Seventh Circuit Orders Disgorgement of Objector Side Payments in Federal Class Action

In recent years, courts and other commentators have expressed frustration with those who assert bad-faith objections to proposed federal class-action settlements to extract a personal payoff to withdraw their objection.[1] In 2018, Federal Rule of Civil Procedure 23 was amended in part to address these concerns. *See* Fed. R. Civ. P. 23 advisory committee's note to 2018 amendment. Rule 23(e)(5) now requires that any objecting class member specify whether the objection applies only to a specific class member, to a group of class members, or to the class as a whole. Rule 23(e)(5) also now requires court approval for any payments made to an objecting class member in connection with withdrawing an objection or an appeal thereof.

On August 6, 2020, the United States Appeals Court for the Seventh Circuit addressed an instance of such "objector blackmail," where the side settlement agreements and payments had been made before the 2018 amendments to Rule 23. *Pearson* v. *Target Corp.*, 2020 WL 4519053 (7th Cir. Aug. 6, 2020).[2] The Court held that, where the objection asserted was on behalf of the class, the appropriate remedy is disgorgement of the side payments.

I. Background

In 2011, a group of plaintiffs filed a putative class action in the Northern District of Illinois, alleging that three entities—NBTY, Inc., Rexall Sundown, Inc., and Target Corp.—had made false claims about the efficacy of certain dietary supplements that they manufactured or distributed. In 2013, the parties negotiated a settlement of the litigation that the district court hearing the case ultimately approved over the objections of various class members. The objectors appealed the decision, and the Seventh Circuit reversed, finding the settlement to contain "fatal weaknesses" including a disproportionate award of fees to lead plaintiffs' counsel. *Pearson* v. *NBTY, Inc.*, 772 F.3d 778, 787 (7th Cir. 2014).

In 2015, the parties reached a new settlement (referred to in subsequent decisions as the "*Pearson II* settlement") that addressed the deficiencies the Seventh Circuit had identified. Nonetheless, three class members objected to the *Pearson II* settlement in short briefs that the Seventh Circuit later described as "light on citations to law and fact." The district court again approved the settlement over the objections, and, again, the objectors appealed. This time, however, all three objectors quickly withdrew their appeals after filing them.

Suspecting that side deals had taken place, class member Theodore Frank[3] filed a motion in the district court seeking disgorgement of any payments made to the objectors in exchange for dismissing their appeals. The

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[1] *See, e.g.*, *In re Petrobras Sec. Litig.*, 2018 WL 4521211, at *7 (S.D.N.Y. Sept. 21, 2018) (imposing sanctions against "extortionate objectors"), *aff'd*, 778 F. App'x 46 (2d Cir. 2019); *In re Initial Pub. Offering Sec. Litig.*, 728 F. Supp. 2d 289, 295 (S.D.N.Y. 2010) (imposing an appeal bond against bad-faith objectors and noting that "numerous courts . . . have recognized that professional objectors undermine the administration of justice by disrupting settlement in the hopes of extorting a greater share of the settlement for themselves and their clients"); Elizabeth J. Cabraser & Adam N. Steinman, *What Is A Fair Price for Objector Blackmail? Class Action Objectors and the 2018 Amendments to Rule 23*, 24 Lewis & Clark L. Rev. 549, 555 (2020) (" the objector problem . . . had become the single most reported problem with the [pre-2018 version of Federal Rule of Civil Procedure 23], as identified by plaintiff attorneys, defense attorneys, and judges alike").

[2] Unless otherwise specified, all quotations in this memorandum are from this decision, which can be found at http://media.ca7.uscourts.gov/cgi-bin/rssExec.pl?Submit=Display&Path=Y2020/D08-06/C:19-3095:J:Hamilton:aut:T:fnOp:N:2559724:S:0.

[3] Frank is the founder of the Center for Class Action Fairness and is a "leading critic of abusive class-action settlements[.]"

district court denied the motion for lack of jurisdiction, but the Seventh Circuit reversed. *Pearson* v. *Target Corp.*, 893 F.3d 980, 986 (7th Cir. 2018) ("*Pearson II*").

On remand, discovery revealed that each objector to the *Pearson II* settlement had received side payments, totaling $130,000, to dismiss their appeals. The district court denied disgorgement, however, finding that "'the record failed to confirm suspicions of blackmail or other wrongdoing'" by the objectors and that "there was 'no basis to conclude that the side settlements harmed the class' by taking money that had been earmarked for it." Frank appealed the decision.

II. The Seventh Circuit Holds Private Payoffs to Objectors Asserting Class-Wide Objections to a Settlement Are Inequitable and Must Be Disgorged

For the third time, the Seventh Circuit overturned the *Pearson* district court, holding that "settling an objection that asserts the class's rights in return for a private payment to the objector is inequitable and that disgorgement is the most appropriate remedy."

The Seventh Circuit explained that class members asserting objections to a settlement on behalf of the entire class take on a fiduciary duty to act in good faith and avoid self-dealing. To support this finding, the Court relied heavily on *Young* v. *Higbee Co.*, 324 U.S. 204 (1945), in which the Supreme Court of the United States held that two individuals objecting to a company's bankruptcy plan on behalf of all of the company's preferred shareholders took on "a duty to fairly represent [the] common rights" shared by all such preferred shareholders. *Id.* at 212.

Analogizing to *Young*, the Seventh Circuit found that "the objections to the *Pearson II* settlement raised by [the three objectors] alleged defects which, if genuine, would have injured every member of the class by binding them all to an unfair, unreasonable, or inadequate settlement." Under the Court's reasoning, the principles espoused in *Young* "impose a limited representative or fiduciary duty on the class-based objector who, by appealing the denial of his objection on behalf of the class, temporarily takes 'control of the common rights of all' the class members and thereby assumes 'a duty fairly to represent those common rights.'" The Court also observed that the objectors did not appear to have much faith in their own objections, both because they were submitted in very short briefs with few legal citations and because their side settlements reflected a discount from the face value of their objections ranging from 94% to 99.2%.

The Seventh Circuit rejected counterarguments advanced by the objectors, including that the payments to the objectors did not harm the class. The Court explained that a portion of the payment for one objector came from the common settlement fund for all class members, and, regardless, an objector could not trade away the potential benefits to the entire class for a private payment, no matter the source. "Money that class counsel were willing to part with to finally resolve the litigation consisted of savings that ought to have enured to the class—not to defendants, the three objectors, or their lawyers."

Having found that the *Pearson II* objectors could not equitably retain the proceeds from their side settlements, the Seventh Circuit—referencing, among other cases, the Supreme Court's recent decision addressing disgorgement in *Liu* v. *Sec. & Exch. Comm'n*, 140 S. Ct. 1936 (2020)[4]—held that, "[i]n theory, the best remedy for

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Adam Liptak, *When Lawyers Cut Their Clients Out of the Deal*, N.Y. Times, Aug,. 12, 2013, https://www.nytimes.com/2013/08/13/us/supreme-court-may-hear-novel-class-action-case.html.

[4] *See* our memorandum entitled "Supreme Court Holds That SEC Disgorgement Is a Form of Equitable Relief" (July 27, 2020), which can be found at https://www.cahill.com/publications/firm-memoranda/2020-07-27-supreme-court-holds-that-sec-disgorgement-is-a-form-of-equitable-relief.

the objectors' private appropriation of value that belonged to the class would be to pay those sums into the common fund for direct distribution to all class members." As the settlement funds had already been distributed, however, this remedy presented the "practical problem" that administration costs associated with distributing the $130,000 would swallow up all of the disgorged funds. As a result, the Court instead concluded that "the appropriate remedial framework here is the constructive trust" and recommended that the disgorged amounts, less the objectors' costs and attorneys' fees, be provided to the Orthopedic Research and Education Foundation, the entity designated by the settlement agreement to receive undistributed funds.

The Seventh Circuit concluded its opinion by positing that "reasonable and good-faith objections to [class-action settlements will not] be deterred or chilled by [its] holding[.]" In support of this prediction, the Court explained that, under the 2018 amendments to Federal Rule of Civil Procedure 23, an objector that can "say specifically why the class or a part of it has been deprived of the fair, reasonable, and adequate settlement to which it is entitled" may "'seek payment for providing such assistance under Rule 23(h).'" The Court also warned, however, that district courts should be wary of objectors that seek to "dress[] a class-based objection in individual clothing to avoid scrutiny under *Young* and our decision here."

III. Implications

The Seventh Circuit's remedy of disgorgement may have limited impact on future cases, as under the amended Rule 23, a court can now forbid an objector side settlement before the payment is made, and such settlements can be made contingent on court approval.[5]

The decision is significant, however, because it is the first Court of Appeals decision to provide guidance relevant to when a district court should disapprove side settlements with objectors. Pearson suggests that where an objection is asserted on behalf of the class, a side settlement to withdraw the objection should rarely, if ever, be approved.

The decision may thus deter some objectors—at least in the Seventh Circuit—from asserting objections to or appeals from future settlements. While Federal Rule of Civil Procedure 23(h) provides an avenue for an objector's counsel to recoup the fees incurred litigating the objection, that Rule provides no additional benefit to the objector itself. As such, class-wide objectors may be more reluctant to spend the time litigating objections that, at best, will only marginally increase each class member's benefit and will not result in any additional payment to the objector beyond that provided to the rest of the class.

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Should you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Lauren Perlgut at 212.701.3558 or lperlgut@cahill.com; or Nicholas N. Matuschak at 212.701.3279 or nmatuschak@cahill.com; or email publications@cahill.com.

[5] Indeed, in *Pearson II*, decided in June 2018, the Seventh Circuit stated "[t]he pending amendments to Rule 23 may solve the problem prospectively, but that does nothing for the case before us." 893 F.3d at 987.

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