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Employer Update

Seventh Circuit Adopts More Stringent Certification Standard for FLSA Collective Actions

By Gary D. Friedman and Jonathan Sokotch

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Over the last several years, there has been a heightened focus among courts and practitioners on whether the principles set forth in the US Supreme Court's landmark decision in *Wal-Mart Stores, Inc., v. Dukes*, 131 S.Ct. 2541 (2011), should be applied in, or are even relevant to, FLSA collective actions. Much of the focus has centered on whether any aspect of the "more rigorous" Rule 23 certification standard articulated in *Dukes* is even inherently compatible with any analysis of certifying or decertifying collective actions under Section 216(b) of the FLSA.

Most federal courts that have addressed the issue have been loath to apply *Dukes* principles or any of the Rule 23 jurisprudence to FLSA collective actions. There have been only a handful of federal district courts, and now, for the first time, a circuit court, that have either applied the Rule 23 standard or analogized to Rule 23 when addressing certification and/or decertification of FLSA collective actions. In a decision that will be widely cited by employers, and may gain traction in other federal circuits, the Seventh Circuit Court of Appeals in *Espenscheid v. DirectSat USA LLC*, 2013 WL 407446 (7th Cir. Feb. 4, 2013), held essentially that there is no principled basis for applying a different standard to certifying an FLSA collective action than to certifying a Rule 23 class, and simply eliminated the distinction recognized by most other circuits. Equally as important, Judge Posner, in writing for the *Espenscheid* court, took head on the critical issue of what constitutes representative evidence in an FLSA collective action, or whether such evidence is proper.

The Lower Court's Decision

The three plaintiffs (Plaintiffs) in *Espenscheid* filed a "hybrid" wage and hour class action lawsuit in the US District Court for the Western District of Wisconsin, pursuing both a nationwide FLSA collective action and several Rule 23(b)(3) class actions premised on various parallel federal and state wage and hour laws. The crux of the action involved claims by a putative class of more than two thousand satellite technicians (Technicians) who spent their time installing and repairing satellite equipment at customers' homes, and who alleged that they were instructed not to record all of their time worked. This included certain pre-shift and post-shift work such as filling out paperwork, picking up equipment from the warehouse and calling customers. The suit also alleged that Technicians worked through

unpaid lunch breaks and that the overtime rate for Technicians – who were paid on a per-job basis – was calculated incorrectly. These practices allegedly resulted in a failure to pay the overtime rate for certain hours worked in excess of 40 in a workweek in violation of the FLSA and parallel state laws. The district court conditionally certified the FLSA collective action, and soon after certified the Rule 23 state law classes, finding that Plaintiffs' challenge was to the "uniform policies and practices" of their employer. The district court, however, later decertified the FLSA collective action and Rule 23 actions, finding the trial plan Plaintiffs had submitted to be infeasible and unmanageable. Plaintiffs appealed these decertification decisions to the Seventh Circuit.

The Seventh Circuit's Decision Affirming Decertification

Application of the *Dukes* Rule 23 Certification Standard to FLSA Collective Actions.

In its decision, the Seventh Circuit first addressed the standard to apply to the decertification analysis of the FLSA collective class, concluding that the provisions of Rule 23 were applicable to **both** the FLSA collective class and the state law class claims.

Section 216(b) of the FLSA, which governs FLSA collective actions, is silent as to the procedural mechanism for certification of FLSA collective actions. The vast majority of courts throughout the US, including several circuit courts, have followed the "two-stage" or *Lusardi* procedure[1] for certifying FLSA collective actions, involving a lenient standard for conditional certification (the first stage), with issuance of notice to the potential class members and then the right for defendant to move to decertify (the second stage), after ample discovery has occurred.[2] Among most courts following this two-stage approach, the standard used for certification or decertification of an FLSA collective action – which involves determination of whether the class members are "similarly situated" – is viewed to be less stringent than it is for a Rule 23 class.

Judge Posner rejected this separate construct for FLSA collective actions, finding that the slight differences between FLSA collective actions and Rule 23 class actions – that FLSA collective actions are "opt-in" actions while Rule 23 actions are "opt-out,"[3] and that Rule 23 has "detailed procedural provisions" articulating its certification standard, while the FLSA offers no such guidance – do not provide "good reason to have different standards for the certification of the two different types of action." One arguable purpose of the more stringent Rule 23 standard, Judge Posner acknowledged, is to protect the rights of the unnamed class members in Rule 23 class actions who would be bound by judgment or settlement, unless they elected to opt out. However, another function of Rule 23, he observed, is efficiency, which is as relevant to FLSA collective actions as it is to Rule 23 classes. In applying Rule 23 to FLSA actions, Judge Posner concluded that the case law had "largely merged" the Rule 23 and FLSA collective action certification standards, citing several federal decisions where the court either mentioned that certification of FLSA and Rule 23 classes involved consideration of similar factors, or where the court actually utilized language from Rule 23 in deciding certification of an FLSA class.[4] Holding that the Rule 23 standard was the correct one to apply to both the FLSA and state law classes, the Court proceeded to analyze the decertification issue exclusively through that prism.[5]

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Rejection of Trial by Representative Proof

At the heart of many FLSA class cases is the question of whether representative evidence should be or can be used to prove the plaintiffs' class claims at trial, and Judge Posner's analysis of Plaintiffs' proposed use of representative testimony provides useful guidance on this important issue.

Judge Posner assumed, for purposes of the decision, that Plaintiffs could prove at trial that the defendant's policies violated the FLSA. However, determination of damages at a class trial was not feasible, Judge Posner found, as it would require individualized inquiry in the form of "2341 separate evidentiary hearings." The damages suffered by each class member could not be computed on an efficient class basis because of substantial variances between the experiences of each class member. Plaintiffs tried to "get around the problem of variance," by proposing to present testimony at trial from 42 "representative" members of the class. The jury, according to this plan, would determine the average number of uncompensated hours per week from these 42 representatives. Post-trial, Plaintiffs would then use this average to determine the amount of damages owed each class member, by adding the average number of uncompensated hours to the weekly pay totals that each class member had already received.

Judge Posner flatly rejected this proposed use of representative testimony. First, Plaintiffs failed to show that the "representatives" were indeed representative of the rest of the class. Class counsel had conducted no statistical sampling in selecting the representatives to ensure a random sample, and were wholly "unable to explain" their method for choosing these representatives. Judge Posner surmised that, having apparently not sought to make random selections, class counsel had perhaps "hand-picked" the representatives to "magnify the damages sought by the class." Thus, Judge Posner's decision stands for the important proposition that courts must engage in a rigorous analysis of the representativeness of any sample of witnesses (or evidence) selected by plaintiffs who seek to prove their FLSA class claims through representative testimony.

Even if the 42 representatives turned out "by pure happenstance" to be representative, Judge Posner rejected Plaintiffs' plan to extrapolate the experience of the 42 to the rest of the class as deeply flawed. Given the substantial variances between class members[6], having the jury ascertain an average number of unworked weekly hours from the 42 "representative" Technician class members and then allocating that average number of unpaid hours to each class member would radically overcompensate some and undercompensate others, Judge Posner concluded in rejecting Plaintiffs' proposal. While Judge Posner did not specifically invoke *Dukes* in rejecting Plaintiffs' proposed use of representative testimony, his reasoning in doing so has some important analogies to the reasoning in that seminal case. The Supreme Court in *Dukes* rejected class counsels' plan to use representative testimony to establish damages – which the Court derisively termed a "trial by formula" – because it would deprive Wal-Mart of their due process right to litigate their separate defenses to the individual class members' claims. Judge Posner's decision similarly rejected the "trial by formula" approach of using representative proof to establish damages on a class-wide basis in the FLSA context.

Scrutiny of Class Trial Plan

Judge Posner then took class counsel to task for their poorly crafted trial plan, which failed to comport with the framework proposed by the district court. The district court had proposed to bifurcate the class trial into liability and damages phases and to divide the class into three kinds of subclasses. Plaintiffs, Posner noted, had opposed bifurcation and asserted that the 42 representative witnesses were each in, and would each testify on behalf of, each of the three subclasses. And, as discussed above, Plaintiffs proposed to establish damages via representative evidence. In memorable language, Judge Posner characterized this approach to trial as: "a shapeless, freewheeling trial that would combine liability and damages and would be virtually evidence-free so far as damages were concerned." Judge Posner

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speculated that class counsel was attempting to force settlement by proposing an unpredictable, costly and unmanageable trial. Of this strategy, the Court admonished that "class counsel cannot be permitted to force settlement by refusing to agree to a reasonable method of trial." The rigor of Judge Posner's analysis sends a strong message that courts should closely scrutinize the feasibility of plaintiffs' trial plans **before** certifying and permitting FLSA collective actions to proceed to trial.

Practical Implications for Employers

The *Espenscheid* decision cannot be dismissed as an outlier given the court, the judge who drafted the decision and the emerging legal trends in FLSA collective actions in the wake of *Dukes*. Thus, there are several immediate implications that stem from the *Espenscheid* decision, including the following:

- Even in cases pending outside the Seventh Circuit, employers will rely on *Espenscheid* to argue that elements of Rule 23 and aspects of *Dukes* should apply to FLSA collective actions, including such issues as the standard to be applied in evaluating expert reports at the certification stage. This issue is likely to be further illuminated by the Supreme Court's forthcoming decision this term in *Comcast v. Behrend*.
- Employers can use *Espenscheid* to oppose certification where plaintiffs have not prepared a reasonable trial plan by citing Judge Posner's admonition that "class counsel cannot be permitted to force settlement by refusing to agree to a reasonable method of trial." Even if no trial plan has been prepared, employers can draw on Judge Posner's rigorous analysis of the trial plan to request that courts focus on the feasibility and manageability of trying FLSA claims on a class basis, and not just on whether the class members are "similarly situated," which plaintiffs often insist is the only relevant inquiry for certification.
- While *Espenscheid* is a "hybrid" wage and hour case, as it involves an FLSA collective action and Rule 23 state law classes, employers may argue that Judge Posner would have reached the same conclusion even in the face of a stand-alone FLSA action. The plaintiffs' class action bar will, undoubtedly, respond that *Espenscheid* is confined to its facts and that extrapolating these principles outside the hybrid class context is not justified. However, there is certainly enough grist in Judge Posner's opinion for employers to carry the day on this argument.
- The decision also supports the proposition that the method for calculating damages in FLSA collective actions must be simple and mechanical – as opposed to individualized and fact intensive – for certification to be appropriate.
- Employers should now probe, even at the certification stage, whether and how plaintiffs intend to try their class claims on a representative basis. If plaintiffs do intend to use representative evidence (which is typically the case), employers should insist that plaintiffs use statistical sampling and perhaps engage the participation of an expert, in selecting the "representatives." Moreover, employers can use *Espenscheid* to challenge plans by plaintiffs to extrapolate the damages of individual class members from "representative" evidence, particularly if those plans do not account for variances between the class members.

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1 This procedure was initially articulated by the US District Court for the District of New Jersey, in *Lusardi v. Xexox Corp.*, 118 F.R.D. 251 (D.N.J. 1987).

2 *See, e.g., Meyers v. Hertz Corp.*, 624 F.3d 537, 554-55, n.10 (2d Cir. 2010) ("[T]he district courts of this Circuit appear to have coalesced around a two-step method ... which, while again not required by the terms of FLSA or the Supreme Court's cases, we think is sensible"); *Zavala v. Wal-Mart Stores Inc.*, 691 F.3d 527 (3d Cir. 2012) (articulating a two-stage certification process where plaintiff has the burden of showing, by a preponderance of the evidence, that the class members are similarly situated); *In re HCR Manorcare, Inc. v. Cole & Rogers*, 2011 WL 7461073 (6th Cir. Sept. 28, 2011) (rejecting defendant's assertion that Dukes overruled the FLSA two-step certification procedure).

3 FLSA collective actions are "opt-in" because prospective class members must affirmatively file a consent form with the court to join the class. Rule 23 classes are "opt-out" because prospective class members automatically become part of the class once a class is certified without having to take any affirmative steps, but must file a document with the court in order to "opt-out" of the class.

4 *See Alvarez v. City of Chicago*, 605 F.3d 445, 459 (7th Cir. 2010) (drawing on commonality and predominance concepts from Rule 23 in evaluating certification of FLSA suit); *Thiessen v. General Electric Capital Corp.*, 267 F. 3d 1095, 1105 (10th Cir. 2001) (in the context of an ADEA collective action case, stating that Rule 23 and traditional collective action certification standards all "allow for consideration of the same or similar factors"); *Shushan v. Univ. of Colo.*, 132 F.R.D. 263, 265 (D. Colo. 1990) (applying Rule 23 to an FLSA collective action).

5 It is noteworthy that, procedurally, Judge Posner used the Rule 23 standard to determine **only** whether to decertify the FLSA collective action. What the decision does not expressly address – perhaps by design – is whether the concept of a conditional certification (stage one) should even exist in an FLSA case, or if the two stages should be merged into one. Given his articulation of a clear preference for the Rule 23 standard, which describes a one stage certification procedure, many will interpret the decision as advocating a conflating of the two stages.

6 Variances pointed out by Judge Posner included: that the Technicians each worked different amounts of overtime; that the overtime rate for each Technician would vary given that they were paid on a per-job basis; that some Technicians may have under-reported their work-time because they wanted to impress the company with their efficiency, not because of any unlawful direction from the defendant; and that unrecorded work-time would have to be reconstructed from memory on an individual basis because of the lack of records substantiating the alleged unrecorded work-time.

Delaware Supreme Court Applies Business Judgment Standard to Executive Compensation Analysis

By Steven Margolis and Zahava Blumenthal

The Delaware Supreme Court recently upheld a Delaware Chancery Court ruling holding that a company's board of directors did not commit corporate waste in implementing a bonus plan under which payments to executives would not be tax deductible to the company under Internal Revenue Code Section 162(m) (Section 162(m)).[1] In its January 14, 2013 decision in *Freedman v. Adams*, the court focused on the board's exercise of its business judgment in affirmatively choosing not to adopt a more tax efficient Section 162(m)-compliant bonus plan in order to retain flexibility in its structuring of incentive compensation arrangements. This ruling affirms both the wide latitude granted to employers in establishing and administering compensation plans and also the care that must be taken in designing such plans and disclosing their terms to shareholders.

Deductibility Under Section 162(m)

Section 162(m) generally relates to the disclosure of executive compensation. It limits the ability of a publicly held company to deduct "applicable employee remuneration" paid to a "covered employee" in excess of $1 million in a year. A company's "covered employees" generally consist of its chief executive officer and its next three most highly compensated officers (excluding the chief executive officer and chief financial officer).

This ruling affirms both the wide latitude granted to employers in establishing and administering compensation plans and also the care that must be taken in designing such plans and disclosing their terms to shareholders.

Deductible compensation paid to a covered employee constitutes "applicable employee remuneration" unless it falls under one of several specified exceptions, including "other performance-based compensation," which occurs when:

- the compensation is paid solely on account of the attainment of one or more performance goals;
- the performance goals are determined by a compensation committee of the board of directors that is comprised solely of two or more outside directors;
- the material terms under which the compensation is to be paid are disclosed to shareholders and approved by a majority in a separate shareholder vote before the payment of such remuneration; and
- before any payment is made, the compensation committee certifies that the performance goals and any other material terms have been satisfied.

As a result, if a public company chooses to pay a covered employee compensation in excess of $1 million annually, that company frequently must choose between a compensation arrangement that is flexible and one that is tax-efficient – that is, a Section 162(m) plan.

The Business Judgment Rule

The business judgment rule, which has evolved under US case law, is intended to permit corporate directors to carry out their managerial roles without fear of constant shareholder and similar litigation. In *Aronson v. Lewis*[2], the Delaware Supreme Court described the business judgment rule as the presumption that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company. If a court does not find that the board abused its discretion, then the court will respect the board's business judgment and decisions. To satisfy the *Aronson* test and overcome the business judgment presumption, a plaintiff must allege particularized facts that create reasonable doubt that (1) a majority of the directors are disinterested and independent or (2) the challenged transaction was the product of a valid exercise of the board's good-faith, informed business judgment.[3]

Corporate Waste

Case law has also given rise to the corporate waste theory. To prove corporate waste, a plaintiff must show that in the context of a payment, "the exchange was so one-sided that no business person of ordinary, sound judgment would conclude that the company had received adequate consideration."[4] If reasonable, informed minds might disagree, then a court will respect the director's business judgment and will not attempt to evaluate the wisdom of the bargain or the adequacy of the consideration.[5] In short, a board's decision will generally be upheld unless it cannot be attributed to any rational purpose.[6] Conversely, a valid waste claim will deprive a board of the protection of the business judgment rule.[7]

Freedman v. Adams

In *Freedman*, the board of directors of XTO Energy Inc. (XTO) approved a compensation plan under which it paid bonuses from 2004 to 2007 to its chief executive officer and certain other officers totaling more than $130 million. These bonus payments would not be tax deductible to XTO because they did not fall under one of the exceptions specified under Section 162(m) and, in particular, the definition of "other performance-based compensation." XTO disclosed in its annual proxy statements that it chose to implement this plan rather than a plan that provided for tax-deductible compensation that complied with Section 162(m) because it did not want to be constrained in its ability to compensate XTO's executives. Shareholder Susan Freedman brought suit, alleging that XTO's board committed waste by failing to adopt a plan that could have made the bonus payments tax deductible if paid pursuant to a Section 162(m) plan as "other performance-based compensation." (The plaintiff also alleged that the board committed a bad-faith breach of its duty of loyalty, but the trial court ruled against the plaintiff on this point, and the plaintiff did not bring it up on appeal.)

> "The decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment."

The trial court held that the board's conscious decision not to adopt a Section 162(m) bonus plan fell within the board's business judgment, and the foregone tax deduction could be viewed as an employee compensation expense. XTO's decision fell within a line of Delaware cases dismissing compensation-related waste claims because the size and structure of executive compensation are inherently matters of judgment, and in the absence of fraud, the court would give broad deference to the board's business judgment.[8]

The Delaware Supreme Court affirmed, quoting the *Walt Disney* court's statement that a "claim of waste

will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets." By contrast, the XTO board made a conscious decision to forego tax savings in order to retain more control over compensation arrangements. Moreover, the XTO board had articulated to its shareholders not only the existence of the plan but also the plan's tax consequences and the board's justifications for implementing the plan nonetheless.

In response to Freedman's contention that the board's failure to adopt a Section 162(m)-compliant bonus plan constituted waste because it amounted to a gift in the form of tax payments that were not required, the Delaware Supreme Court wrote:

> There are two reasons why the complaint fails to state a claim for waste. First, although Freedman alleges that the benefits of having a Section 162(m) plan are "obvious," the complaint does not allege that any of the bonuses paid to XTO's executives actually would have been tax deductible under such a plan. Second, the XTO board was aware of the tax law at issue, but intentionally chose not to implement a Section 162(m) plan. The board believed that a Section 162(m) plan would constrain the compensation committee in its determination of appropriate bonuses. The decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment. Even if the decision was a poor one for the reasons alleged by Freedman, it was not unconscionable or irrational.

Conclusion

The Delaware Supreme Court's ruling in *Freedman* affirms that employers, and corporate boards, have wide latitude in making compensation decisions. Among other things, they may implement compensation arrangements that give rise to additional corporate expenses beyond direct compensation to employees. Nevertheless, both to avoid and to defeat shareholder and similar litigation, a board should document its reasoning (1) in implementing a given compensation arrangement and (2) in not implementing alternative classes of compensation arrangements. Moreover, a board should be sure to adequately and timely disclose to its shareholders, in proxy statements and elsewhere, both the substance and effect of its decisions and the considerations that were taken into account in reaching them.

1 *Freedman v. Adams*, No. 230, 2012, 2013 WL 144638 (Del. Jan. 14, 2013) (affirming *Freedman v. Adams*, C.A. No. 4199–VCN, 2012 WL 1345638 (Del. Ch. Mar. 30, 2012)).

2 473 A.2d 805 (Del. 1984).

3 *In re The Dow Chemical Company*, No. 4349-CC (Del. Ch. Jan. 11, 2010).

4 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006).

5 *Glazer v. Zapata*, 658 A.2d 176, 183 (Del. Ch. 1993) (citing *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988); *Saxe v. Brady*, 184 A.2d 602 (Del. Ch. 1962)).

6 *Freedman v. Adams*, No. 230, 2012, 2013 WL 144638.

7 *Id*.

8 *See also In re Walt Disney Co. Deriv. Litig.*, 731 A.2d 342, 362 (Del. Ch. 1998); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

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