adequacy to questions of allocation the advantage judges have over class counsel with respect to partiality becomes somewhat larger. An attorney interested only in maximizing his or her fee will typically be indifferent between settlements with different allocation schedules but identical overall class recoveries.⁸⁰ Class attorneys thus have less incentive to take care on the issue of allocation. Moreover, it may sometimes be in counsel's interest to favor one subgroup over another.⁸¹ There may occasionally be a risk that the settlement will skew towards the segment of the class that includes the named plaintiff.⁸² The defendant may also influence the allocation decision by favoring one subgroup or subclass over others.⁸³ For example, in settings where the defendant wishes to maintain good relations with current customers or

⁸⁰ See Richard A. Nagareda, *Turning from Tort to Administration*, 94 *Michigan Law Review* 899, 953 (1966) ("The distribution of compensation within the plaintiff class -- whether any particular claimant actually will receive what is promised in the grid -- will be of little concern to class counsel who wish simply to obtain a fee award based upon the aggregate benefit to the class as a whole, the hours worked by class counsel, or a combination of both.") For a formal argument that the problem of motivating counsel to achieve the best result for the class as a whole cannot be solved without sacrificing the incentive to allocate the proceeds fairly, see Bruce L. Hay, *The Theory of Fee Regulation in Class Action Settlements*, 46 *American University Law Review* 1429, 1472 (1997). But see Paul H. Edelman, Richard A. Nagareda and Charles Silver, *The Allocation Problems in Multiple-Claimant Representations*, 14 *Supreme Court Economic Review* 95 (2006) (arguing that maximization and allocation problems can be solved simultaneously with an appropriately designed fee structure).

⁸¹ For example, counsel may have individual, non-class clients whose recoveries are tied to the fortunes of one subgroup in the class. See Roger Cramton, *Individualized Justice, Mass Torts, and "Settlement Class Actions": An Introduction*, 80 *Cornell Law Review* 811, 832 (1995) ("[S]ide settlements suggest that class counsel has been laboring under an impermissible conflict of interest and that it may have preferred the interests of current clients to those of the future claimants in the settlement class"). For controversial settlements involving organized interests, the class counsel may shade the recovery to favor more vocal elements of the class whose opposition might threaten settlement approval. A similar misallocation may occur if the litigation is being conducted by a committee of lead counsel, where one member of the team threatens to defect unless the subclass or group he or she represents receives extra compensation.

⁸² This danger may be present, for example, in litigation under the Private Securities Litigation Reform Act, which presumptively selects as lead plaintiffs the candidate with the largest financial interest in the relief sought. 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb).

⁸³ See John C. Coffee, Jr., *Conflicts, Consent, and Allocation After Amchem Products--Or, Why Attorneys Still Need Consent to Give Away Their Clients' Money*, 84 *Virginia Law Review* 1541, 1545 (1998) ("[E]ven if the plaintiffs' attorney is neutral as to the various subgroups within the class, the attorney still has no incentive to resist an allocation plan favored by the defendant, who often has an interest in preferring one subgroup within the class over another.") For example, in settings where the defendant wishes to maintain good relations with current customers or investors, the defendant may be more willing to concede on points favoring the interests of the preferred group.

investors, the defendant may be more willing to concede on points favoring the interests of such preferred groups.

Because allocation decisions involve only a modest information disparity between court and counsel and the partiality disparity is high, the appropriate level of scrutiny should be more demanding than a requirement that the settlement have a rational basis.⁸⁴ On the other hand, the scrutiny does not need to be more exacting, than are justified in light of the significant costs of the review procedure itself.. It remains the case that counsel has superior knowledge of the factors bearing on allocation; and the danger of partiality, while potentially worrisome, does not usually rise to the level of a direct conflict between counsel and the class or any subgroup in the class. Thus a court addressing an allocation question should employ an intermediate level of scrutiny, requiring that counsel provide a well-reasoned explanation when the settlement treats one subgroup substantially more favorably than another.⁸⁵ This explanation should demonstrate why a class member shielded from knowledge of his or her position in the class could reasonably agree to the proposed schedule.⁸⁶ Material bearing on this question could include analysis of differences in the strength of the legal claims among class members, discussion of the transactions costs that would be involved in making finer distinctions among subgroups, and testimony or representations by counsel, mediators, experts, or others involved in the settlement process.

⁸⁴ Heightened scrutiny for allocation questions is recommended in Nancy Morawetz, *Bargaining, Class Representation, and Fairness*, 54 *Ohio State Law Journal* 1 (1993); Susan Koniak & George Cohen, *Under Cloak of Settlement*, 82 *Virginia Law Review* 1051 (1996).

⁸⁵ I interpret Richard Nagareda's recommendation that reviewing courts exercise "hard look" scrutiny over mass tort settlements as essentially specifying such an intermediate level of review. See Richard A. Nagareda, *Turning from Tort to Administration*, 94 *Michigan Law Review* 899, 903, 976-81 (1996). The same general effect would seem to follow from his later recommendation that judges demand from class counsel a "reasoned explanation of the class settlement terms." Richard A. Nagareda, *Administering Adequacy in Class Representation*, 82 *Texas Law Review* 287, 363 (2003).

⁸⁶ See Geoffrey P. Miller, *Conflicts of Interest in Class Action Litigation: An Inquiry into the Appropriate Standard*, 2003 *University of Chicago Legal Forum* 581 (2003); David A. Dana, *Adequacy of*

It appears that courts do, in general, apply an intermediate scrutiny on allocation questions. Some courts are explicit on this point, describing the Courts have described the level of scrutiny required under these circumstances as “heightened.”⁸⁷ Intermediate scrutiny is suggested when courts indicate that they are troubled by allocation issues, even if they do not reject a settlement for that reason alone,⁸⁸ or when courts demand good reasons for approving a settlement that forecloses claims of a subgroup in the class while providing no or minimal consideration.⁸⁹ Intermediate scrutiny is evident where appeals courts uphold a district court’s careful and thoroughly articulated consideration of allocation and collusion issues,⁹⁰ and where appeals courts remand cases because district courts approved the extinguishment of certain claims without adequate explanation.⁹¹ Where courts articulate an apparently lenient standard of scrutiny on allocations, it is typically the case that counsel has, in fact, made reasonable efforts to distribute the settlement proceeds fairly in circumstances where perfection in allocation is impossible.⁹²

Representation After Stephenson: A Rawlsian/Behavioral Economics Approach to Class Action Settlements, 55 Emory Law Journal 279 (2006).

⁸⁷ In re Lupron Mktg. and Sales Practices Litig., 228 F.R.D. 75, 88 & n.27 (D. Mass. 2005) (“When a settlement class is proposed, it is incumbent on the district court to give heightened scrutiny to the requirements of [Rule 23](#) in order to protect absent class members.”).

⁸⁸ See, e.g., Synfuel Technologies, Inc. v. DHL Express (USA), Inc., 463 F.3d 646 (7th Cir. 2006); Reynolds v. Beneficial National Bank, 288 F.3d 277, 282 (3d Cir. 2002) (observing presence of an “unremarked conflict of interest” because class members would receive no more than \$30 whether they had taken out three loans or twenty).

⁸⁹ See, e.g., Mirfasihi v. Fleet Mortgage Corp., 748 (7th Cir. 2006) (requiring convincing justification for a settlement that extinguished the claims yet provided no relief for one segment of the class); Molski v. Gleich, 318 F.3d 937 (9th Cir. 2003); National Super Spuds, Inc. v. New York Mercantile Exchange, 660 F.2d 9 (2d Cir. 1981).

⁹⁰ See, e.g., Rutter & Wilbanks Corp. v. Shell Oil, 314 F.3d 1180, 1189 (10th Cir. 2002).

⁹¹ See, e.g., Mirfasihi v. Fleet Mortg. Co., 450 F.3d 745, 751 (7th Cir. 2006) (remanding a settlement with instructions that the “district court should consider and analyze the full cross-section of potentially applicable state law and arrive at a clearer estimate of the potential value of the information-sharing class’s claims to allow proper evaluation of the reasonableness.”).

⁹² See, e.g., In re Nasdaq Market-Makers Antitrust Litigation, 2000 WL 37992, at *2 (S.D.N.Y. Jan. 18, 2000) (“[a]n allocation formula need only have a reasonable, rational basis”); Maley v. Del Global Technologies Corp., 186 F.Supp.2d 358, 367 (S.D.N.Y. 2002); In re American Bank Note Holographics, Inc., 127 F.Supp.2d 418, 430 (S.D.N.Y. 2001) (“[a]s with other aspects of settlement, the opinion of experienced and informed counsel [on appropriate allocation] is entitled to considerable weight”); In re PaineWebber Ltd.

Conversely, when courts articulate what appears to be a stringent standard of scrutiny on the allocation issue, the facts are typically egregious – as in the nationwide asbestos settlements which purported to extinguish substantial claims of “future” claimants, many of whom were unaware that they even were members of the class.⁹³

The requirement of fairness may also be interpreted to require that the settlement not be infected by conflict or collusion. The analysis of the appropriate scrutiny level in this context can again consider the factors of information and interest. The relevant context is the situation where “yellow flags” of impropriety are present – aspects of the settlement that are readily observable by the court, difficult for counsel to disguise, and predictive, (albeit imperfectly) of conflicted or collusive conduct.

Judges are ordinarily at a disadvantage, as compared with counsel, when it comes to recognizing the presence of conflict or collusion. When a yellow flag of potential collusion is present, however, the information disparity between judge and counsel is substantially lessened, and the justification for heightened judicial scrutiny correspondingly increased. As to interest, the usual presumption is that counsel is acting as a faithful fiduciary of the class. When yellow flags of collusion are present, that presumption no longer holds. Overall, therefore, the presence of yellow flags justifies a more intrusive level of judicial scrutiny than would be warranted if the only question were the adequacy of the settlement. But because these are only yellow flags – because the warning signals are imperfect proxies for misconduct – the court should not exercise the most intrusive possible review in this context. Instead, the court should require that counsel provide well-reasoned reasons

Partnerships Litigation, 171 F.R.D. 104, 129 (S.D.N.Y. 1997) (requiring that distinctions in settlement allocation be rationally based on legitimate considerations).

⁹³ *Ortiz v. Fibreboard Corp.*, 527 U.S. 815 (1999); *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997).

why the apparently troubling danger signals are in fact the result of considerations that are either benign or favorable from the perspective of the class.

Three yellow flags are most salient. First is the situation in which the judge observes evidence of a reverse auction settlement.⁹⁴ Markers of a reverse auction include the presence of overlapping class actions involving similar claims against the same defendant; settlement discussions limited to one of the competing groups of plaintiffs' attorneys; settlement discussions initiated by the defendant; settlement with the group of attorneys who present a less substantial threat of carrying the case forward to trial; lack of an extended process of settlement bargaining by the settling attorneys; agreements that promote the award of a lucrative and potentially justified attorneys' fee; and sudden expansion of the scope of the settled case (for example, by converting the action from a state-wide to a nation-wide class).⁹⁵

When some or all of these conditions are present, the court can infer the possibility of improper motivation. In such a case the court should require counsel to come forward with a well-reasoned explanation for the choices made, justifying them as either benign or favorable to the interests of the class. If counsel is able to come forward with such an explanation the court may conclude that the settlement is reasonable despite the superficial appearance of unfairness. If counsel is unable to come forward with a well-reasoned explanation the court should reject the settlement. Although reverse auction cases are

⁹⁴ A reverse auction can occur without collusion: the defendant plays off competing teams of plaintiffs' attorneys against one another without engaging in a collusive deal with any of them. But evidence of a reverse auction at least creates the possibility that the "winning" team of plaintiffs' attorneys has failed to deal with the defendant on a fully arms-length basis.

⁹⁵ Most of these factors were present in the leading reverse auction case, *Reynolds v. Beneficial National Bank*, 288 F.3d 277, 286 (7th Cir. 2002).

uncommon, this appears to be a rough approximation of the approach that courts actually use when confronted with evidence of a possible reverse auction settlement.⁹⁶

Another yellow flag arises when a case settles very early in the litigation,. Like settlements of overlapping classes, “shotgun” settlements present a context in which judicial competence vis-à-vis counsel is greater than in the ordinary class settlement. It is true that judges lack much information about the optimal timing of a settlement. Settling early presents significant potential benefits: class members receive compensation sooner; the deductions for attorneys’ fees and expenses are likely to be smaller; and the defendant may be willing to settle for more at an early stage of the litigation because doing so avoids more litigation costs. On the other hand early settlements present substantial risks: the class attorneys are vulnerable to settling cheap with a better-informed defendant; and early reasonableness in settlement behavior may impair plaintiffs’ bargaining position.⁹⁷

Assessing this risk-benefit tradeoff is a quintessential judgment call for class counsel. Thus if this were the only consideration, judicial review of the timing of class settlements would appropriately be deferential.

But the timing of settlements also impacts the issue of interest. Settlements reached very early, before the facts have been ascertained or the legal positions of the parties tested in any respect, reduce the transparency of the settlement process and impair the effectiveness of judicial review. In such cases the “cloak of settlement”⁹⁸ can leave the

⁹⁶ In *Reynolds*, for example, the court of appeals remanded the litigation for further consideration. On remand, the district court allowed the proponents of the settlement with an opportunity to explain why it represented a good value to the class, but rejected the proposed settlement in light of the inadequate representation provided by class counsel. *Reynolds v. Beneficial National Bank*, 260 F.Supp.2d 680 (N.D. Ill. 2003).

⁹⁷ On early, reasonable settlement offers as signals of weakness, see Robert Gertner & Geoffrey P. Miller, *Settlement Escrows*, 24 *Journal of Legal Studies* 87 (1994).

⁹⁸ The phrase is from Susan Koniak & George Cohen, *Under Cloak of Settlement*, 82 *Virginia Law Review* 1051 (1996).

judge with little to go on. Shielded from effective judicial oversight, the parties have greater leeway to engage in collusive or conflicted settlements. The concern about partiality therefore justifies more intrusive judicial scrutiny than would be warranted if the only question were the correctness of a professional judgment call by the class attorneys.

Thus if a settlement is presented for approval prior to any substantial discovery or testing of legal theories, the court can appropriately demand a well-reasoned explanation for why the compromise was reached so early in the process. To satisfy the requirement of reasonableness, proponents of the settlement should be required to justify the timing as benign or favorable to the class. Perhaps, for example, the pertinent facts are already known as a result of a government investigation or prior litigation against the same defendant. The defendant may have a compelling need to settle the litigation swiftly – for example, because it is engaged in merger negotiations that could be derailed by the uncertainties associated with the pending litigation. If a mediator has participated in the process, his or her testimony may be relevant. Even the simple explanation that the early settlement offered value to the class by conserving on litigation costs might be deemed sufficient if the court finds no other evidence of collusion or conflict of interest.

“Confirmatory” discovery may also provide a justification, although the court should be cautious because of the hydraulic pressures that may follow from a settlement-in-principle. The fee methodology may also be relevant: the risk of conflict or collusion in an early settlement would appear to be greater if counsel expects to be compensated on a percentage basis than if the fee will be determined under the lodestar method.⁹⁹ If the court concludes

⁹⁹ This is so because under the percentage method, counsel may be able to obtain a high hourly return when settlement occurs after only a small amount of time has been devoted to the case; the lodestar method, in contrast, in effect penalizes counsel for early settlements because the hours used to compute the lodestar would be small in number.

that the proponents have offered a well-reasoned explanation, it may approve the settlement despite the timing; otherwise it can reject the settlement and require the parties to develop more information.

The case law is consistent with the idea that early settlements should receive intermediate scrutiny. Thus, a concern for preserving meaningful judicial review appears to lie behind statements requiring at least some factual investigation by counsel as a precondition to approval.¹⁰⁰ It is also in this light that we should understand references in the case law to the need for heightened scrutiny of settlement classes.¹⁰¹ The problem with settlement classes is not that certification is deferred until settlement¹⁰² but rather that these arrangements remove an impediment (certification prior to settlement) that would otherwise deter early settlements. Settlement classes therefore indirectly increase the risks of impaired judicial review and conflicted or collusive behavior. Responding to this concern, courts allow settlement classes to go forward¹⁰³ but demand stronger justifications of the decisions made than would be required if the settlement had occurred later in the litigation.

A third yellow flag is the presence in the settlement of significant elements of non-pecuniary relief, especially “coupon” or “voucher” settlements. These have come under

¹⁰⁰ See, e.g., *Isby v. Bayh*, 75 F.3d 1191, 1199 (7th Cir. 1996); *In re Matzo Food Products Litigation*, 156 F.R.D. 600, 604 (D.N.J. 1994) (noting that the factual record must be sufficiently developed before settlement can be approved); *Murillo v. Texas A&M University System*, 921 F.Supp. 443 (S.D. Tex. 1996) (requiring that counsel have engaged in “sufficient discovery”).

¹⁰¹ See *Hanlon v. Chrysler Corp.*, 150 F.3d 1011, 1026 (9th Cir. 1998); *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation*, 55 F.3d 768, 805 (3d Cir. 1995) (reviewing courts should be “even more scrupulous than usual in approving settlements where no class has yet been formally certified”); *Weinberger v. Kendrick*, 698 F.2d 61, 73 (2d Cir. 1982) (“district judges [reviewing settlement class settlements] are bound to scrutinize the fairness of the settlement agreement with even more than the usual care”); *Mars Steel Corp. v. Continental Illinois National Bank & Trust*, 834 F.2d 677, 681 (7th Cir. 1987) (“when class certification is deferred, a more careful scrutiny of the fairness of the settlement is required”).

¹⁰² This can actually be a benefit to class members. See Geoffrey P. Miller, *Rethinking Certification and Notice in Opt-Out Class Actions*, 74 *University of Missouri Kansas City Law Review* 637 (2006).

attack in recent years as offering little to the class while unjustifiably enriching class counsel.¹⁰⁴ But coupon settlements can be beneficial: they may offer more value to the class than the best available cash settlement¹⁰⁵ and may under some conditions enhance deterrence in situations where damages are heterogeneous and difficult to determine.¹⁰⁶ The real problem with coupon settlements is the risk that because they are difficult to value, they will be used as means for justifying conflicted or collusive settlements.¹⁰⁷

For this reason, as with other yellow flags discussed in this section, judges should apply an intermediate level of scrutiny to coupon settlements, requiring the proponents of the settlement to provide a well-reasoned justification for the decision to use non-pecuniary relief. This explanation should include analysis of the features of the coupons showing that they are well-designed to provide genuine value to the class (for example, coupons that are transferable provide greater value than ones that are not, and coupons that can be used for a products that members of the class are likely to purchase in any event are preferable to coupons for unusual or idiosyncratic items).¹⁰⁸ Counsel should also explain why the settlement being presented to the court is at least as beneficial as the best available cash settlement.¹⁰⁹ Testimony about the course of settlement bargaining may be relevant in this regard: if attorneys for the class tried hard, but failed, to obtain an all-cash settlement, this

¹⁰³ See *Amchem Products, Inc. v. Windsor*, 591 U.S. 591 (1997).

¹⁰⁴ See, e.g., Christopher R. Leslie, *A Market-Based Approach to Coupon Settlements in Antitrust and Consumer Class Action Litigation*, 49 *UCLA L. Rev.* 991 (2002).

¹⁰⁵ See Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 *Law and Contemporary Problems* 97 (1997).

¹⁰⁶ See A. Mitchell Polinsky and Daniel L. Rubinfeld, *A Damage-Revelation Rationale for Coupon Remedies*, Stanford Institute for Economic Policy Research Discussion Paper No. 04-09 (2005).

¹⁰⁷ See Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 *Law and Contemporary Problems* 97 (1997); Richard A. Nagareda, *Administering Adequacy in Class Representation*, 82 *Texas Law Review* 287, 337 (2003).

¹⁰⁸ See Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 *Law and Contemporary Problems* 97 (1997).

¹⁰⁹ See Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 *Law and Contemporary Problems* 97 (1997).

evidence tends to support the use of coupon relief. The attorneys' fee application is also relevant. If counsel seeks a fee under the lodestar method, the presence of non-pecuniary relief is less troubling because the uncertainty in valuing such relief is not then being used as a basis to support the fee (this will almost always be the case for coupon settlements in federal court).¹¹⁰ On the other hand, if the fee request is based on a percentage calculation that does not include a value for the non-pecuniary relief, this circumstance could provide a reason for approving the settlement (because counsel would then be seeking no compensation for a benefit provided to the class).

Courts reviewing coupon settlements act consistently with the intermediate level of this analysis. Many coupon settlements have survived judicial review, notwithstanding the problems identified with these arrangements.¹¹¹ On the other hand, courts recognize the need to scrutinize coupon settlements more intensively than all-cash deals,¹¹² and reject them when they conclude that counsel has failed to provide a well-reasoned explanation for the choices made.¹¹³ Intermediate scrutiny is also implied by the Class Action Fairness Act, which requires that “[i]n a proposed settlement under which class members would be awarded coupons, the court may approve the proposed settlement only after a hearing to

¹¹⁰ The Class Action Fairness Act provides, albeit inartfully, that if the fee in a coupon settlement is to be calculated under the percentage method, the award to counsel is to be based on the value of the coupons actually redeemed. 28 U.S.C. § 1712(a). The non-redemption risk imposed by this requirement is significant enough to cause most plaintiffs' attorneys to request fees under the lodestar method, which is expressly approved under CAFA. 28 U.S.C. § 1712(b)(2) (“[n]othing in this subsection shall be construed to prohibit application of a lodestar with a multiplier method of determining attorney’s fees.”) At least one state – Texas – requires that class counsel be compensated with coupons along with the class. See Texas Code Ann. § 26.003(b).

¹¹¹ See, e.g., *In re Mexico Money Transfer Litigation*, 267 F.3d 743, 748 (7th Cir. 2001); *Shaw v. Toshiba America Information Systems, Inc.*, 91 F.Supp.2d 942 (E.D. Tex. 2000).

¹¹² See *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation*, 55 F.3d 768, 803 (3d Cir. 1995) (“the fact that the settlement involves only non-cash relief . . . is recognized as a prime indicator of suspect settlements”); *In re Mexico Money Transfer Litigation*, 267 F.3d 743, 748 (7th Cir.2001) (the fact customers got coupons is “enough to raise suspicions”).

determine whether, and making a written finding that, the settlement is fair, reasonable and adequate for class members.”¹¹⁴

C. Exacting Scrutiny: Attorneys’ Fees

Fee requests are categorically different than the other matters that come before the court on motion to approve a class action settlement. In other respects the court is simply asked to give a “thumbs up” to a settlement negotiated by the parties. In the case of fee requests, the court’s job is usually to set the fee. Counsel for the parties cannot establish a fee; and the court always has equitable discretion to award a fee it deems appropriate even if the parties have negotiated a different fee.¹¹⁵ The link between the fee determination and settlement approval is established by the fact that both are frequently performed at the fairness hearing, and that the settlement agreement may condition the effectiveness of the settlement as a whole on judicial approval of the requested fee. The functions, however, are conceptually distinct.

Application of the information and interest framework discussed above suggests that judges should play an active role in the setting of attorneys’ fees. Consider first the matter of information. Judges, it may be assumed, are at a considerable disadvantage on this issue compared with counsel. Although many judges have practiced law, it is probable that few have been professional plaintiffs’ attorneys. Their legal practices, moreover, are often far in the past. It is unlikely that many judges keep as current on questions of attorneys’ fees as do the plaintiffs’ attorneys who appear before them. This informational

¹¹³ E.g., *Synfuel Technologies, Inc. v. DHL Express (USA), Inc.*, 463 F.3d 646 (7th Cir. 2006); *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation*, 55 F.3d 768, 803 (3d Cir. 1995).

¹¹⁴ 12 U.S.C. § 1712(e).

¹¹⁵ See *Trief v. Dun & Bradstreet Corp.*, 840 F.Supp. 277, 282 (S.D.N.Y.1993) (when common fund created, court is not bound by amount of fee award requested by counsel).

disparity, however, is to some extent mitigated by the simplifying strategies of the lodestar and percentage methodologies, which provide the judge with guidance that will be useful in evaluating counsel's fee requests. Judges may also consult available empirical research which reports and analyzes fee and expense awards across a range of cases.

When it comes to interest, however, the disparity between judges and class counsel becomes large indeed. The request for an award of fees and expenses places class counsel in a direct conflict with the interests of the class. Because the defendant is typically indifferent between paying the class and paying its lawyers, the matter is nearly a zero-sum game: the more counsel gets in fees and expenses, the less will be available to class members in recovery. In these circumstances, the partiality of counsel makes their judgment on the proper award of fees inherently suspect.

When the analyses of information and interest are combined, the result is a requirement of exacting scrutiny. Courts should not defer to counsel's requests. Instead, the court should demand from plaintiffs' counsel a convincing showing that the amounts requested for fees and expenses are, in fact, within the range of reason.¹¹⁶ If counsel fails to make such a showing, the court should award fees and expenses only up to the level justified by the information presented.

This requirement of exacting scrutiny is articulated in the authoritative sources. Exhortations to active involvement in fee requests are found in the advisory committee notes to Rule 23(e) itself.¹¹⁷ Courts recognize that the fee request presents a direct and

¹¹⁶ The concept of the range of reason can be fleshed out by examining the difference between the proposed fee and the mean fees awarded by courts in class action cases of similar dimension. See Theodore Eisenberg & Geoffrey P. Miller, *Attorneys' Fees in Class Action Settlements: An Empirical Study*, 1 *Journal of Empirical Legal Studies* 27 (2004).

¹¹⁷ See Fed.R.Civ.P. 23(h), 2003 Advisory Committee Notes (“[a]ctive judicial involvement in measuring fee awards is singularly important to the proper operation of the class-action process.”)

unavoidable conflict of interest between attorneys and class counsel.¹¹⁸ The fee request creates a “danger . . . that the lawyers might urge a class settlement at a low figure or on a less-than-optimal basis in exchange for red-carpet treatment for fees.”¹¹⁹ Accordingly, courts safeguard the interests of the class.¹²⁰ The need for heightened,¹²¹ even “beady-eyed”¹²² scrutiny has been described as “especially acute”¹²³ and a “heavy [judicial] duty”.¹²⁴ Indeed, where district courts fail to provide adequate explanation for the basis of their approval of such requests, appellate courts are willing to find that district courts abused their discretion, and to vacate and remand settlement orders.¹²⁵

The general requirement of exacting scrutiny of fee requests may be differentially administered depending on the context. Several situations are relevant. First is the case where the court independently sets the fee (for example, where the settlement agreement says nothing about attorneys’ fees, or states only that counsel will apply to the court for an award). No deference is warranted in these cases: the court should independently

¹¹⁸ See, e.g., *Staton v. Boeing Co.*, 313 F.3d 447 (9th Cir. 2002); *In re Cendant Corp. Litigation*, 264 F.3d 201, 254-55 (3d Cir. 2001) (explaining that because clients seek to maximize recovery and lawyers seek to maximize fees, “there is often a conflict between the economic interests of clients and their lawyers, and this fact creates reason to fear that class counsel will be highly imperfect agents for the class”); *In re Cendant Corp. PRIDES Litigation*, 243 F.3d 722, 730 (3d Cir. 2001) (discussing “the danger inherent in the relationship among the class, class counsel, and defendants” and recognizing “an especially acute need for close judicial scrutiny of fee arrangements in class action settlements”); *In re WPPSS Litigation*, 19 F.3d 1291, 1302 (9th Cir. 1994); *Matter of Continental Illinois Securities Litigation*, 962 F.2d 566, 583 (7th Cir. 1992); *Skelton v. General Motors Corp.*, 860 F.2d 250, 253 (7th Cir. 1988), cert. denied, 493 U.S. 810 (1989) (once attorneys secure settlement for class, their role changes from fiduciary for clients to claimant against fund).

¹¹⁹ *Weinberger v. Great Northern Nekoosa Corp.*, 925 F.2d 518, 524 (1st Cir. 1991).

¹²⁰ *Florin v. Nationsbank of Georgia N.A.*, 60 F.3d 1245, 1247 (7th Cir. 1995).

¹²¹ *In re Unisys Corp. Retiree Medical Benefits ERISA Litigation*, 886 F. Supp. 445, 457 (E.D.Pa. 1995) (in common fund case court should apply heightened judicial scrutiny to fee request); *Weinberger v. Great Northern Nekoosa Corp.*, 925 F.2d 518, 526 (1st Cir. 1991); *In re Fine Paper Antitrust Litigation*, 840 F.2d 188, 195-96 (3d Cir. 1988).

¹²² *Reynolds v. Beneficial National Bank*, 288 F.3d 277, 286 (7th Cir. 2002).

¹²³ *In re GMC Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 820 (3d Cir. 1995).

¹²⁴ *Piambino v. Bailey*, 757 F.2d 1112, 1139 (11th Cir. 1985).

¹²⁵ See *Powers v. Eichen*, 229 F.3d 1249, 1257-58 (9th Cir. 2000), *Gunter v. Ridgewood Energy Corp.*, 223 F.3d 190, 192 (3d Cir. 2000).

determine the fee, and should view counsel's fee request on essentially the same terms as it would any presentation from a party in an adversarial proceeding.

A common variant is the situation where the settlement agreement and notice state that counsel intends to apply to the court for an award of fees in or up to a certain amount or percentage. These disclosures express counsel's intentions and thus provide information that might be pertinent to the class member's decision whether to opt out or object. These statements constrain the court's discretion, but only on the upside; awards above those mentioned in the settlement notice would arguably alter the terms of the settlement in a manner adverse to the class and thus require a new notice and fairness hearing. This is not a serious constraint because if the plaintiffs' attorneys have stipulated that they will not seek a fee above a certain amount the court has no reason to award a higher fee.

Representations about the fee counsel intends to seek should not, however, constrain the court's discretion to award a fee lower than that contemplated in the notice. Lack of objection to the fee on the part of class members provides scant support for the reasonableness of the fee given that class members rarely object to anything.¹²⁶ Nor should the court allow the proposed fee to operate as an "anchor" for analysis.¹²⁷ Instead the court should set the fee based on an independent analysis, viewing the announced fee target as only one option with no particular priority among many others.

¹²⁶ See Theodore Eisenberg and Geoffrey Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues*, 57 *Vanderbilt Law Review* 1529 (2004).

¹²⁷ See Gretchen B. Chapman & Eric J. Johnson, *Incorporating the Irrelevant: Anchors in Judgments of Belief and Value*, in Thomas Gilovich, Dale Griffin, and Daniel Kahneman, eds., *Heuristics and Biases: The Psychology of Intuitive Thought* 120-138 (2002); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 *Science* 1124 (1974).

The analysis changes when the defendant pays the fee.¹²⁸ If the settlement does not generate a common fund – for example, consumer class actions with non-pecuniary relief or corporate litigation resulting in “therapeutic” governance changes – the defendant must pay the fee if it is to be paid at all. In such cases the settlement agreement will often contain a clear sailing clause which provides that the defendant will not object to a fee award up to a certain amount.

The appropriate level of judicial deference to clear sailing agreements has been controversial. On the one hand, they might appear not to involve the class’s interests at all since the fee is not coming out of the class’s pockets. To the extent class interests are involved, the defendant’s self-interest may be thought to protect against excess. Because the adversaries have essentially agreed to a fee – the defendant promising not to object and the plaintiff agreeing (at least implicitly) not to seek more – the court may be tempted to defer. The problem, however, is that the bargaining process is suspect: when clear sailing agreements are negotiated along with the merits relief, the plaintiff may agree to less for the class in exchange for a higher fee.¹²⁹ The degree of scrutiny should not be reduced merely because the defendant has agreed to pay the fee separately from the class recovery. Given simultaneous negotiation of the fees and merits, the parties have little difficulty trading one off against the other.¹³⁰

¹²⁸ There is nothing, in principle, to prevent the parties from making such an agreement in the ordinary common fund case; the parties could agree that in addition to endowing a fund for the benefit of the class the defendant will make a separate payment to counsel. But since the common fund provides the resources out of which a fee can be paid, the defendant has no interest in how the proceeds are distributed between the class and counsel. Accordingly, defendants never, or almost never, agree to pay counsel in true common fund cases.

¹²⁹ See William D. Henderson, *Clear Sailing Agreements: A Special Form of Collusion in Class Action Settlements*, 77 *Tulane Law Review* 813 (2003).

¹³⁰ See *Staton v. Boeing Co.*, 313 F.3d 447 (9th Cir. 2002); *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litigation*, 55 F.3d 768, 819-20 (3d Cir. 1995).

The tools of information and interest can assist analysis here. Relative to class counsel, judges lack information about the substantive give-and-take in settlement bargaining. But they are equipped to evaluate whether the process itself is designed to generate good outcomes for the class. On this score the disparity in information between judge and counsel is slight. As to interest, counsel's desire for a higher fee is directly adverse to the interests of the class in maximizing the settlement proceeds. The analysis suggests, therefore, that courts should apply exacting scrutiny over fees sought pursuant to clear sailing agreements that are negotiated concurrently with the merits relief. In practice the courts have recognized the problem of conflict of interest presented here, and have in fact imposed a form of heightened scrutiny over their provisions.¹³¹ Exacting scrutiny over clear sailing agreements negotiated simultaneously with the merits relief appears appropriate.¹³²

A different analysis obtains if the clear sailing agreement is negotiated after agreement on merits.¹³³ If the parties truly separate these negotiations, a clear sailing agreement carries an imprimatur of validity. Once the merits relief is concluded a collusive tradeoff is impossible. The defendant has an incentive to negotiate vigorously over fees. In such a case the class either has no interest in the fee – its compensation having already

¹³¹ See, e.g., *Weinberger v. Great Northern Nekoosa Corp.*, 925 F.2d 518, 520-25 (1st Cir. 1991); *BTZ, Inc. v. Great N. Nekoosa Corp.*, 47 F.3d 463, 465 (1st Cir. 1995); *In re Skinner Group, Inc.*, 206 B.R. 252, 262 n.14 (N.D. Ga. 1997); *Levit v. Filmways, Inc.*, 620 F.Supp. 421, 423024 (D.Del. 1985); *Duhaim v. John Hancock Mut. Life Insurance Co.*, 989 F.Supp. 375 (D.Mass. 1997); *Clark v. Experian Information Solutions, Inc.*, 2003 WL 22940579 (D.S.C. 2003).

¹³² However, given the advantages clear sailing agreements offer of reducing risk, coupled with the information they potentially provide the court as to reasonable fees, they should not be declared per se invalid, as recommended by Professor Henderson. See William D. Henderson, *Clear Sailing Agreements: A Special Form of Collusion in Class Action Settlements*, 77 *Tulane Law Review* 813 (2003).

¹³³ There is no legal requirement that counsel separately negotiate fees and merits. Cf. *Evans v. Jeff D.*, 475 U.S. 717, 737-38 (1986) (rejecting the argument that fees and merits must be separately negotiated in fee-shifting context). But nothing prevents a court, exercising its responsibility to review class action settlements under Rule 23(e), from applying a heightened level of scrutiny to fee requests based on clear sailing agreements simultaneously negotiated with the merits.

been determined – or its interest is adequately represented by the defendant. The problem of partiality is largely gone. Accordingly, where there is a bona fide separation of fees and merits, the court should not exercise exacting scrutiny over the fee request.¹³⁴

Finally, consider the situation where the class is entitled to an award of fees under a fee-shifting statute. Here, too, the appropriate level of judicial scrutiny should depend on whether the parties have separated the negotiation of fees and merits. Where a bona fide, demonstrable separation has occurred, the court may apply deferential scrutiny.¹³⁵

Exacting scrutiny is warranted, however, if the parties combine the negotiation of fees and merits and agree either to a lump-sum common fund coupled with a waiver of rights under the fee-shifting statute or to a merits settlement coupled with a limitation on the defendant's statutory fee obligation.

IV. Tiered Scrutiny for Business Decisions

Applying graduated levels of scrutiny based on characteristics of the underlying inquiry is a practice wholly familiar to courts. It is well established, for example, that judges apply one of three levels of scrutiny to the decisions of corporate boards and management. Courts apply an extremely deferential review to ordinary business decisions, an intermediate level of review to takeover transactions, and a heightened scrutiny to business decisions threatened by self-interest. As discussed more fully below, our proposed three-tier structure is not only in accord with this type of judicial inquiry, but the driving considerations of information disparity and impartiality motivating our proposal

¹³⁴ To obtain the benefits of this lower level of scrutiny the parties may wish to provide the court with evidence substantiating that the separation of fees and merits negotiations was, in fact, bona fide. A written agreement in principle, dated before the fee negotiations commenced, would be probative, as would the testimony of mediators or others who participated in the settlement negotiations.

¹³⁵ See *In re Fine Paper Antitrust Litigation*, 751 F.2d 562, 582-83 (3d Cir. 1984) (recognizing that when the negotiations are separated, the court may rely on the workings of the adversary system to generate an appropriate fee).

also serve as a lens through which we can understand why these varying levels of judicial deference to business decisions have developed. To highlight their mutually reinforcing features, our three-tiered proposal and the regime of graduated scrutiny of business judgments are summarized in Figure 1 below.

Figure 1: Standards of Review and Levels of Scrutiny

Standard of Review:	Deferential:	Intermediate Scrutiny:	Strict Scrutiny:
Issue involved in board/management decision:	Ordinary business decisions.	Allocational issues among classes of claimants (takeovers)	Conflicts of Interest (self-dealing)
Issue involved in Class Action Settlement:	Ordinary settlement decisions: e.g., adequacy	Allocational issues among classes of claimants	Conflicts of Interest (self-dealing)

A. Lenient Scrutiny: Ordinary Business Decisions

In the context of deference to corporate decision-making, the most lenient judicial scrutiny is applied to ordinary business decisions. Courts use the business judgment rule to insulate the board from liability even where their actions are negligent, so long as there is no evidence of bad faith. In *Shlensky v. Wrigley*,¹³⁶ the Illinois Supreme Court reasoned that unless the conduct of the defendant-directors “at least borders on”¹³⁷ fraud, illegality, or conflict of interest, the court should not interfere with the business judgment. This rule of deference to business decisions is motivated by the recognition that judges are ill equipped to question the business judgments of business professionals. A leading case on this point – old but still expressing good law – is *Dodge v. Ford Motor Co.*¹³⁸ The authorities cited in *Dodge* make it clear that there must be fraud or a breach of good faith to justify a court’s intrusion into the internal affairs of corporations. This is evidenced by the *Dodge* court’s refusal to interfere with the directors’ decision expand the business at the

¹³⁶ 237 N.E.2d 776 (Ill. 1968).

¹³⁷ 237 N.E.2d 776, 780 (Ill. 1968).

expense of current income (the board decision called for lower prices to expand sales). The *Dodge* court's reluctance to question the judgment of the directors was motivated by its explicit recognition that "judges are not business experts."¹³⁹

This judicial reluctance to question business judgments mirrors (and is reinforced by) our analytical framework focusing on information disparity and impartiality. Recognizing that boards and management possess superior information regarding the specifics of the business, courts will not question their judgment in the absence of bad faith. This reasoning is consistent with our analysis suggesting courts should be deferential to class counsel in considering the adequacy of a settlement proposal on account of the relative competence of the court as compared with class counsel. The reasoning in *Smith v. Van Gorkem*¹⁴⁰ that the lenient scrutiny afforded by the business judgment rule applies only to decisions that are "informed," further echoes and underscores the importance of the information disparity. The deference to class counsel regarding adequacy, like the deference to management decisions, is premised on the notion that these parties have an informational advantage over the court. Where this informational advantage does not hold, the justification for deference is weakened.

B. Intermediate Scrutiny: Takeovers

Courts apply a second, intermediate level of scrutiny to business decisions in the takeover context. This intermediate scrutiny was developed in *Unocal Corp. v. Mesa Petroleum Co.*¹⁴¹ where the Delaware Supreme Court considered the proper role of the board in hostile tender offers. Recognizing the self-interest problem inherent to the

¹³⁸ 170 N.W. 668 (Mich. 1919).

¹³⁹ 170 N.W. 668, 684 (Mich. 1919).

¹⁴⁰ 488 A.2d 858 (Del. 1985)

¹⁴¹ 493 A.2d 946 (Del. 1985).

takeover defense situation, the *Unocal* court was unwilling to grant the level of deference afforded by the business judgment rule in this context, as doing so would confer entirely too much power on the target board without much accountability and could thereby facilitate entrenchment. On the other hand, the heightened scrutiny of the fairness standard seemed inappropriate, as the Chancery Court specifically found the board had concluded in good faith that it had reasonable grounds to believe the hostile offer posed a threat to Unocal's corporate policy and effectiveness. Finding both the lenient scrutiny of the business judgment rule and the exacting scrutiny of the fairness standard inappropriate for the inquiry, the *Unocal* court created an intermediate standard of scrutiny.¹⁴² This intermediate scrutiny is satisfied so long as the defensive measure is reasonable in relation to the threat posed by the hostile tender offer.

Like the lenient scrutiny of the business judgment rule, the intermediate scrutiny standard in the context of corporate takeovers can also be understood in terms of the information and impartiality framework we propose. Indeed, the very reasoning behind the *Unocal* court's development of the intermediate standard echoes our discussion compelling intermediate scrutiny for fairness issues in class settlements. In the class settlement context the intermediate scrutiny is justified because there is some risk class counsel may not be impartial as to allocation but no direct conflicts of interest¹⁴³ requiring exacting scrutiny. Analogously, the *Unocal* court's efforts were motivated by the recognition that self-interest could taint the impartiality of the target board. This threat, however, was tempered by the finding of good faith, thus making the most exacting scrutiny inappropriate. Likewise, the requirement laid down by the *Unocal* court that the board action be reasonable in relation

¹⁴² 493 A.2d 946 (Del. 1985). See also Andrew G.T. Moore II, *The Birth of Unocal—A Brief History*, 31 Del. J. Corp. L. 865. As the sole living member of the court to decide *Unocal*, Judge Moore's analysis is revealing.

to the threat posed roughly tracks the requirement of a well-reasoned explanation to satisfy the intermediate scrutiny of our proposed three-tier structure.

C. Exacting Scrutiny: Conflict of Interests

Finally, a third, more exacting level of scrutiny is applied to business decisions involving a conflict of interests. Where a fiduciary duty is accompanied by a substantial threat of self-dealing, courts invoke the exacting scrutiny of the entire fairness or intrinsic fairness test and its resulting shift of the burden of proof.¹⁴⁴ For example, this standard is utilized to address disputes arising in management buy-outs,¹⁴⁵ squeeze-out mergers between majority and minority shareholders,¹⁴⁶ and transactions between a parent corporation and a subsidiary.¹⁴⁷ Where there is a conflict of interests, the entire fairness test requires the court to examine both the procedure of the deal (fair procedure) and the deal price (fair price),¹⁴⁸ and the burden is on the board to satisfy both judicial inquiries. On the other hand, corporate law will typically allow conflicted transactions to go forward, notwithstanding the risk of self-dealing, if the proposal has been approved by disinterested parties with authority to act in the matter.¹⁴⁹

The heightened scrutiny applied conflict of interest transactions, like the two lesser forms of scrutiny into business judgments, maps well onto our analytical framework focusing on information disparity and impartiality. We argue for enhanced judicial scrutiny of conflict of interest considerations in class settlement proposals, specifically attorney fee proposals, where there is a direct conflict of interest between class counsel and

¹⁴³ Recall the qualifying assumption that fee negotiations are separate.

¹⁴⁴ *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

¹⁴⁵ *Mills Acquisition v. Macmillan*, 559 A.2d 1261 (Del. 1989)

¹⁴⁶ *Weinberger v. UOP, Inc.*, 457 A.2d 701.

¹⁴⁷ *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

¹⁴⁸ 457 A.2d 701.

¹⁴⁹ See, e.g., Del. Gen. Corp. Law § 144 (dealing with interested directors transactions).

the class members. However, where procedural protections are in place – specifically, where there has been a *bona fide* and reliable separation of the fee negotiations and merits relief – the level of scrutiny can be appropriately reduced. Our insistence on exacting scrutiny and convincing evidence where the partiality of class counsel is suspect reflects the same underlying concern motivating the exacting scrutiny of the entire fairness test and its shift of the burden of proof.

Conclusion

The confusion and inconsistency in standards for review of class action settlements is due to a failure to recognize that different levels of scrutiny are suited to different questions. Courts should apply lenient scrutiny on questions going to the settlement’s adequacy, requiring only plausible justifications for decisions made in the absence of indicia of fraud, collusion or lack of effective bargaining by class counsel. Courts should apply intermediate scrutiny to concerns about fairness – allocation issues, coupon relief, shotgun settlements, and settlements in overlapping cases – and should insist on well-reasoned explanations for why these concerns are unfounded. Exacting scrutiny is indicated for counsel fees and for other decisions implicating a direct conflict of interest on the part of class counsel. Overall, Rule 23(e)’s requirement that a settlement be “reasonable” should be administered flexibly depending on the issue involved.

Appendix: Factor Tests in the Federal Circuits

First Circuit: No established test.

Second Circuit: (1) the complexity, expense and likely duration of the litigation; (2) the reaction of the class to the settlement; (3) the stage of the proceedings and the amount of discovery completed; (4) the risks of establishing liability; (5) the risks of establishing damages; (6) the risks of maintaining the class action through the trial; (7) the ability of the defendants to withstand a greater judgment; (8) the range of reasonableness of the settlement fund in light of the best possible recovery; (9) the range of reasonableness of the settlement fund to a possible recovery in light of all the attendant risks of litigation.¹⁵⁰

Third Circuit: (1) the complexity, expense and likely duration of the litigation; (2) the reaction of the class to the settlement; (3) the stage of the proceedings and the amount of discovery completed; (4) the risks of establishing liability; (5) the risks of establishing damages; (6) the risks of maintaining a class action through the trial; (7) the ability of defendants to withstand a greater judgment; (8) the range of reasonableness of the settlement fund in light of the best recovery; (9) the range of reasonableness of the settlement fund to a possible recovery in light of all the attendant risks of litigation; (10) the maturity of the underlying substantive issues, as measured by the experience in adjudicating individual actions, (11) the development of scientific knowledge, (12) the extent of discovery on the merits; (13) other factors that bear on the ability to assess the probable outcome of a trial on the merits of liability and individual damages; (14) the

existence and probable outcome of claims by other classes and subclasses; (15) the comparison between the results achieved by the settlement for individual class or subclass members and the results achieved – or likely to be achieved – for other claimants; (16) whether class or subclass members are accorded the right to opt out of the settlement; (17) whether any provisions for attorneys’ fees are reasonable; and (18) whether the procedure for processing individual claims under the settlement is fair and reasonable; and (19) any other potentially relevant and appropriate factors.¹⁵¹

Fourth Circuit: (1) the posture of the case at the time settlement was proposed; (2) the extent of discovery; (3) the circumstances surrounding the negotiations; (4) the experience of counsel; (5) the relative strength of the plaintiffs’ case on the merits; (6) the existence of any difficulties of proof or strong defenses the plaintiffs are likely to encounter if the case goes to trial; (7) the anticipated duration and expense of additional litigation; (8) the solvency of the defendants and the likelihood of recovery on a litigated judgment; and (9) the degree of opposition to the settlement.¹⁵²

Fifth Circuit: (1) the existence of fraud or collusion behind the settlement; (2) the complexity, expense, and likely duration of the litigation; (3) the state of the proceedings and the amount of discovery completed; (4) the probability of plaintiffs’ success on the merits; (5) the range of possible recovery; (6) the opinions of the class counsel, class representatives, and absent class members.¹⁵³

¹⁵⁰ County of Suffolk v. Long Island Lighting Co., 907 F.2d 1295 (2d Cir. 1990); City of Detroit v. Grinnell Corp., 495 F.2d 448, 463 (2d Cir. 1974).

¹⁵¹ In re Prudential Insurance Company of America, 148 F.3d 283, 323 (3d Cir. 1998); Girsh v. Jepson, 521 F.2d 153, 157 (3d Cir. 1975).

¹⁵² In re Jiffy Lube Securities Litigation, 927 F.2d 155 (4th Cir. 1991).

¹⁵³ Reed v. General Motors Corp., 703 F.2d 170, 172 (5th Cir.1983).

Sixth Circuit: (1) the plaintiffs' likelihood of ultimate success on the merits balanced against the amount and form of relief offered in settlement; (2) the complexity, expense and likely duration of the litigation; (3) the stage of the proceedings and the amount of discovery completed; (4) the judgment of experienced trial counsel; (5) the nature of the negotiations; (6) the objections raised by the class members; (7) the public interest.¹⁵⁴

Seventh Circuit. Decisions in 2006 recited two different lists. First: (1) the probability of plaintiff prevailing on its claims; (2) the expected costs of future litigation; (3) hints of collusion; and (4) other factors.¹⁵⁵ Second: (1) the strength of plaintiffs' case compared to the amount of defendants' settlement offer; (2) an assessment of the likely complexity, length and expense of the litigation; (3) an evaluation of the amount of opposition to settlement among affected parties; (4) the opinion of competent counsel; and (5) the stage of the proceedings and the amount of discovery completed at the time of settlement).¹⁵⁶

Eighth Circuit: (1) the merits of the plaintiff's case, weighed against the terms of the settlement; (2) the defendant's financial condition; (3) the complexity and expense of further litigation; and (4) the amount of opposition to the settlement.¹⁵⁷

Ninth Circuit: (1) the strength of plaintiffs' case; (2) the risk, expense, complexity, and likely duration of further litigation; (3) the risk of maintaining class action status throughout the trial; (4) the amount offered in settlement; (5) the extent of discovery completed, and the stage of the proceedings; (6) the experience and views of counsel; (7)

¹⁵⁴ In re Southern Ohio Correctional Facility, 173 F.R.D. 205, 212 (S.D. Ohio 1997).

¹⁵⁵ Mirfasihi v. Fleet Mortgage Corp., 450 F.3d 745, 748 (7th Cir. 2006).

¹⁵⁶ Synfuel Technologies, Inc. v. DHL Express (USA), Inc., 463 F.3d 646, 653 (7th Cir. 2006).

¹⁵⁷ Grunin v. Int'l House of Pancakes, 513 F.2d 114, 124 (8th Cir. 1975).

the presence of a governmental participant; (8) the reaction of the class members to the proposed settlement; and other, unspecified factors.¹⁵⁸

Tenth Circuit: (1) whether the proposed settlement was fairly and honestly negotiated; (2) whether serious questions of law and fact exist, placing the ultimate outcome of the litigation in doubt; (3) whether the value of an immediate recovery outweighs the mere possibility of future relief after protracted and expensive litigation; (4) the judgment of the parties that the settlement is fair and reasonable.¹⁵⁹

Eleventh Circuit: (1) the strength of the case for plaintiff on the merits, balanced against the extent of the settlement offer, (2) the complexity, length and expense of further litigation, (3) the substance and extent of opposition to the settlement by the class members, (4) the reaction of members of the class to the settlement, (5) the opinion of competent counsel, and (6) the progress of the proceedings.¹⁶⁰

D.C. Circuit. There is no established test, but courts have examined (1) whether the settlement is the result of arms-length negotiations; (2) the terms of the settlement in relation to the strength of plaintiffs' case; (3) the stage of the litigation proceedings at the time of settlement; (4) the reaction of the class; (5) the opinion of experienced counsel.¹⁶¹

Federal Circuit. No definite test.

State Courts. Some state courts also use factor tests. In Texas the relevant factors include: (1) whether the parties negotiated the settlement at arm's length, or whether it was the product of fraud or collusion; (2) the complexity, expense, and likely duration of the

¹⁵⁸ Molski v. Gleich, 307 F.3d 1155, 1172 (9th Cir. 2002); Officers for Justice v. Civil Service Commission of San Francisco, 688 F.2d 615, 625 (9th Cir. 1982).

¹⁵⁹ Jones v. Nuclear Pharmacy, Inc., 741 F.2d 322 (10th Cir.1984).

¹⁶⁰ Bennett v. Behring Corp., 737 F.2d 982, 986 (11th Cir. 1984).

¹⁶¹ In re Lorazepam & Clorazepate Antitrust Litigation, 205 F.R.D. 369 (D.D.C. 2002); see also Collins v. Pension Benefit Guarantee Corp., 1996 WL 335346 (D.D.C. 1996).

litigation; (3) the stage of the proceedings, including the status of discovery; (4) the factual and legal obstacles that could prevent the plaintiffs from prevailing on the merits; (5) the possible range of recovery and the certainty of damages; (6) the respective opinions of the participants, including class counsel, class representatives, and the absent class members.¹⁶²

In Illinois the court looks to (1) the strength of the case for the plaintiffs on the merits, balanced against the relief offered in settlement; (2) the defendant's ability to pay; (3) the complexity, length, and expense of further litigation; (4) the amount of opposition to settlement; (5) the presence of collusion in reaching the settlement; (6) the reaction of the members of the class to the settlement; (7) the opinion of competent counsel; (8) and the stage of the proceeding and the amount of discovery completed.¹⁶³

¹⁶² General Motors Corp. v. Bloyed, 916 S.W.2d 949, 955 (Tex. 1996).

¹⁶³ GMAC Mortgage Corp. of Pennsylvania v. Stapleton, 236 Ill. App. 3d 486, 177 Ill. Dec. 697, 603 N.E.2d 767 (1st Dist. 1992).