

# Class Reaction

*Recent settlements harbor lessons for the long term.*

BY BARRY B. CEPELEWICZ

**R**ECENT BLOCKBUSTER deals have made for several record years in class action settlements. By mid-2005, for example, the mean settlement value for shareholder class actions had risen to a new record of \$25.8 million, up from the 2002 record of \$23.5 million.<sup>1</sup> The important and interesting settlements were by no means limited to well-known bear market cases like WorldCom and Enron. Recent class action resolutions, within the U.S. Court of Appeals for the Second Circuit and nationwide, have come in a variety of contexts, and are likely to have an impact for years to come.

Here are some of the most notable recent class action resolutions since

2005 and eight lessons we should learn from them.

## 1. Honesty Is the Best Policy

Consumer class actions have been in the spotlight lately, and for good reason. Americans are still recovering from a historic wave of corporate malfeasance. Consumers and investors are vigilant and quick to criticize. Accordingly, businesses would do well to remember that embellishing a product through false or exaggerated claims is a sure way to come under scrutiny.

In *Chavez v. Netflix, Inc.*,<sup>2</sup> consumers sued Netflix, the DVD rental firm, alleging that its advertising and marketing materials—particularly statements about “unlimited” DVD rentals and “one-day delivery”—were false and misleading. Last October, without

admitting liability, Netflix agreed to a “coupon settlement,” where, instead of cash, the class consumers receive a free month of upgraded service.

In addition, wireless networking manufacturer Netgear denied wrongdoing but announced the settlement of a similar class action suit.<sup>3</sup> The complaint alleged a disparity between the bandwidths offered by Netgear’s Wi-Fi products and their actual performance. As part of the settlement agreement, Netgear must change its advertising by adding a disclaimer that “actual throughput will vary.” Final approval is expected soon.

Similarly, in *Silversmith v. Natrol, Inc.*,<sup>4</sup> class counsel filed actions against sports nutrition product developer Prolab that were ultimately consolidated in New York. The complaints alleged that Prolab’s “Andro” nutri-



tional supplements were falsely marketed as increasing muscle growth and strength. Without admitting fault, Prolab reached a settlement agreement that awards a total of \$5 million in cash, discount cards and coupons to class members.

## 2. Stand by Your Product

Whether it is mobile phones or laptop computers, the availability and quality of long-term customer service and support play an increasing role in the customer's initial purchase decision. Companies have learned that by positioning themselves as customer-focused and satisfaction-driven, potential catastrophes can be averted with relative ease. Partnering with customers and maintaining trust seem especially important for products that experience runaway success; the greater the profits, the greater the consumer backlash when things go wrong.

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Apple Computer's iPod products have been particularly successful, and with each new generation, iPod has advanced, packing more storage capacity into a smaller device. So when the owners of first, second, and third generation iPod products brought a class action suit in California alleging that Apple misrepresented the playtime and life span of iPod batteries,<sup>5</sup> Apple could have set its customers adrift, hoping they might cough up more cash for the latest, sleekest version. Instead, Apple agreed to a settlement, which received final approval in April, that allows consumers to choose one from several forms of compensation, including store credits or extended warranty coverage. The settlement has an estimated value of \$15 mil-

lion, but in terms of preserving Apple's ongoing public relations and goodwill, it looks like a sound investment.

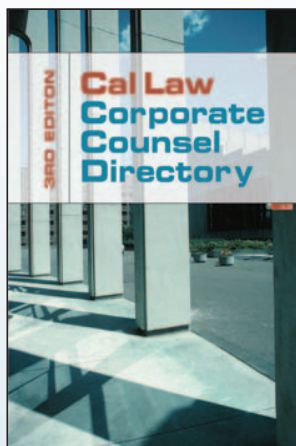
## 3. Consumers Will Complain

Businesses should remember that the Internet has given consumers a powerful voice to share everything from recommendations to boycotts. In the process, it has also given potential plaintiffs an effective tool for organizing. When calculating the PR value of settling versus litigating, a corporate defendant should carefully consider that some kinds of settlements may be more valuable than others.

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## Class Actions

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The *Netflix* and *Netgear* settlements, for example, have been criticized as clever marketing ploys disguised as consumer redress.<sup>6</sup> Under the *Netflix* settlement as initially proposed, after customers got their month of free upgraded service, they would be automatically enrolled in an upgraded program and charged an additional monthly fee unless they unsubscribed. Objectors organized an impressive resistance and developed an alternative settlement, expected to be approved shortly, with terms far more favorable to consumers.<sup>7</sup>

The negative backlash has not proved fatal to either settlement; in fact, *Netgear's* first quarter 2006 earnings were up 26 percent from the same period last year. But *Netflix* objectors were angry, and organized, enough to throw up a significant roadblock that other corporate defendants should prepare to face.

### 4: Avoid Complacency

Keep in mind that “Because that’s the way we’ve always done it” does not always make good policy. For years, it was customary for freelance authors to sell their works without a written contract. In exchange for a fee, the author granted the publisher the right of first publication in a specified edition of a newspaper or magazine, but in all other respects the author retained ownership of the work.

Then, freelance writers filed a class action complaint against commercial electronic databases, including Reed Elsevier, Inc. (LEXIS) and Knight-Ridder, Inc., in *In re Literary Works in Electronic Databases Copyright Litigation*.<sup>8</sup> The complaint alleged that after the plaintiffs’ works were first published, the commercial databases infringed the plaintiffs’ copyrights by licensing those works without the authors’ permission.

Last September, Judge George B. Daniels of the Southern District of New York approved an agreement to settle the copyright dispute. The defendants agreed to pay up to \$18 million to compensate authors for both past infringement and future electronic use of the works.

### 5: Don’t Fix Prices

Companies reflecting on their business practices should

take note: Consumers are no longer waiting for the Federal Trade Commission or regulatory agencies to prosecute violations of federal antitrust law. Many are going it alone, and successfully. In *In re Cosmetics Cases*,<sup>9</sup> class plaintiffs sued a number of cosmetics and fragrance manufacturers, including Estee Lauder, Chanel, and Christian Dior, as well as department stores that sell those products, alleging numerous antitrust violations, including price fixing and artificially depressing supply. As part of the settlement, the defendants agreed to refrain from price fixing, and to provide plaintiffs with \$175 million in cosmetics

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and fragrance products.

In another antitrust case, *Lankford v. Dow Chemical Co.*, plaintiffs in 29 states and the District of Columbia alleged that three companies—Dow, DuPont Dow Elastomers, and E.I. du Pont de Nemours—conspired to fix prices of Neoprene, a synthetic rubber used in the manufacture of countless consumer products. Because the wronged parties purchased products containing the material rather than purchasing Neoprene directly, it was judged

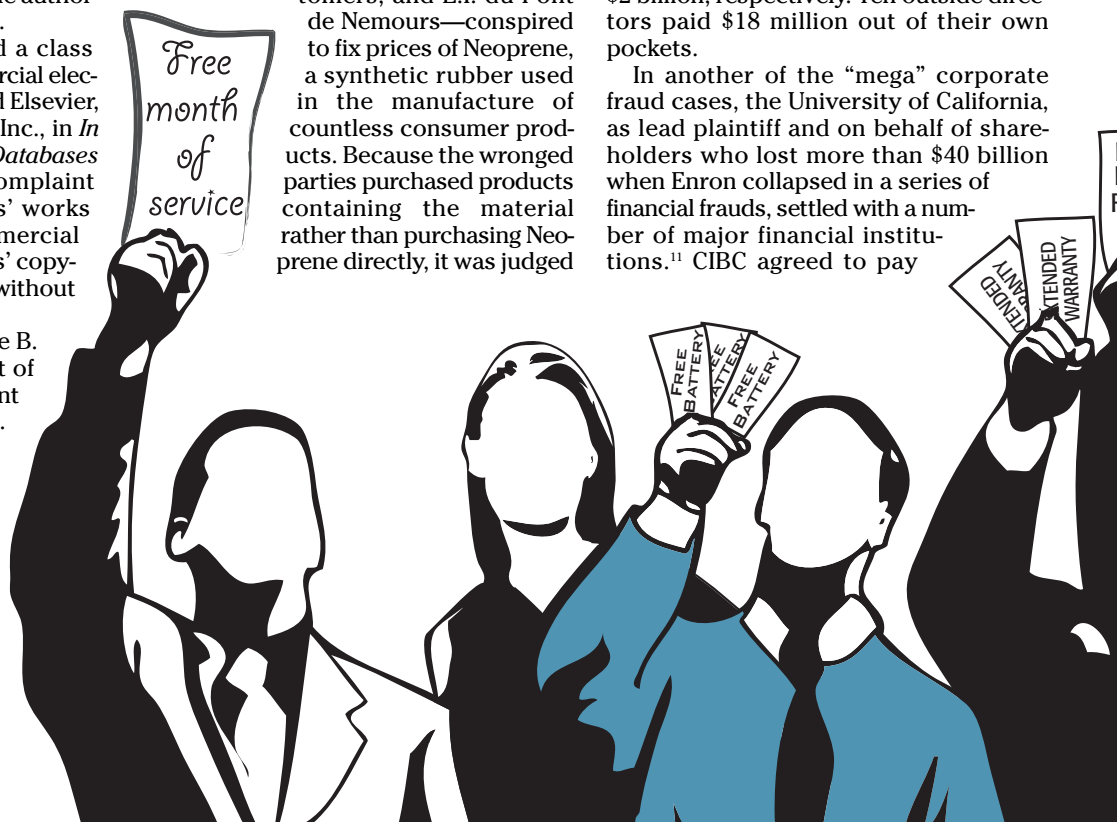
impossible to identify the individuals harmed; even if it were possible, the cost of distributing settlement funds to individual class members would have dwarfed their actual recoveries. The defendants agreed to a \$4.2 million settlement.

### 6: Don’t Blame the Hierarchy

As anyone who has picked up a newspaper lately knows, aggrieved securities holders have achieved historic recoveries through class actions, while executive compensation continues to climb. And with great compensation comes great responsibility. Although the Enron and WorldCom cases have already been heavily commented and reported on, the criminal trials of Kenneth Lay and Jeffrey Skilling have renewed public interest in what caused the giants to topple. While concerns for ethics and avoiding conflicts may already be part of our daily practice, these cases still caution everyone in the legal and corporate worlds against the slightest appearance of impropriety.

In September, U.S. District Judge Denise Cote of the Southern District of New York granted final approval to all settlements in the WorldCom securities litigation.<sup>10</sup> Defendants included WorldCom’s underwriters and directors, Arthur Andersen LLP and former executives Bernard Ebbers and Scott Sullivan. The settlements netted a historic \$6.1 billion for holders of WorldCom stocks and bonds. Citigroup and JPMorgan, which underwrote the securities, paid \$2.6 billion and \$2 billion, respectively. Ten outside directors paid \$18 million out of their own pockets.

In another of the “mega” corporate fraud cases, the University of California, as lead plaintiff and on behalf of shareholders who lost more than \$40 billion when Enron collapsed in a series of financial frauds, settled with a number of major financial institutions.<sup>11</sup> CIBC agreed to pay



\$2.4 billion; JPMorganChase & Co. settled for \$2.2 billion, Citigroup for \$2 billion, and Lehman Brothers for \$222.5 million. Enron outside directors settled for \$168 million.

In addition to underscoring the ethical obligations of counsel, cases like Enron and WorldCom should teach us not to follow blindly the advice of experts, or trust someone else to catch a mistake. According to some commentators, the alleged shell game of Enron improprieties was blessed at multiple hierarchical layers—by in-house counsel, accounting experts, special counsel, executives, and credit officers, to name a few. And while many eyebrows were raised along the way, most people assumed that if the laundry was really dirty, someone else would have smelled it.

### 7: Litigation Is Risky

Developments in the cases against pharmaceutical developer Merck & Co., Inc. involving Vioxx should remind us that settlement can potentially save billions of dollars. Facing more than 10,000 personal injury lawsuits alleging that Merck misrepresented the safety of Vioxx, Merck adopted a “no settlements” strategy, opting instead to try every case to verdict. But most financial and legal experts now criticize that strategy, citing recent New Jersey jury verdicts of \$4.5 million and \$9 million against Merck. By carrying that strategy into the class action context, Merck risks a \$30 billion downside.

This spring, a New Jersey appellate court upheld class certification in a class action lawsuit brought by health plans that paid for Vioxx prescriptions. While the litigation is less dramatic than the wrongful death and personal injury actions, one commentator has suggested that the relatively dry health plan class action could be “similar to bringing down the notorious Al Capone

on nothing more than the rather dull charge of income tax evasion.”<sup>12</sup>

### 8: Employee Class Actions Pay

Finally, employers take note: The best defense can very well be a good offense. To reduce potential liability for discrimination, employers should consider some of the terms agreed to by recent settling employers, such as implementing comprehensive compliance plans designed to curb discriminatory practices and/or to promote diversity in the workplace.

In *EEOC v. Abercrombie & Fitch Stores, Inc.*,<sup>13</sup> employees alleged that the national clothing retailer engaged in a pattern or practice of race, color, national origin, and sex discrimination, in violation of Title VII, in the recruitment, hiring, assignment, promotion, and discharge of minorities and women. The case was resolved through a consent decree filed contemporaneously with the complaint, and approved following a fairness hearing. The decree enjoins the retailer from discriminatory practices and requires marketing materials to reflect racial and ethnic diversity. Abercrombie & Fitch agreed to create an “Office of Diversity,” and to hire 25 full-time “diversity recruiters.” In addition, the retailer will also establish a settlement fund of \$40 million to provide monetary awards (15 percent back pay and 85 percent compensatory damages) to the settlement class.

Last year, Home Depot agreed to pay \$5.5 million to settle a discrimination and retaliation suit on behalf of 38 Colorado employees who alleged hostile work environments and discrimination on the basis of sex, race and national origin at the home-improvement giant based in Atlanta, Ga.<sup>14</sup> The complaint alleged that defendant, a nationwide home improvement retailer, engaged in a pattern or practice of hostile work environment discrimination against employees in violation of Title VII at its 30-plus stores in Colorado.

Managers allegedly subjected female employees to sexually offensive comments and unwelcome sexual advances, and made derogatory comments about the competence and work habits of women, blacks, and Hispanics. Employees who complained about the harassment claimed they were subjected to adverse terms and condi-

tions of employment, including disparaging comments about their performance, over-scrutinization of their work, demotion, and discharge.

Under a 30-month consent decree, Home Depot will pay up to \$5.6 million to resolve the case. The bulk of the money will constitute monetary relief to claimants, with \$3 million to 38 charging parties and \$2.5 million to a Class Settlement Fund for distribution to other claimants (potential claimants are individuals employed at any time since Jan. 1, 2000). The Equal Employment Opportunity Commission and Home Depot will jointly enter into a contract with a fund administrator, and Home Depot will pay up to \$80,000 of the administrator’s expenses, and reserve \$50,000 in an escrow account for additional expenses.

### Conclusion

Recent settlements can teach important lessons to employers, manufacturers, retailers, and lending institutions and, more particularly, to their general counsel. For better or worse, class action litigation is increasingly shedding its nuisance image, and is being seen as a powerful tool for influencing legal and corporate practice and policy. Accordingly, businesses must familiarize themselves with such litigation, examine their corporate practices to assess their exposure and, among other things, create appropriate compliance plans to mitigate the risk of such lawsuits.

1. See “Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?” available at [http://www.nera.com/Publication.asp?p\\_ID=2544](http://www.nera.com/Publication.asp?p_ID=2544) (May 17, 2006).

2. Cal. Superior Ct., San Francisco, Case No. CGC-04-434884.

3. *Zilberman v. Netgear, Inc.* (Cal. Sup. Ct., Santa Clara Co.)

4. *Silversmith et al. v. Natrol, Inc. d/b/a Prolab Nutrition, Inc.* (New York Co. Index No. 126276/02).

5. *Lisa Chin et al. v. Apple Computer*, (Cal. Sup. Ct., San Mateo Co., Case No. CIV 436509).

6. See [http://www.techdirt.com/articles/20051128/1221235\\_F.shtml](http://www.techdirt.com/articles/20051128/1221235_F.shtml) (May 23, 2006).

7. See <http://www.NetflixSettlementSucks.com> (May 23, 2006).

8. *In re Literary Works in Electronic Databases Copyright Litigation* (S.D.N.Y. MDL No. 1379).

9. *Azizian v. Federated Dept. Stores, Inc.*, (N.D. Cal. Docket No. 4:03-CV-03359-SBA).

10. *In re WorldCom Securities Litigation* (S.D.N.Y. Master File No. 02 Civ. 3288 (DLC)).

11. *In re Enron Corporation Securities Litigation (Newby, et al. v. Enron Corp., et al.)* (S.D. Tex. H-01-3624).

12. See “Certification of Nationwide Vioxx Class Action Against Merck Affirmed by New Jersey Appellate Court,” available at <http://www.newsinferno.com/archives/1037#more-1037> (May 17, 2006).

13. No. 04-4731 (N.D. Cal. April 14, 2005).

14. *EEOC v. Home Depot, U.S.A., Inc., d/b/a The Home Depot*, No. 04 D 1776 (D. Colo. Sept. 30, 2005).

