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Settlement and Compromise

Are Benefit Plans Members of a Settlement Class?

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A critical term in any class action settlement agreement is the definition of the settlement class. This term typically lists the persons and entities that are included in the settlement class, as well as those that are excluded, thereby identifying who gets a slice of the settlement pie.

In *Rothstein v. American International Group*, the U.S. Court of Appeals for the Second Circuit considered the definition of a settlement class in a securities class action settlement. As is common in such settlements, the settlement agreements contained a provision excluding the defendant's "affiliates" from recovering settlement proceeds. The rationale for this exclusion was presumably to prevent alleged wrongdoers from profiting or diverting funds from alleged victims.

Although class-action settlement agreements frequently exclude defendants' affiliates from the settlement class, this case presented an unusual question: Are employee benefit plans sponsored by the settling defendant its affiliates such that they are excluded from the settlement class? After reviewing the text of the settlement agreements at issue and the ERISA statute, which limits an employer's ability to influence sponsored plans, the Second Circuit held that benefit plans sponsored by the defendant were not its "affiliates," and thus were entitled to share in the settlement proceeds.

This decision is significant because it provides practical guidance on drafting class action settlement agreements while leaving open several questions. Among other guidance, the Second Circuit admonished drafters of class action settlement agreements to specify any entities sought to be excluded from the settlement class, rather than using the more generic "affiliates." That said, the Second Circuit did not indicate whether the basis for its holding—the constraints imposed on employers by the ERISA statute—might also result in similar outcomes where other types of sponsored entities request settlement distributions, so this area is ripe for further development.

Background

This case arose from a securities class action settlement involving American International Group, Inc. (AIG) and other defendants. The settlement agreements define the "Settlement Class" to include "all persons and entities who purchased or otherwise acquired AIG Securities during the period of time from October 28, 1999, through April 1, 2005," but they exclude "any parent, subsidiary, affiliate, officer, or director of AIG." The agreements do not define the term "affiliate." *Rothstein v. Am. Int'l Grp.*, 14–4067(L), ---F.3d---, 2016 WL 5075939, at *1 (2d Cir. Sept. 20, 2016).

Four employee benefit plans sponsored by AIG or its affiliates (the Plans) submitted claims to the settlement claims administrator requesting settlement distributions. However, the claims administrator rejected them on the basis that the Plans were "affiliates" of AIG and thus ineligible for distributions under the settlement agreements' terms.

Thereafter, the Plans filed a motion in the district court seeking an order directing the claims administrator to approve their claims. The district court denied this motion, agreeing with the claims administrator that the Plans were AIG's "affiliates."

The Second Circuit's Decision

The Second Circuit reversed and held that the Plans were not AIG's "affiliates." It began its analysis by consulting Black's Law Dictionary, which defines an "affiliate" as "[o]ne who controls, is controlled by, or is under common control with an issuer of a security." In addition, it cited SEC Rule 144, which similarly defines an "affiliate" of an issuer of securities as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer."

Based on these definitions, the Second Circuit determined that whether the Plans are "affiliates" turns on whether they are "controlled by, or are under common control with, AIG." *Rothstein*, 2016 WL 5075939, at *8 (citing *Affiliate*, Black's Law Dictionary (10th ed. 2014) and 17 C.F.R. §§230.133(a)(1), 240.12b-2).

To clarify the meaning of "control," the Second Circuit again consulted Black's Law Dictionary and the SEC's rules. Black's Law Dictionary defines "control" as the "direct or indirect power to govern the management and policies of a person or entity." Similarly, the SEC defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person whether through the ownership of voting securities, by contract, or otherwise." Accordingly, the Second Circuit determined that whether the Plans are "affiliates" of AIG turns on whether AIG possesses the direct or indirect power to "direct or cause the direction of [the Plans'] management and policies." *Rothstein*, 2016 WL 5075939, at *8 (citing Control, Black's Law Dictionary (10th ed. 2014) and 17 C.F.R. §§230.405, 240.12b-20).

The Second Circuit then reviewed the district court's decision. In its memorandum and order, the district court had identified several indicia of "control," including (1) the Plans' sponsorship by AIG or an affiliate, (2) the appointment of AIG employees to positions of authority within the Plans' administrator, and (3) AIG's power to disband the Plans "without reason." In addition, the district court had relied on *In re Motorola Securities Litigation*, 644 F.3d 511 (7th Cir. 2011), in which the U.S. Court of Appeals for the Seventh Circuit considered a nearly identical set of facts and held that because the Plan's administrator was appointed by Motorola and served at the pleasure of its board of directors, the Plan was its affiliate.

The Second Circuit declined to adopt this reasoning. The court observed that neither the district court nor the Seventh Circuit had considered the ERISA statute (Employee Retirement Income Security Act), which "presumes that the interests of the employer and the employer-sponsored plan are adverse" and sets up a structure to "insulate the trust from the employer's interest." Specifically, ERISA imposes fiduciary duties on corporate officers and directors serving on retirement boards that require them to act with "complete loyalty to participants."

In light of these statutory constraints, the Second Circuit held that none of the facts cited by the district court established that AIG controlled the Plans. In particular, AIG's sponsorship was insufficient because ERISA ensures that the Plans are managed "solely in the interest of the…participants and beneficiaries." Similarly, AIG's ability to appoint and remove members of the Plans' administrator did not suffice because such appointees serve as fiduciaries to the Plans, their participants, and their

beneficiaries, and thus must observe the "highest duties known to law." Likewise, AIG's power to disband the Plans did not imply authority over their management or policy decisions because ERISA's "strict fiduciary duties block such influence."

The Second Circuit also cited the purpose of excluding "affiliates" from a settlement class, which is to "ensure that those who perpetrated, or otherwise profited from, the alleged [wrong] would not benefit from the settlement." However, it found no risk of rewarding wrongdoers here because the Plans' participants and beneficiaries were not alleged to have committed securities violations.

Finally, the Second Circuit stated that a contrary interpretation of the term "affiliate" would encourage plan fiduciaries to demand language expressly including employer-sponsored plans as settlement class members, but doing so would not prevent interpretive disputes where "affiliates" were also excluded. By contrast, the Second Circuit stated that its interpretation, which limits "affiliates" to "entities that could conceivably profit despite their own possible participation in the alleged securities violation," would avoid this outcome. Moreover, the Second Circuit emphasized that if drafters wish to exclude employer-sponsored plans, "they can simply say so."

Conclusions

Following this decision, drafters of class-action settlement agreements should include clear, explicit language excluding employer-sponsored plans if they want to prevent them from sharing in the settlement proceeds. Otherwise, such plans will be settlement class members by default.

In addition, practitioners should keep in mind several open questions. First, the Second Circuit relied heavily on ERISA's statutory constraints to hold that employer-sponsored plans are not "affiliates," but it is not clear that sponsored entities not covered by ERISA would necessarily be "affiliates." Indeed, other statutes could similarly limit a sponsor's control over such entities.

Another issue to watch is how to calculate amounts due to employer-sponsored plans, as the Second Circuit observed in this decision that such amounts could vary depending on whether plan-level or participant-level data is used to calculate losses. Lastly, the circuits are now split on whether employer-sponsored plans are "affiliates" of settling defendants, and it remains to be seen whether the Supreme Court will ultimately take up this issue.

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