Chapter III
The Legislative Process and the Courts

Free enterprise, the freedom to pursue one's economic self-interest, is an intrinsic part of the capitalist system. Men and women are free to choose their own line of work with few or no governmental restraints or subsidies, and businesses and entrepreneurs are free to combine any resources at their command to produce products and services for profit. Workers and consumers are free to produce, purchase, and exchange any good or service, provided that their activity does not infringe on others' rights. Of course, individuals are not free of the constraints of limited resources and unlimited wants. Moreover, some actions are also constrained by the rule of law.

American capitalism as an economic system is based on the principle of *laissez-faire* (from the French, meaning, roughly, "to let do"). **Laissez-faire** has come to mean minimum government interference and regulation in private and economic lives. In a pure **laissez-faire economy**, government has a role limited to setting the rules — a system of law establishing and defining contract and property rights, ensuring national defense, and providing certain public goods that the private sector cannot and would not provide. Public goods are goods and services, such as roads, canals, and national defense, that are not always generated by market transactions.

In reality, the role of government in modern American capitalism is greatly expanded from merely setting the rules and providing public goods. No society has ever conformed to the laissez-faire ideal. In particular, in addition to government efforts to provide public assistance and to attempt to stabilize the economy, government intervention is often the response to widely recognized failures of the free market system. Section A describes various market failures that are often used to justify government regulation. Section B provides an introduction to public choice economics: a theory of why government bodies — in particular, legislatures and administrative agencies — may fail to achieve their putative goals. Finally, Section C looks at the economics of the court system. It discusses public choice theory as applied to the courts, as well as offers an economic perspective on why parties file suit and settle (or do not settle) cases, court procedures such as discovery and class actions, and the growing use of arbitration as an alternative to the public courts.

A. Normative Grounds for Government Intervention

Under some fairly well-defined circumstances, economists recognize that the market fails to produce the allocative efficiencies predicted by economic theory. A **market failure** is a situation where the private market fails to produce the optimal level of a particular good. Widely recognized market failures are information problems (market prices cannot reflect risks unless those risks are known), externalities (positive or negative third-party effects that are not considered in private decision making), monopoly (dominance of a product market by a single firm), and public goods (goods for which it is very costly to exclude consumption by individuals who are not willing to pay for the good). These market failures are discussed in greater detail later in this section.

Market failures are often viewed as justifications for government intervention in a market. If the normative goal of government policy is to improve economic efficiency, then

government intervention to correct market failures can be justified as the pursuit of that goal. In order to achieve improved economic efficiency, the marginal cost of the intervention must not exceed that marginal benefit derived from correcting the market failure. The government can respond to market failures in a number of ways. One approach is for the government not to do anything at all. Such an approach could be a reflection of an ideological position that absolute freedom in the market place is more important than government intervention in the name of efficiency. This approach may also reflect a belief that the cost of the cure can be greater than the cost of the disease. A second approach, and one that occupies the opposite end of the continuum of possible responses, is for the government to take over the market or industry and try to do a more efficient job. An intermediate approach calls for the government to intervene in the market as a regulator of certain limited activities of otherwise competitive firms. Regulation can range from requiring certain types of warnings on package labels, to tax incentives, to total control over prices.

1. Market Failures

The four most widely accepted economic justifications for government intervention in the free market are information problems, externalities, monopoly, and public goods.

a. Information Problems

In the economist's purely competitive market, all economic actors are assumed to have perfect knowledge of all information relevant to making a decision. Under those conditions, the consumer's decision to purchase an "unsafe" product — for example, a product for which normal use results in a serious injury to one percent of the users over the useful life of the product — is simply a decision on the part of the consumer to bear the risk. Of course, the producer bears part of the risk in the form of a lower price. Thus, the market makes adjustments to account for risk properly. Similar examples of market adjustment under perfect information about relevant risks can be developed for the sale of risky securities and employment at unsafe workplaces. The fact that the market takes the risk into account means that the market is functioning properly — that is, according to theory.

In the real world, however, the market may fail to make adjustments because one of the parties to a transaction — typically the worker or consumer — does not have the information that is necessary to make an informed choice about the risk bearing that the individual is about to undertake. The failure of the market to assimilate all relevant information is referred to as an **information problem**. This is not to say that informed choices regarding risk are not commonly made in the real world. For example, a worker's decision to go to work for a company is based on many considerations, including hours, wages, retirement benefits, health insurance, job security, and working conditions (including safety and the overall environment). It is conceivable that a worker would accept a very risky job if the wages were high enough to compensate for the risk of getting killed. (The workers who hang girders in skyscrapers willingly accept the risk because either they prefer the risk, or they are compensated for it, or both.) On the other hand, in many industrial workplaces there is a possibility of coming into contact with dangerous chemicals that appear harmless, but may nevertheless have serious long-term effects. If the employer knows of the problem and conceals it from employees, the employer benefits through lower operating costs — including lower wages that do not reflect the risk of the job. And,

workers are harmed monetarily by lower wages and physically by the increased risk of illness. Thus, under some circumstances, government intervention in the form of safety inspections, research, and worker's compensation may be justified on efficiency grounds. In some instances, even the employer will not know that the chemical is dangerous. Accordingly, the risk is not known. Obviously, neither the market nor government regulators can adjust to unknown risks.

Several major federal regulatory schemes, including securities, consumer protection, and worker safety, are designed to correct the information problems in the market. The primary philosophy of the federal securities laws, which govern the issuance and trading of corporate stock and bonds, is the disclosure of information about the soundness of financial instruments. Even if the information disclosed reveals that the instrument is very risky, the company is allowed to sell the instrument because the investor is assumed to have based his or her decision to incur the risk on the truthful information made available under the regulation. Product-safety and worker-safety legislation addresses some of the information issues raised in the preceding paragraphs. Consumer-protection legislation regarding deceptive trade practices and debtor-creditor relations may be viewed as government solutions to problems that can arise when one party to a transaction has an informational advantage. Here, the primary regulatory response is to require the disclosure of information in an understandable manner. The economics of risk is discussed in more detail in Chapter VI.

b. Externalities

The operation of the invisible-hand mechanism envisioned by Adam Smith was based in part on the assumption that producing firms incur all of the costs associated with the production of their product. The industrialization and urbanization of society have made individuals' actions much more interdependent than in Smith's time. In many instances, some of the costs of producing a product "spill over" and injure third parties that are not part of the production process. The total cost to society in terms of resources consumed is the sum of the private costs paid by the producer and the external costs — **externalities** — that are borne by the third party. If the legal system does not provide for compensation to the third parties, then the producer will be able to operate at a cost of production that does not fully reflect the cost in terms of society's resources. Thus, the presence of externalities suggests that the social consequences of self-interested behavior may not always be in the interest of "society."

Pollution is the most obvious example of an externality. The traditional manner in which the law has dealt with externalities is through tort law. **Tort law** enables property owners to bring lawsuits whenever their private-property rights are infringed upon in a manner inconsistent with their use of the property. However, tort law is generally inadequate to handle the problems associated with externalities such as industrial pollution, because of the inability to define enforceable property rights in clean air and clean water. Moreover, the large number of individuals who may claim a right to clean air are not able to negotiate with the polluter because of the enormous transaction costs. Affected third parties often do not have the incentive or the legal right to bring suit. As a result, in some instances, tort law may be inadequate to force polluters to bear the full cost of their activities. In the absence of regulation, polluters will generally produce a greater output (of both goods and pollution) than would have been forthcoming in a competitive market with zero transaction costs and well-defined property rights. This overallocation of resources to the production of a product is considered a misallocation

from society's perspective.

The misallocation of resources that results from the inability of the market to define or enforce property rights in "free" goods like air and water provides a theoretical justification for government intervention in the market. The federal government's response to externalities is reflected in a number of environmental protection statutes, which are the basis of several cases in this casebook. More generally, externalities are the subject of Chapter IV.

c. Monopoly

The competitive market system is the primary regulator of the behavior of businesses. Rivalry generated in the pursuit of profits forces firms to produce at maximum efficiency. Competition among firms prevents the realization of excessive private economic power. As with any general rule, however, there are exceptions. For several different reasons, an individual firm (or group of competing firms acting as one firm) may occasionally dominate a particular market — that is, become a **monopoly**. For example, DeBeers dominates the world diamond trade because it controls the primary source of new diamonds.

Monopoly power may lead to a misallocation of resources that justifies government intervention in the market. A monopoly restricts the production of its product, resulting in buyers bidding up the product's price until it becomes so high that some buyers decide to stop bidding (that is, they drop out of the market). The consumers who end up purchasing the product at the higher price have done so voluntarily and thus have indicated that the exchange is mutually beneficial. The economic problem with a monopoly is that the potential gains from the mutually beneficial exchanges that would have occurred at the competitive market price, but which do not occur at the higher monopoly price, are not realized. Those potential gains from trade are lost forever. The consumers who dropped out of the market for the monopolized product will be able to spend their money elsewhere. However, because they would have preferred to purchase the monopolized good at the competitive price, these consumers are worse off than they would have been in a competitive market. In summary, the misallocation of resources that results from a monopoly is related to the restriction of output, which suggests that resources are underallocated to the monopolized market. Moreover, the pursuit of monopoly power through government restrictions — an activity referred to as **rent seeking** — wastes resources because some resources are devoted to using the political power of the state to coerce the redistribution of resources. Obviously, rent seeking is very different than the mutually beneficial exchange that characterizes voluntary market transactions — as developed in Section B below. The analysis of monopoly as a market failure is developed in more detail in Chapter VII.

The misallocation of resources attributed to monopoly is another theoretical justification for government intervention into the market. The federal antitrust laws are the government's response to this market failure. It is important to realize, however, that the antitrust laws present business with a perplexing paradox. On the one hand, becoming the biggest and the best at the particular businesses is the goal of almost all firms; on the other hand, the antitrust laws do not look favorably upon firms that have grown to dominate their industry. Thus, it has been suggested that the antitrust laws inhibit firms from maximizing their economic potential. However, this inherent conflict is not generally much of a problem. Antitrust cases are presented and analyzed throughout this book.

d. Public Goods

A public good is a good where consumption by one individual does not prevent its consumption by other individuals. This means that when a supplier provides a public good to one person, he or she supplies the good to all. In contrast, a **private good** is one that, when consumed by one individual, cannot be consumed by other individuals. An example of a private good is a cheeseburger; once I eat that cheeseburger, no one else can consume it. Individuals have an incentive to hide their preferences or demands for public goods. They cannot be excluded from consuming public goods produced by others, so why should they volunteer to pay for those goods? For individuals, such **free riding** behavior is rational.

The classic example of a public good is national defense. National defense must protect all individuals in the country; it is physically impossible to protect some people and leave others unprotected. Everyone agrees that national defense is needed. But will everyone, as individuals, supply it, or will everyone rely on someone else to do it? Rational, self-interested people would like to enjoy the benefits of national defense, while letting everyone else pay for it. Because national defense is a public good, if someone else defends the country, you are defended for free. You can be a free rider. The problem is that everyone has an incentive to be a free rider, but if everyone is a free rider, then there won't be any national defense. In such cases, the government can step in to require that everyone pay part of the cost of national defense to make sure that no one is a free rider.

2. Distributional Issues

Some individuals do not fare very well under the market system, while others prosper. Lawyers, law professors, the federal government, the president, and Congress devote much time, rhetoric, and effort to the equity of income distribution (or, as the case may be, income redistribution). Whether the proposal is imposing new gasoline taxes, extending dairy price supports, or decreasing corporate income taxes, the equity of such an action is sure to be debated. In following these debates, it becomes clear that there is much genuine disagreement over what constitutes a fair distribution of income. Opponents of higher gasoline taxes will argue that higher taxes on gasoline are unfair to poor Americans who must use their cars to commute to work; in turn, advocates of higher gasoline taxes will argue that it is only fair for car users to be taxed, since they cause many of the pollution problems in urban areas. Members of the farm lobby will argue for price supports on milk to increase the incomes of poor dairy farmers; consumer groups will oppose the measure on the grounds that it unfairly transfers income away from milk consumers.

Some economists also may have strong personal views concerning the equity of various income distributions. However, economists recognize that their views are subjective value judgments. In spite of his or her personal subjective views, most economists recognize that positive economic analysis cannot generate testable hypotheses concerning the optimal distribution of income in society. Because of their training in scientific methodology, most economists (as economists) are agnostic with regards to such questions.

Instead of evaluating the fairness of various income distributions, economists tend to focus on other aspects of redistribution proposals. In particular, they pay much attention to the efficiency consequences of various proposals to redistribute income. Although it is tempting to imagine that programs such as tax reform simply transfer income from those who need it less to

those who need it more without any adverse side effects, redistribution never works so simply. Inevitably, some individuals will incur costs to avoid paying higher taxes, while others will adjust their circumstances to qualify for new subsidies. Due to such activity, it almost always ends up costing some groups in society more than a dollar for each dollar that is transferred to other groups. Economists, therefore, are aware that any program to redistribute income involves a trade-off between equity and efficiency. And, as discussed above, economists are ill-equipped to evaluate the correctness of such a trade-off.

B. Public Choice Economics

Most of economics is concerned with private choices. Numerous analytical tools, such as the supply-and-demand model and marginal analysis, have been developed to help economists understand how markets work. Public choice economics applies the methodology of economics to political decision making. In other words, it applies generally accepted principles of rational economic behavior to decisions made by politicians, bureaucrats, and interest groups.

The basic assumption of public choice economics is that political decision makers behave just like consumers and businesses — they attempt to maximize their own self-interest. For example, the politician is viewed as responding to incentives in the same utility maximizing manner when making legislative and executive decisions as he or she does when shopping for groceries, housing, or an automobile. This is hardly a startling revelation for long-time observers and participants in the Washington public policy arena, but it is important to take these incentives into consideration when analyzing laws, regulations, and other new political institutions. In this view, interest groups, lobbyists, politicians, bureaucrats, and even public policy analysts have one thing in common — they all are entrepreneurs. They are constantly looking to exploit opportunities for gain within the political system. As a consequence, much government regulation fails to achieve its putative goals.

This section illustrates the public choice perspective by considering the incentives of two groups involved in the development of public policies — politicians and bureaucrats. Government policy making is far removed from the anonymous decision making that characterizes market transactions. Although markets appear to be chaotic, they guide resources to their highest value uses when allowed to work. In contrast, government is personal and political, and it is a serious mistake to talk about "the government" or "the federal and state governments" as if they are benevolent despots. When "the government" guides the allocation of resources, every decision becomes a political decision. Moreover, it is naive to view government decision makers as merely benign agents of the people, carrying out the people's will.

The public choice perspective on legislation suggests that interest groups compete against one another for the passage of favorable legislation. In this view, legislation is the result of a rent-seeking process in which legislation is "sold" by legislators and "bought" by the highest bidders. Special-interest legislation provides relatively large benefits (rents) to a relatively small, but well-organized group, at the expense of a much larger number of unorganized voters — taxpayers and consumers. A large amount of empirical research provides support for interest-group explanations for the emergence of economic regulations that apply to specific industries. Interest groups demand — and all levels of government supply — protective regulation, monopoly, and other special privileges. The political activity of interest groups seeking special favors from legislators and other government decision makers is referred to as **rent seeking**,

where the excessive (monopoly) profits earned by interest groups as a result of their political activity are referred to as rents. Recently, this approach to legislative activity has incorporated a more entrepreneurial role for legislators.

Money for Nothing:
Politicians, Rent Extraction, and Political Extortion

Fred S. McChesney (1997) pp. 20–23, 41–42

. . . [T]he basic economic model of regulation . . . remains one of rent creation. Rent creation is the standard perspective undoubtedly because . . . the economic model of regulation . . . [is] . . . one of *exchange*. . . . Politicians and their beneficiaries conclude a bargain that, like the typical contract, makes them both better off. Newly created rents are exchanged for votes and money; the multiparty auction allocates rents across groups. To the understandable confusion of lawyers, economists frequently use the word "bribe" to describe the "consideration" (the lawyers' term) paid over — quite legally — to politicians in return for regulatory favors.

It is not surprising that, perhaps instinctively, economists would turn to models of contract (exchange) to model regulation. Economics is often described as the study of the allocation of scarce resources among competing ends. . . . The principal mechanism by which scarce goods and services are allocated in market-based economies is exchange. Thus, economists have been interested in exchange since the development of economic science as a distinct discipline. Adam Smith began *The Wealth of Nations* (1776) with a description of people's "propensity to truck, barter and exchange one thing for another."

But analysis of regulation via a contract-based model entails three conceptual problems. First, the essence of contract is Pareto superiority: contracting parties are better off, and no one is worse off. That is obviously not true in the regulatory setting, where the benefits to producers (to some extent shared with politicians) come at the expense of consumers.[1] . . .

Second, consider that the "contract" between regulator-supplier and regulated beneficiary is not an ordinary legal contract. Payment is made in order to make the private party better off, and in the process the politician gains as well. But were the politician to take the money and then refuse to create the rents, the aggrieved private party would have no legal recourse. The law effectively does not prohibit an agreement involving money in exchange for political favors (although . . . it does regulate it). But the law does not enforce it, either.

The rent-creation contract is not illegal, but extralegal. The parties to the regulatory contract therefore must find their own, self-help ways to ensure that the promised performance is rendered on both sides. In this sense, rent creation is no different from any number of private exchanges made every day, in which individuals rely on one another's good faith and the desirability of continued relations, not the courts, for enforcement of the agreement.

Describing regulation as essentially a contract between politicians and regulated beneficiaries entails a third conceptual question: might other sorts of relationships also exist between the two groups? In the real world, voluntary contracts do not make up the complete set of human interactions. . . . People are thrown together involuntarily — on one side at least, if not

[1] Indeed, since the losses to consumers must be greater than the gains to producers, the regulatory contract is not even Kaldor-Hicks superior, which is the same as saying that regulation, unlike private contracts, is on net wealth-reducing.

both — in settings involving torts, even crimes, such as theft.

Obviously, these interactions do not leave both sides better off. But to the criminal (thief), the fact that his victims suffer while he gains is of scant importance. His only concern is whether he gains more through the involuntary exchange (theft) than he could by any voluntary exchange.[2]

In short, bribery (contract) is not the only form of interaction observed in the world. "In the general case, the individual will observe two ways to persuade: by a threat and by a bribe." In the course of the ordinary day, an individual will typically combine bribes to some people (for example, his spouse) with threats to others (for example, his children) in order to induce the behavior that is desired or expected. Other people do the same with him: his boss probably relies on a combination of carrots and sticks.

Why would politicians not use the same dual strategy in their dealings with people? Certainly, private beneficiaries may pay bribes (legal or illegal) to politicians for regulatory largesse. But instead of or in addition to accepting bribes, might not politicians also take, or extort, from private parties?

A politician has alternative ways to interact with private parties. He may seek votes or money from producers and offer rents from consumers in exchange, as in the orthodox economic theory of regulation-as-bribery. But a politician may also make his demands on private parties, not by promising benefits, but by threatening to impose costs — a form of political extortion or blackmail. If the expected cost of the act threatened exceeds the value of what private parties must give up to avoid legislative action, they rationally will surrender the tribute demanded of them. With constant marginal utility of wealth, a private citizen will be just as willing to pay legislators to have rents of $1 million created as she will to avoid imposition of $1 million in losses. With declining marginal utility of income, the citizen will pay more to avoid the losses than she will to obtain the gains.

Once the politician is seen as an independent actor in the regulatory process, his objective function cannot be treated as single-valued. He will maximize total returns to himself by equating at the margin the returns from votes, contributions, bribes, power, and other sources of personal gain or utility. All these, in turn, are positive functions not only of private benefits he confers but also of private costs he agrees not to impose.

The political strategy of cost forbearance can assume several forms. Perhaps most obvious is the threat to deregulate an industry previously cartelized. Expected political rents created by earlier regulation are quickly capitalized into firm share prices. If politicians later breach their contract and vote unexpectedly to deregulate, the shareholders suffer a wealth loss. Rather than suffer the costs of deregulation, shareholders will pay politicians a sum, up to the amount of wealth loss threatened, to have them refrain from deregulating. And in fact one routinely observes payments to politicians to protect previously enacted cartel measures. Dairy

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[2] . . . Of course, an agreement to make payments to avoid imposition of harm could be called a contract, in the same sense that responding to the choice "Your money or your life," offered by one wielding a gun, could be deemed a gift. Both popularly and legally, however, such a transaction — whatever option is chosen — "is still regarded as a robbery even though the participation of the victim was necessary to its completion, for the victim is compelled to choose between two alternatives, both of which are his as of right."

interests pay handsomely for continuation of congressional milk-price supports; physician and dentist political action committees (PACs) contribute large sums for continuation of self-regulation. . . .

Subsequent payments to avoid postcontractual opportunism by politicians are to be distinguished from contractual payments to enhance rent longevity *ex ante*. Both politicians and rent recipients gain when the durability of regulation can be increased, that is, when legislators are held to longer contracts. But new arrivals on both sides succeed to the interests of the original contracting parties. A legislator not party to the original bargain has less incentive to abide by the political rent-creation deal struck by his predecessors unless he too is compensated. Guaranteed rent durability is thus impossible. Among owners of firms, subsequent purchasers of shares with expected rents capitalized into their prices are vulnerable to extraction of previously created rents on the part of opportunistic politicians. Payments to political newcomers to secure performance of previously negotiated contracts earn no rents. Rather, they protect against windfall losses that new legislators could impose otherwise.

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The rent-extraction model . . . is essentially a model of extortion by politicians. They are paid not to legislate — money for nothing. The model extends the economic theory of regulation to include the gains available to politician-maximizers from alleviating costs threatened or actually imposed on private actors by legislators themselves and by specialized bureaucratic agencies. Status as a legislator confers a property right not only to create political rents but also to impose costs that would destroy private rents. In order to protect these returns, private owners have an incentive to strike bargains with legislators, as long as the side payments to politicians are lower than the losses expected from the law threatened.

Their ability to impose costs enables politicians to demand payments not to do so. As with rent creation, the process of rent extraction in the short run might seem to involve only transfers — from capital owners to politicians, rather than from consumers to producers. But the long-run implications are the more important ones. The transfers required to protect returns to private investments create disincentives to invest in valuable specific capital in the first place. Even when politicians eventually eschew intervention, the mere threat and the payments required to remove it must distort private investment decisions.

The model of rent extraction set out here in no way undermines the orthodox model of rent-creating regulation; rather, it supplements the rent-creation model by recognizing alternative sources of political gains.[3] Indeed, [Nobel Laureate George] Stigler's original article foreshadowed a complementary rent-extraction model: "The state — the machinery and power of the state — is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries. . . . Regulation may be actively sought by an industry, or it may be thrust upon it." Conditions that make political rent creation relatively unattractive to politicians make private rent extraction more attractive. The relative attraction of rent extraction has also

[3] To return to the bribery/extortion analogy, one who solicits bribes from some people to increase their welfare is hardly precluded thereby from demanding payment from other people not to decrease theirs.

increased as constitutional protection of private rights has diminished.

True, credibility issues, problems of political opportunism, and perhaps other imperfections in private-capital protection may create disincentives for capital owners to buy off legislators — just as opportunism and political-rent protection may discourage payments for rent creation. Yet rent creation is an ongoing, frequently observed phenomenon of modern politics. The complementary question thus is posed: do private actors in fact pay significant sums to induce government *not* to act?

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If so, one cost of government regulation has been missed. Heretofore, the economic model has identified several different costs of government regulation: deadweight consumer loss, resources expended as private parties seek rents, costs of compliance with regulation. . . . To these should be added the costs of protecting private capital, even when politicians ultimately are persuaded not to regulate. . . .

Notes and Questions

1. Regulation — Public Interest v. Private Interest: The history of economic regulation shows that industry-specific regulatory agencies tend to lose sight of their public interest mission over time. That is, although an agency may be created to control a particular industry, experience reveals that most regulatory agencies eventually adopt the perspective of the industries they regulate. This is referred to as **regulatory capture**. Thus, eventually, the regulated industry frequently benefits from the regulation.

This observation has led some students of the regulatory process to suggest that one should look to the beneficiaries of the regulation in attempting to identify the parties that demanded and procured the regulation. For example, the Interstate Commerce Commission was created to control price discrimination by railroads. Some customers complained that price cuts were helping large shippers at the expense of small shippers. However, the primary effect of price discrimination was the destruction of the railroads' cartel which tried to raise prices above competitive levels. The railroads were competing for the large customers through price cuts and rebates, and the cartel was crumbling as a result. This socially beneficial competition was eliminated by the government's imposition of fixed rates which effectively enforced the cartel. Consumers, who presumably represented the "public interest," did not benefit from the regulation. Instead the benefits flowed to the railroads through the higher prices that resulted from the elimination of competition. In fact, some scholars have argued that the railroads engineered (pun intended) the creation of the ICC.

It is not unusual for administrative agencies to act in the interest of the regulated industry rather than in the so-called public interest. One explanation that has often been given is that the selection of board or commission members is biased toward choosing individuals from the industry. This is likened to hiring the fox to guard the henhouse. On the other hand, the hiring of industry insiders may be necessary because they may be the only available individuals with the special knowledge of the industry that is required to make a meaningful contribution to the agency. Such knowledge is rarely found in "outsiders." Further, it is not clear that selecting board and commission members from outside the industry would change the result. As outsiders become aware of the special problems facing an industry, they are likely to become sympathetic and supportive of the industry.

There are other reasons why regulated industries will tend to have relatively more impact on regulations than representatives of the public interest. The regulated industry has the greatest interest in the rules and regulations to be promulgated by the agency. Thus, in administrative hearings on proposed rule-makings, their perspective is likely to be better articulated than that of the public interest. This bias is not surprising, because individual citizens do not have the incentive to voice their positions on public policy issues due to free-rider problems. Thus, there is an underrepresentation of dispersed citizens' interests in the political process in general and the administrative process in particular. The economics of regulation has revealed numerous instances when public-interest sounding regulations in the name of public safety and health have turned out to be well-disguised restrictions on competition. This is especially true in fields where licenses and board certifications are required.

Economists and legal commentators often treat the adoption and implementation of public policies as if the individuals who make up "the government" selflessly act in the public interest. However, experience teaches us that self-interested government decision makers often do not make decisions that are in the public interest.

Public Choice scholarship also assumes that the public interest is more difficult to ascertain than the normal political science scholarship assumes. Government is not assumed to be an “it” but a “they” that is made up of individual actors who have preferences, just like any other economic actor.

2. Incentives of Regulators: The economic theory of regulation emphasizes the competition among interest groups to influence legislators and bureaucrats. The theory gives rise to various predictions about the likely outcomes of this competition — i.e., about which interest groups are more likely to succeed in obtaining favorable regulations. Andrew P. Morriss, Bruce Yandle, and Andrew Dorchak summarize some of the central predictions, which they describe as "principles that characterize agency incentives":

- "All else being equal, in a competitive struggle among interest groups seeking political favors, the winning group will be one that is relatively small in size, so that the political benefits are concentrated and the cost of achieving agreement is low."
- "All else being equal, the political process will prefer regulatory outcomes that spread the costs of regulations over a large and diverse population to outcomes that concentrate costs on smaller, more homogenous populations."
- "All else being equal, the winning interest group will be the one that has the lowest cost of organizing and communicating with politicians."
- "Politicians and all other participants in the political process, including members of the bureaucracy, seek to minimize their own costs when acting on behalf of interest groups or the general public."
- "Politicians must signal their performance to interest groups that support them by taking actions that reflect the symbolic preferences of the interest group, that deliver real benefits to the group, or that impose real costs on other groups to the advantage of the interest group."
- "The unorganized general public is rationally ignorant about the details of specialized legislation or regulation designed by politicians and regulators to favor particular groups."

- "Interest groups prefer long-term, uninterrupted political benefits to short-term arrangements."
- "Regulations typically have differential effects on regulated entities."

Andrew P. Morriss et al., *Choosing How to Regulate*, 29 Harvard Environmental Law Review 179, 223–28 (2005) (italics omitted). As you read the other cases in this chapter (and in this casebook), think about how well these principles explain the government regulations involved. How well does the economic theory explain what regulations get adopted?

3. Rationally-Ignorant Voters: One of the principles noted by Morriss et al. is that politicians are able to cater to special interests because they are not closely monitored by voters. Interestingly, the self-interest that is so important in the market system leads to ignorance in the political system. Recall that every activity involves an opportunity cost. The time a voter spends becoming knowledgeable about the candidates requires the voter to forego some other valuable use of that time. Hence, rational voters would require that they gain some benefit from the use of such time. Clearly, there is some benefit to each voter if the best candidate wins an election. However, the only time a single vote in an election has any value is when it is the tie breaking vote. With millions of voters, the chance of any one voter casting the tie breaking vote is minuscule. The expected benefit of casting an informed vote is therefore virtually zero. Faced with a comparison of the marginal cost of informing oneself about the candidates and the marginal benefit of doing so, it is little wonder that voters are simply advancing their self-interest by spending their time where it will have the greatest impact on their well-being. Thus, many voters are **rationally ignorant** of politicians and public policies. They take a free ride, and legislators are able to pass legislation that does not come close to anyone's understanding of the public interest. Moreover, by cloaking interest-group legislation in public-interest rhetoric, politicians make it even more costly to monitor their behavior.

4. Baptists and Bootleggers: Can you think of an example where two different special interest groups would favor the same piece of legislation for different reasons? Sometimes the legislative process makes for strange bedfellows. For example, two different groups supported state laws requiring liquor stores to be closed on Sundays. Baptists found such legislation to be favorable for religious reasons, while bootleggers found their covert trade to be much more profitable when liquor was not legally available. Thus, the bootleggers and Baptists joined forces in the fight for Sunday closing laws. More generally, this "Baptists and Bootleggers" theory suggests that regulations are more likely to be enacted when supported by those who favor it for moral reasons (e.g., the Baptists) and by those who benefit economically (e.g., the bootleggers). Can you think of other examples?

5. The Welfare Costs of Rent Seeking and Rent Extraction: Rent seeking is harmful to society because it results in two types of social costs. First, the political creation of monopoly harms society in the same way as any other monopoly — through the restriction of output and misallocation of resources. Second, the potential for government-conferred rents leads interest groups to use resources to capture those rents through the political process. Such rent-seeking expenditures attempt to transfer wealth from one group to another. This use of scarce resources represents a social loss, because the resources could have been used for productive purposes instead of merely dividing up the economic pie. See, for example, Gordon Tullock, *The Welfare Costs of Tariffs, Monopoly, and Theft*, 32 Western Economic Journal 5 (1967); Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 Journal of Political Economy 807

(1975). See also the graphical analysis in Chapter VII.

6. Public Policy Analysts and the Search for Market Failures: Many economists, public policy analysts, and legal commentators scrutinize markets looking for market imperfections which provide justification for some form of government intervention. It is generally and implicitly assumed by such investigators that the government policy that emerges will be faithfully executed by legislators and bureaucrats. Public choice economists, in contrast, are specialists at identifying government failures — instances where the incentive structures facing legislators and regulators make it almost impossible for a government policy to meet its stated objectives. Indeed, many economists believe that the government has the incentive to over-regulate because decision makers do not fully consider all of the costs and benefits of market intervention. When this occurs, the government is more likely to cause a negative externality than reduce one. See, for example, Leland Yeager, *Is There a Bias Toward Overregulation*, in Is the Market a Test of Truth and Beauty?: Essays in Political Economy 321-348 (Leland B. Yeager, ed., 1983).

City of Columbia v. Omni Outdoor Advertising, Inc.

Supreme Court of the United States

499 U.S. 365 (1991)

JUSTICE SCALIA delivered the opinion of the Court.

This case requires us to clarify the application of the Sherman Act to municipal governments and to the citizens who seek action from them.

I

Petitioner Columbia Outdoor Advertising, Inc. (COA), a South Carolina corporation, entered the billboard business in the city of Columbia, South Carolina (also a petitioner here), in the 1940's. By 1981 it controlled more than 95% of what has been conceded to be the relevant market. COA was a local business owned by a family with deep roots in the community, and enjoyed close relations with the city's political leaders. The mayor and other members of the city council were personal friends of COA's majority owner, and the company and its officers occasionally contributed funds and free billboard space to their campaigns. According to respondent Omni Outdoor Advertising, Inc., these beneficences were part of a "longstanding" "secret anticompetitive agreement" whereby "the City and COA would each use their [*sic*] respective power and resources to protect . . . COA's monopoly position," in return for which "City Council members received advantages made possible by COA's monopoly."

In 1981, Omni, a Georgia corporation, began erecting billboards in and around the city. COA responded to this competition in several ways. First, it redoubled its own billboard construction efforts and modernized its existing stock. Second — according to Omni — it took a number of anticompetitive private actions, such as offering artificially low rates, spreading untrue and malicious rumors about Omni, and attempting to induce Omni's customers to break their contracts. Finally (and this is what gives rise to the issue we address today), COA executives met with city officials to seek the enactment of zoning ordinances that would restrict billboard construction. COA was not alone in urging this course; concerned about the city's recent explosion of billboards, a number of citizens, including writers of articles and editorials in local newspapers, advocated restrictions.

In the spring of 1982, the city council passed an ordinance requiring the council's

approval for every billboard constructed in downtown Columbia. This was later amended to impose a 180-day moratorium on the construction of billboards throughout the city, except as specifically authorized by the council. A state court invalidated this ordinance on the ground that its conferral of unconstrained discretion upon the city council violated both the South Carolina and Federal Constitutions. The city then requested the State's regional planning authority to conduct a comprehensive analysis of the local billboard situation as a basis for developing a final, constitutionally valid, ordinance. In September 1982, after a series of public hearings and numerous meetings involving city officials, Omni, and COA (in all of which, according to Omni, positions contrary to COA's were not genuinely considered), the city council passed a new ordinance restricting the size, location, and spacing of billboards. These restrictions, particularly those on spacing, obviously benefited COA, which already had its billboards in place; they severely hindered Omni's ability to compete.

In November 1982, Omni filed suit against COA and the city in Federal District Court, charging that they had violated §§ 1 and 2 of the Sherman Act, as well as South Carolina's Unfair Trade Practices Act. Omni contended, in particular, that the city's billboard ordinances were the result of an anticompetitive conspiracy between city officials and COA that stripped both parties of any immunity they might otherwise enjoy from the federal antitrust laws. In January 1986, after more than two weeks of trial, a jury returned general verdicts against the city and COA on both the federal and state claims. It awarded damages, before trebling, of $600,000 on the § 1 Sherman Act claim, and $400,000 on the § 2 claim. The jury also answered two special interrogatories, finding specifically that the city and COA had conspired both to restrain trade and to monopolize the market. Petitioners moved for judgment notwithstanding the verdict, contending among other things that their activities were outside the scope of the federal antitrust laws. In November 1988, the District Court granted the motion.

A divided panel of the United States Court of Appeals for the Fourth Circuit reversed the judgment of the District Court and reinstated the jury verdict on all counts. We granted certiorari.

II

In the landmark case of *Parker* v. *Brown*, 317 U.S. 341 (1943), we rejected the contention that a program restricting the marketing of privately produced raisins, adopted pursuant to California's Agricultural Prorate Act, violated the Sherman Act. Relying on principles of federalism and state sovereignty, we held that the Sherman Act did not apply to anticompetitive restraints imposed by the States "as an act of government."

* * *

It suffices for the present to conclude that here no more is needed to establish, for *Parker* purposes, the city's authority to regulate than its unquestioned zoning power over the size, location, and spacing of billboards.

Besides authority to regulate, however, the *Parker* defense also requires authority to suppress competition — more specifically, "clear articulation of a state policy to authorize anticompetitive conduct" by the municipality in connection with its regulation. We have rejected the contention that this requirement can be met only if the delegating statute explicitly permits the displacement of competition. It is enough, we have held, if suppression of competition is the "foreseeable result" of what the statute authorizes. That condition is amply met here. The very purpose of zoning regulation is to displace unfettered business freedom in a manner that regularly has the effect of preventing normal acts of competition, particularly on the part of new

entrants. A municipal ordinance restricting the size, location, and spacing of billboards (surely a common form of zoning) necessarily protects existing billboards against some competition from newcomers.

The Court of Appeals was therefore correct in its conclusion that the city's restriction of billboard construction was prima facie entitled to *Parker* immunity. The Court of Appeals upheld the jury verdict, however, by invoking a "conspiracy" exception to *Parker* that has been recognized by several Courts of Appeals. . . .

There is no such conspiracy exception. The rationale of *Parker* was that, in light of our national commitment to federalism, the general language of the Sherman Act should not be interpreted to prohibit anticompetitive actions by the States in their governmental capacities as sovereign regulators. . . .

* * *

For these reasons, we reaffirm our rejection of any interpretation of the Sherman Act that would allow plaintiffs to look behind the actions of state sovereigns to base their claims on "perceived conspiracies to restrain trade." We reiterate that, with the possible market participant exception, *any* action that qualifies as state action is "*ipso facto* . . . exempt from the operation of the antitrust laws." This does not mean, of course, that the States may exempt *private* action from the scope of the Sherman Act; we in no way qualify the well-established principle that "a state does not give immunity to those who violate the Sherman Act by authorizing them to violate it, or by declaring that their action is lawful."

III

While *Parker* recognized the States' freedom to engage in anticompetitive regulation, it did not purport to immunize from antitrust liability the private parties who urge them to engage in anticompetitive regulation. However, it is obviously peculiar in a democracy, and perhaps in derogation of the constitutional right "to petition the Government for a redress of grievances," U.S. Const., Amdt. 1, to establish a category of lawful state action that citizens are not permitted to urge. Thus, beginning with *Eastern Railroad Presidents Conference* v. *Noerr Motor Freight, Inc.*, [365 U.S. 127 (1961),] we have developed a corollary to *Parker*: The federal antitrust laws also do not regulate the conduct of private individuals in seeking anticompetitive action from the government. This doctrine, like *Parker*, rests ultimately upon a recognition that the antitrust laws, "tailored as they are for the business world, are not at all appropriate for application in the political arena." That a private party's political motives are selfish is irrelevant: "*Noerr* shields from the Sherman Act a concerted effort to influence public officials regardless of intent or purpose."

Noerr recognized, however, what has come to be known as the "sham" exception to its rule: "There may be situations in which a publicity campaign, ostensibly directed toward influencing governmental action, is a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor and the application of the Sherman Act would be justified." The Court of Appeals concluded that the jury in this case could have found that COA's activities on behalf of the restrictive billboard ordinances fell within this exception. In our view that was error.

The "sham" exception to *Noerr* encompasses situations in which persons use the governmental *process* — as opposed to the *outcome* of that process — as an anticompetitive weapon. A classic example is the filing of frivolous objections to the license application of a

competitor, with no expectation of achieving denial of the license but simply in order to impose expense and delay. A "sham" situation involves a defendant whose activities are "not genuinely aimed at procuring favorable government action" at all, not one "who ‘genuinely seeks to achieve his governmental result, but does so *through improper means*.'"

Neither of the Court of Appeals' theories for application of the "sham" exception to the facts of the present case is sound. The court reasoned, first, that the jury could have concluded that COA's interaction with city officials "‘was actually nothing more than an attempt to interfere directly with the business relations [*sic*] of a competitor.'" This analysis relies upon language from *Noerr*, but ignores the import of the critical word "directly." Although COA indisputably set out to disrupt Omni's business relationships, it sought to do so not through the very process of lobbying, or of causing the city council to consider zoning measures, but rather through the ultimate *product* of that lobbying and consideration, viz., the zoning ordinances. The Court of Appeals' second theory was that the jury could have found "that COA's purposes were to delay Omni's entry into the market and even to deny it a meaningful access to the appropriate city administrative and legislative fora." But the purpose of delaying a competitor's entry into the market does not render lobbying activity a "sham," unless (as no evidence suggested was true here) the delay is sought to be achieved only by the lobbying process itself, and not by the governmental action that the lobbying seeks. . . .

Omni urges that if, as we have concluded, the "sham" exception is inapplicable, we should use this case to recognize another exception to *Noerr* immunity — a "conspiracy" exception, which would apply when government officials conspire with a private party to employ government action as a means of stifling competition. We have left open the possibility of such an exception, as have a number of Courts of Appeals. . . .

Giving full consideration to this matter for the first time, we conclude that a "conspiracy" exception to *Noerr* must be rejected. We need not describe our reasons at length, since they are largely the same as those set forth in Part II above for rejecting a "conspiracy" exception to *Parker*. As we have described, *Parker* and *Noerr* are complementary expressions of the principle that the antitrust laws regulate business, not politics; the former decision protects the States' acts of governing, and the latter the citizens' participation in government. Insofar as the identification of an immunity-destroying "conspiracy" is concerned, *Parker* and *Noerr* generally present two faces of the same coin. The *Noerr*-invalidating conspiracy alleged here is just the *Parker*-invalidating conspiracy viewed from the standpoint of the private-sector participants rather than the governmental participants. The same factors which, as we have described above, make it impracticable or beyond the purpose of the antitrust laws to identify and invalidate lawmaking that has been infected by selfishly motivated agreement with private interests likewise make it impracticable or beyond that scope to identify and invalidate lobbying that has produced selfishly motivated agreement with public officials. . . .

IV

Under *Parker* and *Noerr*, therefore, both the city and COA are entitled to immunity from the federal antitrust laws for their activities relating to enactment of the ordinances. . . .

* * *

. . . The judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Notes and Questions

1. American Federalism: The United States Constitution is based on the principle of federalism. Federalism conceives of governmental power that is split between a central governing body and state governments. In the United States, the federal government's scope of activity is limited by the powers granted in the Constitution. All other powers are reserved to the states. In *City of Columbia v. Omni Outdoor Advertising*, the Court clarifies the limits of the Sherman Act. The justification for these limits is federalism.

2.* Parker *State Action Immunity v. Perfect Competition: In the 1943 Supreme Court case of *Parker v. Brown*, 317 U.S. 341 (1943), the Court held that state officials and private economic entities who act pursuant to "state action" are provided antitrust immunity. Thus, states could adopt laws that stifled local competition. The *Parker* decision was based on the notion of federalism. In effect, the *Parker* state action immunity represents a willingness to sacrifice some of the benefits of competition in the name of federalism. How significant is this trade-off? From an economic perspective, was *Parker* the correct decision?

3. The Right to Seek Rents?: The Court observes that "with *Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc*. we have developed a corollary to *Parker*: the federal antitrust laws also do not regulate the conduct of private individuals in seeking anticompetitive action from the government." The right to seek anticompetitive action seems to be a prima facie example of rent seeking. Is the Court condoning rent seeking by its decision in *Noerr* and the application of *Noerr* to the facts in *Omni*? Alternatively, is the Court merely deferring to other laws in the protection of the policy making process? Clearly, some rent-seeking behavior like bribing public officials will be disciplined by other laws. However, conduct such as lobbying appears to be an acceptable form of rent seeking. Is there an optimal level of rent seeking? Is rent seeking ever good?

4. More Rent-Seeking Behavior: Clearly, the billboard ordinances benefited COA. In fact, these ordinances helped to solidify COA's monopoly position. As a monopolist, COA will be able to set output and price at a level that creates monopoly profits, but will COA actually see any of these profits? A careful reading of the facts reveals how important these monopoly profits are to COA. The Court's summary of the facts indicates that COA contributed money to the campaign funds of local officials and donated billboard space. When Omni attempted to enter the market in 1981, one of COA's counter measures was to develop and support billboard ordinances. After a year of meeting with city officials, ordinances were finally enacted to protect COA's monopoly. In addition, the Supreme Court opinion came in 1992, ten years after Omni's attempted entry. At any time during the past ten years, COA could have settled or come to some other agreement with Omni. Instead, it obviously saw the benefits of a victory in the Supreme Court after ten years of litigation expense to be worth the cost. In sum, this case is a clear example of rent-seeking behavior by a monopolist. It is likely that much of the monopolist's profits were devoured by its attempt to protect those profits. The resources used in rent seeking could have been consumed instead in productive industries.

5. Rationally-Ignorant Voters: Why don't the voters of Columbia seem to care about the dominant position granted to COA in the billboard market? How does the fact that COA gives free space to political candidates figure into this analysis? Does the fact that voters are rationally ignorant detract from the Court's reliance on federalism in deciding this case? It would certainly

seem like companies who advertised via billboard would have an incentive to organize and fight legislation limiting their choices. Why doesn't this happen? What incentives exist for two different special interest groups seeking two separate pieces of favorable legislation from the same government?

6. Federalism v. Rent Seeking: The Court uses both *Parker* and *Noerr* to draw a line between the actions of COA and the City of Columbia, and actions that fall within the scope of the Sherman Act. *Parker* is based upon the notion that the federal government shall not interfere with those decisions which belong to the states — federalism. States can therefore enact policies that limit intrastate competition. *Noerr* allows citizens to encourage the states to use the powers that they have been granted under the state action exemption of *Parker.* Thus, citizens can ask the states to make policy that limits intrastate competition. Does the combination of these two decisions clear the way for rent-seeking behavior regarding state policy? It appears as if the Court is willing to allow some amount of rent-seeking behavior at the state level in order to protect federalism and self-determination. Is this trade-off wise? How about in the long-run?

7. Constitutional Constraints on Rent Seeking?: The United States Courts of Appeals are split on whether the Due Process and Equal Protection Clauses of the U.S. Constitution provide a basis for invalidating state laws that protect business from competition. In *Craigmiles v. Giles*, 312 F.3d 220 (6th Cir. 2002), the Sixth Circuit struck down a Tennessee law forbidding the sale of caskets other than by a state-licensed funeral director. According to the court, the law "was nothing more than an attempt to prevent economic competition," *id.* at 225, which "[c]ourts have repeatedly recognized . . . is not a legitimate governmental purpose," *id.* at 224. The court of appeals' opinion concluded:

> Judicial invalidation of economic regulation under the Fourteenth Amendment has been rare in the modern era. Our decision today is not a return to *Lochner*, by which this court would elevate its economic theory over that of legislative bodies. *See Lochner v. New York*, 198 U.S. 45 (1905). No sophisticated economic analysis is required to see the pretextual nature of the state's proffered explanations for the 1972 amendment. We are not imposing our view of a well-functioning market on the people of Tennessee. Instead, we invalidate only the General Assembly's naked attempt to raise a fortress protecting the monopoly rents that funeral directors extract from consumers. This measure to privilege certain businessmen over others at the expense of consumers is not animated by a legitimate governmental purpose and cannot survive even rational basis review.

Id. at 229; *see also* St. Joseph Abbey v. Castille, 712 F.3d 215, 227 (5th Cir. 2013) (same). By comparison, the Tenth Circuit in *Power v. Harris*, 379 F.3d 1208 (10th Cir. 2004), upheld a similar Oklahoma statute against constitutional challenge. According to the court, "the Supreme Court has consistently held that protecting or favoring one particular intrastate industry, absent a specific federal constitutional or statutory violation, is a legitimate state interest." *Id.* at 1220. It held:

> Because we find that intra-state economic protectionism, absent a violation of a specific federal statutory or constitutional provision, is a legitimate state interest, we have little difficulty determining that the [Oklahoma statute] satisfies rational-basis review. . . . [T]he [Act] need only be rationally related to the legitimate state interest of intrastate industry protection. There can be no serious dispute that the [Act] is "very well tailored" to protecting the intrastate funeral-home industry. As such, "our inquiry is at an end."

Id. at 1222–23. The court of appeals distinguished the cases relied on by the court in *Craigmiles* as being based on interstate rather than intrastate protectionism. *Id.* at 1219. Should that matter?

West Lynn Creamery, Inc. v. Healy

Supreme Court of the United States

512 U.S. 186 (1994)

JUSTICE STEVENS delivered the opinion of the Court.

A Massachusetts pricing order imposes an assessment on all fluid milk sold by dealers to Massachusetts retailers. About two-thirds of that milk is produced out of State. The entire assessment, however, is distributed to Massachusetts dairy farmers. The question presented is whether the pricing order unconstitutionally discriminates against interstate commerce. We hold that it does.

I

Petitioner West Lynn Creamery, Inc., is a milk dealer licensed to do business in Massachusetts. It purchases raw milk, which it processes, packages, and sells to wholesalers, retailers, and other milk dealers. About 97% of the raw milk it purchases is produced by out-of-state farmers. Petitioner LeComte's Dairy, Inc., is also a licensed Massachusetts milk dealer. It purchases all of its milk from West Lynn and distributes it to retail outlets in Massachusetts.

Since 1937, the Agricultural Marketing Agreement Act, 7 U.S.C. § 601 *et seq.*, has authorized the Secretary of Agriculture to regulate the minimum prices paid to producers of raw milk by issuing marketing orders for particular geographic areas. While the Federal Government sets minimum prices based on local conditions, those prices have not been so high as to prevent substantial competition among producers in different States. In the 1980's and early 1990's, Massachusetts dairy farmers began to lose market share to lower cost producers in neighboring States. In response, the Governor of Massachusetts appointed a Special Commission to study the dairy industry. The commission found that many producers had sold their dairy farms during the past decade and that if prices paid to farmers for their milk were not significantly increased, a majority of the remaining farmers in Massachusetts would be "forced out of business within the year." On January 28, 1992, relying on the commission's report, the Commissioner of the Massachusetts Department of Food and Agriculture (respondent) declared a State of Emergency. In his declaration he noted that the average federal blend price had declined from $14.67 per hundred pounds (cwt) of raw milk in 1990 to $12.64/cwt in 1991, while costs of production for Massachusetts farmers had risen to an estimated average of $15.50/cwt. He concluded:

> "Regionally, the industry is in serious trouble and ultimately, a federal solution will be required. In the meantime, we must act on the state level to preserve our local industry, maintain reasonable minimum prices for the dairy farmers, thereby ensure a continuous and adequate supply of fresh milk for our market, and protect the public health."

Promptly after his declaration of emergency, respondent issued the pricing order that is challenged in this proceeding.

The order requires every "dealer" in Massachusetts to make a monthly "premium payment" into the "Massachusetts Dairy Equalization Fund." The amount of those payments is computed in two steps. First, the monthly "order premium" is determined by subtracting the federal blend price for that month from $15 and dividing the difference by three; thus if the federal price is $12/cwt, the order premium is $1/cwt. Second, the premium is multiplied by the

amount (in pounds) of the dealer's Class I sales in Massachusetts. Each month the fund is distributed to Massachusetts producers. Each Massachusetts producer receives a share of the total fund equal to his proportionate contribution to the State's total production of raw milk.

Petitioners West Lynn and LeComte's complied with the pricing order for two months, paying almost $200,000 into the Massachusetts Dairy Equalization Fund. Starting in July 1992, however, petitioners refused to make the premium payments, and respondent commenced license revocation proceedings. Petitioners then filed an action in state court seeking an injunction against enforcement of the order on the ground that it violated the Commerce Clause of the Federal Constitution. The state court denied relief and respondent conditionally revoked their licenses.

The parties agreed to an expedited appellate procedure, and the Supreme Judicial Court of Massachusetts transferred the cases to its own docket. It affirmed, because it concluded that "the pricing order does not discriminate on its face, is evenhanded in its application, and only incidentally burdens interstate commerce." . . . We granted certiorari, and now reverse.

II

The Commerce Clause vests Congress with ample power to enact legislation providing for the regulation of prices paid to farmers for their products. An affirmative exercise of that power led to the promulgation of the federal order setting minimum milk prices. The Commerce Clause also limits the power of the Commonwealth of Massachusetts to adopt regulations that discriminate against interstate commerce. "This ‘negative' aspect of the Commerce Clause prohibits economic protectionism — that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors. . . . Thus, state statutes that clearly discriminate against interstate commerce are routinely struck down . . . unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism. . . ."

The paradigmatic example of a law discriminating against interstate commerce is the protective tariff or customs duty, which taxes goods imported from other States, but does not tax similar products produced in State. A tariff is an attractive measure because it simultaneously raises revenue and benefits local producers by burdening their out-of-state competitors. Nevertheless, it violates the principle of the unitary national market by handicapping out-of-state competitors, thus artificially encouraging in-state production even when the same goods could be produced at lower cost in other States.

Because of their distorting effects on the geography of production, tariffs have long been recognized as violative of the Commerce Clause. In fact, tariffs against the products of other States are so patently unconstitutional that our cases reveal not a single attempt by any State to enact one. Instead, the cases are filled with state laws that aspire to reap some of the benefits of tariffs by other means. . . .

Under these cases, Massachusetts' pricing order is clearly unconstitutional. Its avowed purpose and its undisputed effect are to enable higher cost Massachusetts dairy farmers to compete with lower cost dairy farmers in other States. The "premium payments" are effectively a tax which makes milk produced out of State more expensive. Although the tax also applies to milk produced in Massachusetts, its effect on Massachusetts producers is entirely (indeed more than) offset by the subsidy provided exclusively to Massachusetts dairy farmers. Like an ordinary tariff, the tax is thus effectively imposed only on out-of-state products. The pricing order thus allows Massachusetts dairy farmers who produce at higher cost to sell at or below the

price charged by lower cost out-of-state producers.[4] If there were no federal minimum prices for milk, out-of-state producers might still be able to retain their market share by lowering their prices. Nevertheless, out-of-staters' ability to remain competitive by lowering their prices would not immunize a discriminatory measure. In this case, because the Federal Government sets minimum prices, out-of-state producers may not even have the option of reducing prices in order to retain market share. The Massachusetts pricing order thus will almost certainly "cause local goods to constitute a larger share, and goods with an out-of-state source to constitute a smaller share, of the total sales in the market." In fact, this effect was the motive behind the promulgation of the pricing order. This effect renders the program unconstitutional, because it, like a tariff, "neutraliz[es] advantages belonging to the place of origin."

* * *

III

* * *

Respondent's principal argument is that, because "the milk order achieves its goals through lawful means," the order as a whole is constitutional. He argues that the payments to Massachusetts dairy farmers from the Dairy Equalization Fund are valid, because subsidies are constitutional exercises of state power, and that the order premium which provides money for the fund is valid, because it is a nondiscriminatory tax. Therefore the pricing order is constitutional, because it is merely the combination of two independently lawful regulations. In effect, respondent argues, if the State may impose a valid tax on dealers, it is free to use the proceeds of the tax as it chooses; and if it may independently subsidize its farmers, it is free to finance the subsidy by means of any legitimate tax.

Even granting respondent's assertion that both components of the pricing order would be constitutional standing alone, the pricing order nevertheless must fall. A pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business. The pricing order in this case, however, is funded principally from taxes on the sale of milk produced in other States. By so funding the subsidy, respondent not only assists local farmers, but burdens interstate commerce. The pricing order thus violates the cardinal principle

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[4] A numerical example may make this effect clearer. Suppose the federal minimum price is $12/cwt, that out-of-state producers can sell milk profitably at that price, but that in-state producers need a price of $15/cwt in order to break even. Under the pricing order, the tax or "order premium" will be $1/cwt (one-third the difference between the $15/cwt target price and the $12/cwt federal minimum price). Assuming the tax generates sufficient funds (which will be the case as long as two-thirds of the milk is produced out of State, which appears to be the case), the Massachusetts farmers will receive a subsidy of $3/cwt. This subsidy will allow them to lower their prices from $15/cwt to $12/cwt while still breaking even. Selling at $12/cwt, Massachusetts dairy farmers will now be able to compete with out-of-state producers. The net effect of the tax and subsidy, like that of a tariff, is to raise the after-tax price paid by the dealers. If exactly two-thirds of the milk sold in Massachusetts is produced out of State, net prices will rise by $1/cwt. If out-of-state farmers produce more than two-thirds of the raw milk, the Dairy Equalization Fund will have a surplus, which will be refunded to the milk dealers. This refund will mitigate the price increase, although it will have no effect on the ability of the program to enable higher cost Massachusetts dairy farmers to compete with lower cost out-of-staters.

that a State may not "benefit in-state economic interests by burdening out-of-state competitors."

More fundamentally, respondent errs in assuming that the constitutionality of the pricing order follows logically from the constitutionality of its component parts. By conjoining a tax and a subsidy, Massachusetts has created a program more dangerous to interstate commerce than either part alone. Nondiscriminatory measures, like the evenhanded tax at issue here, are generally upheld, in spite of any adverse effects on interstate commerce, in part because "[t]he existence of major in-state interests adversely affected . . . is a powerful safeguard against legislative abuse." However, when a nondiscriminatory tax is coupled with a subsidy to one of the groups hurt by the tax, a State's political processes can no longer be relied upon to prevent legislative abuse, because one of the in-state interests which would otherwise lobby against the tax has been mollified by the subsidy. So, in this case, one would ordinarily have expected at least three groups to lobby against the order premium, which, as a tax, raises the price (and hence lowers demand) for milk: dairy farmers, milk dealers, and consumers. But because the tax was coupled with a subsidy, one of the most powerful of these groups, Massachusetts dairy farmers, instead of exerting their influence against the tax, were in fact its primary supporters.

* * *

Finally, respondent argues that any incidental burden on interstate commerce "is outweighed by the 'local benefits' of preserving the Massachusetts dairy industry." In a closely related argument, respondent urges that "the purpose of the order, to save an industry from collapse, is not protectionist." If we were to accept these arguments, we would make a virtue of the vice that the rule against discrimination condemns. Preservation of local industry by protecting it from the rigors of interstate competition is the hallmark of the economic protectionism that the Commerce Clause prohibits. . . .

In [another] case, also involving the welfare of Massachusetts dairy farmers,[5] Justice Jackson described the same overriding interest in the free flow of commerce across state lines:

> "Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his exports, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality." *H. P. Hood & Sons, Inc.* v. *Du Mond*, 336 U.S. 525, 539 (1949).

The judgment of the Supreme Judicial Court of Massachusetts is reversed.

It is so ordered.

Notes and Questions

1. Constitutional Constraints on Rent Seeking? Interstate v. Intrastate Protectionism: The Supreme Court in *Healy* states that "tariffs against the products of other States are so

[5] A surprisingly large number of our Commerce Clause cases arose out of attempts to protect local dairy farmers. The reasons for the political effectiveness of milk producers are explored in G. Miller, The Industrial Organization of Political Production: A Case Study, 149 J. Institutional & Theoretical Economics 769 (1993).

patently unconstitutional that our cases reveal not a single attempt by any State to enact one," and then proceeds to invalidate the combined milk tax-subsidy at issue in the case as indistinguishable from a tariff. Why is it so clear that interstate protectionism is unconstitutional, but much less clear whether the same is true for intrastate protectionism (see note 7 following *Omni Advertising*)? As a matter of constitutional law, the reason is that it is well-established that that "the very purpose of the Commerce Clause was to create an area of free trade among the several States." Wyoming v. Oklahoma, 502 U.S. 432, 470 (1992). The same cannot be said of the Due Process and Equal Protection Clauses. Is there any economic justification for the distinction?

2. The Economics of Free Trade: Most economists agree that barriers to free trade are undesirable. Indeed, a survey of economists has found a "strong" consensus that "[t]ariffs and import quotas usually reduce the general welfare of society." Dan Fuller & Doris Geide-Stevenson, *Consensus Among Economists: Revisited*, 34 Journal of Economic Education 369, 372 (2003). As discussed in Chapter II, even if one country (or state) has an absolute advantage in producing two goods, the country (or state) is still better off specializing in production of one of the goods and trading for the other (the so-called Theory of Comparative Advantage). Trade barriers like tariffs interfere with such beneficial exchanges.

3. Public Choice and Tariffs: The beneficiaries of interstate tariffs are clear: in-state producers avoid competition from lower cost out-of-state producers and so are able to charge higher prices. Out-of-state producers lose markets for their goods (although if the state is a price-taker in the interstate market it will not be able to affect the interstate market price). The real losers from tariffs are in-state consumers, who pay higher prices for goods than they otherwise would. Revenue from a tariff goes to the state treasury. In *Healy*, the tax revenue did not go to the state treasury but instead to in-state producers as a subsidy. Note the role that public choice analysis plays in the *Healy* Court's opinion. The Court indicated that ordinarily in-state producers would be one of the interest groups opposing a tax on milk — the higher price would reduce demand for milk. But in *Healy*, "because the tax was coupled with a subsidy, one of the most powerful of these groups, Massachusetts dairy farmers, instead of exerting their influence against the tax, were in fact its primary supporters."

4. Why Milk?: In footnote 22 (footnote 5 in this excerpt), the Court in *Healy* notes that "[a] surprisingly large number of our Commerce Clause cases arose out of attempts to protect local dairy farmers." Why might that be so? Is it really so surprising that local milk producers would have more pull with state governments than out-of-state milk producers or consumers?

5. Economics and Appellate Advocacy: *Healy* is a good illustration of the potential, but too often untapped, value of economic analysis for advocates. The legal issue in *Healy* was whether the Massachusetts milk tax-subsidy combination was more like an unconstitutional tariff or more like a constitutionally permitted subsidy. In international economics, it is well accepted that a tariff is a subsidy "financed in a very particular way — solely by a tax on consumers of that particular product." W.M Corden, Trade Policy and Economic Welfare 45 (1972). From the perspective of international economics, then, *Healy* is an easy (and correctly decided) case. But strikingly, none of the parties to *Healy* discussed or even cited the international economics literature in its Supreme Court brief, despite its obvious relevance.

C. The Economics of the Court System

Legislatures and administrative agencies obviously are not the only branches of government that make legal rules. Courts do so as well. The rest of this chapter examines the economics of the court system in more detail. First, it looks at public choice theory as applied to the courts. Second, it examines the incentives of parties to sue and settle court cases. Third, the chapter analyzes court procedures from an economic perspective, focusing on discovery and class actions. Finally, fourth, it discusses the use of private alternatives to the public courts.

1. Public Choice and the Courts

We have discussed possible government failures in the legislative and administrative processes identified by public choice theory. Interest groups lobby legislators and bureaucrats to obtain favorable government regulation and to avoid unfavorable government regulation. How does the theory apply to the court system? Institutionally, courts differ in important ways from the legislative and administrative processes. Judges (with the exception of some appellate courts) do not set their own agendas. Instead, they take the cases brought to them by the parties. As a result of the adversarial process, judges generally hear both sides of an issue (although undoubtedly with differing degrees of effectiveness) before deciding a case.

Moreover, the judiciary is more insulated from the political process than any other branch of government and, as a result, judges seem less vulnerable than legislators and bureaucrats to the influence of interest group politics. Therefore, scholars of both law and economics and public choice theory have traditionally had a strong preference for more active judicial involvement in law-making. These scholars have maintained that although the law created by legislatures is often inefficient, the common law system has generally led to efficient laws. However, despite the general preference for litigation over legislation, the judiciary is also susceptible to inappropriate rent-seeking. The courts simply represent another opportunity for interest groups to shape the law.

Republican Party of Minnesota v. White

United States Court of Appeals for the Eighth Circuit

416 F.3d 738 (2005) (en banc)

BEAM, Circuit Judge.

* * *

I. BACKGROUND

Canon 5A(1) and 5B(1) [of the Minnesota Code of Judicial Conduct], the partisan-activities clause, and B(2), the solicitation clause, rein in the political speech and association of judicial candidates in Minnesota. The partisan-activities clause states, in relevant part:

> Except as authorized in Section 5B(1), a judge or a candidate for election to judicial office shall not:
>
> (a) identify themselves as members of a political organization, except as necessary to vote in an election;. . . .
>
> (d) attend political gatherings; or seek, accept or use endorsements from a political organization.

Section 5B(1)(a) provides that "[a] judge or a candidate for election to judicial office may . . . speak to gatherings, *other than political organization gatherings*, on his or her own behalf." (emphasis added). The solicitation clause states,

> A candidate shall not personally solicit or accept campaign contributions or personally solicit publicly stated support. A candidate may, however, establish committees to conduct campaigns for the candidate through media advertisements, brochures, mailings, candidate forums and other means not prohibited by law. . . . Such committees are not prohibited from soliciting and accepting campaign contributions and public support from lawyers, but shall not seek, accept or use political organization endorsements. Such committees shall not disclose to the candidate the identity of campaign contributors nor shall the committee disclose to the candidate the identity of those who were solicited for contribution or stated public support and refused such solicitation. . . .

The facts of this case demonstrate the extent to which these provisions chill, even kill, political speech and associational rights. In his 1996 bid for a seat as an associate justice of the Minnesota Supreme Court, appellant Gregory Wersal (and others working on his behalf) identified himself as a member of the Republican Party of Minnesota, attended and spoke at the party's gatherings, sought the endorsement of the party, and personally solicited campaign contributions. In response to Wersal's appearance at and speech to a Republican Party gathering, a complaint was filed with the Minnesota Lawyers Professional Responsibility Board, alleging that Wersal's actions violated Canon 5A(1)(d). Although the Minnesota Office of Lawyers Professional Responsibility (OLPR) ultimately dismissed the complaint, the complaint accomplished its chilling effect. Wersal, fearful that other complaints might jeopardize his opportunity to practice law, withdrew from the race.

Wersal made a second bid for a seat on the Minnesota Supreme Court in 1998. In 1997 and 1998, Wersal asked the OLPR for advisory opinions regarding the solicitation and partisan-activities clauses. The OLPR's response was mixed, stating it would not issue an opinion regarding personal solicitation, in light of proposed amendments to the Canon and the fact that there were no judicial elections scheduled that particular year. It also stated that it would enforce the partisan-activities clause. Wersal then initiated this litigation. . . .

II. DISCUSSION

A. Judicial Selection in Minnesota

Minnesota has chosen to elect the judges of its courts. Minn. Const. art. 6, § 7. . . . Some thirty-three states employ some form of contested election for their trial courts of general jurisdiction, their appellate courts, or both. As federal judges, we confess some bias in favor of a system for the appointment of judges. Indeed, there is much to be said for appointing judges instead of electing them, perhaps the chief reason being the avoidance of potential conflict between the selection process and core constitutional protections. In promoting the newly drafted United States Constitution, Hamilton argued in Federalist No. 78 that if the people were to choose judges through either an election or a process whereby electors chosen by the people would select them, the judges would harbor "too great a disposition to consult popularity to justify a reliance that nothing would be consulted but the Constitution and the laws." Arguably, concerns about judicial independence and partisan influence, posited by Minnesota as grounds for regulating judicial election speech, are generated, fundamentally, not by the exercise of political speech or association, but by concerns surrounding the uninhibited, robust and wide-open processes often involved in the election of judges in the first place. As Justice O'Connor noted in her . . . concurrence [in Republican Party of Minnesota v. White, 536 U.S. 765 (2002)], "the very practice of electing judges undermines [an] interest" in an actual and perceived

impartial judiciary.

Yet, there is obvious merit in a state's deciding to elect its judges, especially those judges who serve on its appellate courts. It is a common notion that while the legislative and executive branches under our system of separated powers make and enforce public policy, it is the unique role of the judicial branch to *interpret*, and be quite apart from making that policy.

But the reality is that "the policymaking nature of appellate courts is clear." Michael R. Dimino, Pay No Attention To That Man Behind the Robe: Judicial Elections, The First Amendment, and Judges as Politicians, 21 Yale L. & Pol'y Rev. 301, 364 (2003); Stephen J. Ware, Money, Politics and Judicial Decisions: A Case Study of Arbitration Law in Alabama, 30 Cap. U. L. Rev. 583, 594 (2002) ("[It is a] myth that courts are apolitical and do not make policy. The Legal Realists exploded that myth and showed that judges do make policy. This is especially true of judges on states' highest courts."). Courts must often fill gaps created by legislation. And in particular, by virtue of what state appellate courts are called upon to do in the scheme of state government, they find themselves as a matter of course in a position to establish policy for the state and her citizens. "At the [state] appellate level, common-law functions such as the adoption of a comparative fault standard, or the determination of a forced spousal share of intestate property distribution, require a judiciary that is sensitive to the views of state citizens." The courts' policy-making power is, of course, ever subject to the power of the legislature to enact statutes that override such policy. But that in no way diminishes the reality that courts are involved in the policy process to an extent that makes election of judges a reasonable alternative to appointment.

Without question, Minnesota may choose (and has repeatedly chosen) to elect its appellate judges. The very nature of its sovereignty within our federal system guarantees that. . . . If Minnesota sees fit to elect its judges, which it does, it must do so using a process that passes constitutional muster.

B. The First Amendment and Political Speech

Within this context, Minnesota has enacted Canon 5 in an effort to regulate judicial elections. In *White*, the Court held the announce clause of Canon 5, which prohibits judicial candidates from stating their views on disputed legal issues, unconstitutional. It falls to us now to determine whether the partisan-activities and solicitation clauses of Canon 5 are acceptable under the First Amendment.

* * *

It cannot be disputed that Canon 5's restrictions on party identification, speech to political organizations, and solicitation of campaign funds directly limit judicial candidates' political speech. Its restrictions on attending political gatherings and seeking, accepting, or using a political organization's endorsement clearly limit a judicial candidate's right to associate with a group in the electorate that shares common political beliefs and aims.

* * *

D. Minnesota's Purported Compelling State Interest

. . . Minnesota . . . argue[s] that judicial independence, as applied to the issues in this case, springs from the need for impartial judges. Apparently, the idea is that a judge must be independent of and free from outside influences in order to remain impartial and to be so perceived. . . .

One possible meaning of "impartiality" is a "lack of preconception in favor of or against a

particular *legal view*." Quickly discounting this uncommon use of the word, the Court [in *White*] said it could not be a compelling interest for a judge to "lack . . . predisposition regarding the relevant legal issues in a case" because such a requirement "has never been thought a necessary component of equal justice." . . . We follow the Court's direction and likewise dismiss the idea that this meaning of impartiality could be a compelling state interest.

A second possible meaning is a "lack of bias for or against either *party* to [a] proceeding." Calling this the traditional understanding of "impartiality" and the meaning used by Minnesota and amici in their due process arguments, the Court explained that this notion "guarantees a party that the judge who hears his case will apply the law to him in the same way he applies it to any other party." The Court implied, and we find it to be substantially evident, that *this* meaning of impartiality describes a state interest that is compelling. . . .

Being convinced that protecting litigants from biased judges is a compelling state interest, we turn to the "narrow tailoring" examination of the partisan-activities clause under this particular meaning of judicial impartiality. . . .

* * *

1. Unbiased Judges and the Narrow Tailoring of the Partisan-Activities Clause

In one sense, the underlying rationale for the partisan-activities clause — that *associating with a particular group* will destroy a judge's impartiality — differs only in form from that which purportedly supports the announce clause — that *expressing one's self on particular issues* will destroy a judge's impartiality. . . . Indeed, Minnesota argues that a party label is nothing more than shorthand for the views a judicial candidate holds. . . . Thus, the Supreme Court's analysis of the announce clause under this meaning of "impartiality," to wit judicial bias, is squarely applicable to the partisan-activities clause.

> To be sure, when a case arises that turns on a legal issue on which the judge (as a candidate) had taken a particular stand, [be that through *announcing* or *aligning with* particular views,] the party taking the opposite stand is likely to lose. But not because of any bias against that party, or favoritism toward the other party. *Any* party taking that position is just as likely to lose. The judge is applying the law (as he sees it) evenhandedly.

* * *

Political parties are, of course, potential litigants, as they are in this case. . . . Yet even then, any credible claim of bias would have to flow from something more than the bare fact that the judge had associated with that political party. That is because the associational activities restricted by Canon 5 are, as we have pointed out, part-and-parcel of a candidate's speech for or against particular *issues* embraced by the political party. And such restrictions, we have also said, do not serve the due process rights of *parties.* In the case of a political party involved in a redistricting dispute, for example, the fact that the matter comes before a judge who is associated with the Republican or Democratic Party would not implicate concerns of bias for or against that party unless the judge were in some way involved in the case beyond simply having an "R" or "D," or "DFL" (denoting Minnesota's Democratic-Farmer-Labor Party) after his or her name. Thus, the partisan-activities clause does not advance an interest in impartiality toward litigants in a case where, without more, it is a like-minded political party which is one of the litigants.

And in those political cases where a judge is more personally involved, such as where the redistricting case is a dispute about how to draw that judge's district, and even in those cases

discussed above that merely involve a political party as a litigant, recusal is the least restrictive means of accomplishing the state's interest in impartiality articulated as a lack of bias for or against parties to the case. Through recusal, the same concerns of bias or the appearance of bias that Minnesota seeks to alleviate through the partisan-activities clause are thoroughly addressed without "burning the house to roast the pig." . . .

Therefore, the partisan-activities clause is barely tailored at all to serve any interest in unbiased judges, and, at least, is not the least-restrictive means of doing so. Accordingly, it is not narrowly tailored to any such interest and fails under strict scrutiny.

2. Impartiality Understood as "Openmindedness," and the Partisan-Activities Clause

The third possible meaning of "impartiality" articulated by the Supreme Court in *White*, and the one around which its analysis of the announce clause revolved, was "described as openmindedness." The Court explained,

> This quality in a judge demands, not that he have no preconceptions on legal issues, but that he be willing to consider views that oppose his preconceptions, and remain open to persuasion, when the issues arise in a pending case. This sort of impartiality seeks to guarantee each litigant, not an *equal* chance to win the legal points in the case, but at least *some* chance of doing so.
>
> * * *

We conclude that the partisan-activities clause is . . . "woefully underinclusive" . . . [and] that the underinclusiveness of the partisan-activities clause causes it to fail strict scrutiny.

a. Underinclusiveness Belies Purported Purpose

Underinclusiveness in a regulation may reveal that motives entirely inconsistent with the stated interest actually lie behind its enactment. . . .

The same is true of the partisan-activities clause. . . . A regulation requiring a candidate to sweep under the rug his overt association with a political party for a few months during a judicial campaign, after a lifetime of commitment to that party, is similarly underinclusive in the purported pursuit of an interest in judicial openmindedness. The few months a candidate is ostensibly purged of his association with a political party can hardly be expected to suddenly open the mind of a candidate who has engaged in years of prior political activity. And, history indicates it will be rare that a judicial candidate for a seat on the Minnesota Supreme Court will not have had some prior, substantive, political association. . . .

As for the appearance of impartiality, the partisan-activities clause seems even less tailored than the announce clause to an interest in openmindedness. While partisan activity may be an indirect indicator of potential views on issues, an affirmative enunciation of views during an election campaign more directly communicates a candidate's beliefs. If, as the Supreme Court has declared, a candidate may *speak* about her views on disputed issues, what appearance of "impartiality" is protected by keeping a candidate from simply *associating* with a party that espouses the same or similar positions on the subjects about which she has spoken? . . . Given this "woeful underinclusiveness" of the partisan-activities clause, it is apparent that advancing judicial openmindedness is not the purpose that "lies behind the prohibition at issue here."[6]

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[6] Rather, the fruits of Canon 5 appear to bear witness to its remarkably pro-incumbent character.

b. Underinclusiveness Betrays "Compelling" Claim

While it is not necessary for us to reach the question of whether judicial openmindedness as defined in *White* is sufficiently compelling to abridge core First Amendment rights, we note that the underinclusiveness of Canon 5's partisan activities clause clearly establishes that the answer would be no. . . . A clear indicator of the compelling nature of an interest is whether the state has bothered to enact a regulation that guards the interest from all significant threats. . . . Minnesota worries that a judicial candidate's consorting with a political party will damage that individual's impartiality or appearance of impartiality as a judge, apparently because she is seen as aligning herself with that party's policies or procedural goals. But that would be no less so when a judge as a judicial candidate aligns herself with the constitutional, legislative, public policy and procedural beliefs of organizations such as the National Rifle Association (NRA), the National Organization for Women (NOW), the Christian Coalition, the NAACP, the AFL-CIO, or any number of other political interest groups. . . . Indeed, associating with an interest group, which by design is usually more narrowly focused on particular issues, conveys a much stronger message of alignment with particular political views and outcomes. A judicial candidate's stand, for example, on the importance of the right to keep and bear arms may not be obvious from her choice of political party. But, there can be little doubt about her views if she is a member of or endorsed by the NRA. Yet Canon 5 is completely devoid of any restriction on a judicial candidate attending or speaking to a gathering of an interest group; identifying herself as a member of an interest group; or seeking, accepting, or using an endorsement from an interest group. As a result, the partisan-activities clause unavoidably leaves appreciable damage to the supposedly vital interest of judicial openmindedness unprohibited, and thus Minnesota's argument that it protects an interest of the highest order fails.

* * *

3. The Solicitation Clause

We now turn to an analysis of portions of the solicitation clause. The solicitation clause bars judicial candidates from personally soliciting individuals or even large gatherings for campaign contributions. . . . Restricting speech based on its subject matter triggers the same strict scrutiny as does restricting core political speech. . . .

* * *

In 2004, of the three Minnesota Supreme Court seats up for election, only one was contested. . . . In the race that was contested, the incumbent enjoyed a nearly thirty-two percent margin in contributions from outside, non-loan sources. The data from the Minnesota Court of Appeals is even more striking. Of the five Court of Appeals seats up for election, only two were contested. In those two races, the incumbents were able to collect a combined total of $104,172.21 in contributions against a combined challengers' total of just $4,546.46 — nearly twenty-three times as much.

In 2000, Supreme Court incumbents raised a combined $505,120.66. Only two of the challengers raised enough money to trigger disclosure. Their combined total was $23,582.67.

Notably, donations from lawyers and law firm-related political funds account for a substantial portion of incumbents' re-election war chests. In one 2004 Court of Appeals race, such contributions accounted for over forty-three percent of the incumbent's total campaign funds. In the 2004 Supreme Court race, they made up over half of the incumbent's funds.

Since strict scrutiny is clearly invoked, the solicitation clause must also be narrowly tailored to serve a compelling state interest. Minnesota asserts that keeping judicial candidates from personally soliciting campaign funds serves its interest in an impartial judiciary by preventing any undue influence flowing from financial support. We must determine whether the regulation actually advances an interest in non-biased or open-minded judges.[7]

a. Unbiased Judges and the Narrow Tailoring of the Solicitation Clause

. . . Canon 5 provides specifically that all contributions are to be made to the candidate's *committee*, and the committee "shall not" disclose to the candidate those who either contributed or rebuffed a solicitation. . . . An actual or mechanical reproduction of a candidate's signature on a contribution letter will not magically endow him or her with a power to divine, first, to whom that letter was sent, and second, whether that person contributed to the campaign or balked at the request. In the same vein, a candidate would be even less able to trace the source of funds contributed in response to a request transmitted to large assemblies of voters. So, the solicitation clause's proscriptions against a candidate personally signing a solicitation letter or making a blanket solicitation to a large group, does not advance any interest in impartiality articulated as a lack of bias for or against a party to a case.

b. Open-minded Judges and the Narrow Tailoring of the Solicitation Clause

We next consider whether the solicitation clause as applied by Minnesota serves an interest in impartiality articulated as "openmindedness." . . . Given that Canon 5 prevents a candidate from knowing the identity of contributors or even non-contributors, to believe so would be a "challenge to the credulous." Thus, Minnesota's solicitation clause seems barely tailored to in any way affect the openmindedness of a judge. Accordingly, the solicitation clause, as applied by Minnesota, cannot pass strict scrutiny when applied to a state interest in impartiality articulated as openmindedness.

III. CONCLUSION

. . . [W]e hold that [the partisan-activities and solicitation clauses] . . . do not survive strict scrutiny and thus violate the First Amendment. We therefore reverse the district court, and remand with instructions to enter summary judgment for Appellants.

JOHN R. GIBSON, Circuit Judge, with whom McMILLIAN and MURPHY, Circuit Judges, join, dissenting.

* * *

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[7] The dissent cites polls from other states that show concern on the part of those surveyed that lawyers' and plaintiffs' campaign contributions to judicial candidates influence the decisions of judges. The dissent asserts that political parties embody similar threats of "outside influence" on the judiciary. But these poll numbers provide clear evidence that the perception of influence is of a far different kind, one that is not regulated by Canon 5.

While Canon 5 severs judicial candidates from like-minded voters during an election, it expressly allows lawyers, law firms and other interest groups to donate money to their campaigns. In the 2004 Minnesota Supreme Court election, approximately thirty-two percent of all campaign contributions came from law firm political funds and lawyers. And in the only contested race, over ninety-seven percent of such contributions went to the incumbent. We need not speculate about the impact these lawyer contributions have on the appearance of the judiciary's integrity — the poll numbers noted by the dissent leave little question.

. . . [T]he Minnesota Supreme Court has recently reconsidered the provisions of Canon 5 at issue here, held hearings, and received public comment. It is a matter of interest that the parties in this case, in briefing and argument, made no mention of this development. As the canon was reconsidered, amended in part and reiterated in part while this case was pending on rehearing, failure to consider the effect of these developments may well cause this Court's opinion to be moot from its inception.

* * *

The Advisory Committee appointed by the Minnesota Supreme Court to study the issue concluded that there was a threat to the state's interest that required regulation of partisanship in judicial campaigns. . . . While we do not have access to the evidence before the Committee, widely available and publicized evidence substantiates the fear that the majority of the public believes that partisanship does influence the decisions of state courts. For instance, a poll conducted in 1999 showed that 81% of the respondents agreed that "politics influences court decisions." The Advisory Committee recommended deleting the party identification and the attend and speak clauses on narrow tailoring grounds. After receiving the Committee report and conducting a hearing and receiving public comment, the Minnesota Supreme Court decided to retain all three partisan activities clauses.

The Advisory Committee unanimously recommended against changing the ban on the judicial candidate's personal solicitation of campaign contributions. Again, widely available poll numbers support the Committee's conclusion that solicitation of campaign contributions carries with it a significant threat to the state's interest in freedom from external coercion of judges. For example, "a recent Wisconsin poll found that more than three-quarters of those surveyed believe that campaign contributions from lawyers and plaintiffs in high-profile cases influence the decisions of these judges in court," and a study in Texas "found that 83 percent of the public and 79 percent of lawyers believe that campaign contributions have a significant influence on a judge's decision." . . . [A] poll from Texas showed that 48% of state appellate and trial judges surveyed believed that campaign contributions had a fairly significant or very significant degree of influence over judicial decisionmaking. A Pennsylvania survey of registered voters showed that 95% of those surveyed believed that judges' decisions were influenced by large contributions to their election campaigns at least some of the time. This is the kind of evidence that would substantiate the threat to judicial open-mindedness (and the appearance of it) from partisan obligations and from judicial campaign fund-raising.

* * *

There can be no question that the interests at stake here are compelling. There are questions of fact — first, as to whether the threat to those interests posed by partisan involvement in judicial elections and personal solicitation of contributions are severe enough to warrant the measures taken by the Minnesota Supreme Court and second, as to whether the particular remedy chosen was truly selected for the asserted reason. I would remand to the district court for trial of these factual questions in light of new evidence of the Minnesota Supreme Court's most recent deliberations on the subject. . . .

Notes and Questions

1. Public Choice and Elected Judges: Application of public choice theory to elected judges seems relatively straightforward (at least more straightforward than applying it to

unelected judges, as discussed below). The incentives of elected judges are expected to be similar to the incentives of legislators — judges decide cases so as to maximize the likelihood they will be reelected. Indeed, several judges have admitted that reelection concerns may influence their judicial rulings. For example, former California Supreme Court Justice Otto M. Kaus commented: "To this day, I don't know to what extent I was subliminally motivated by the thing you could not forget — that it might do you some good politically to vote one way or the other."

Numerous empirical studies have found a relationship between elections and judicial decision making. Some studies have found that judges cast more politically-popular votes as their reelection approaches and electoral pressures intensify. See, for example, Melinda Gann Hall, *Electoral Politics and Strategic Voting in State Supreme Courts*, 54 Journal of Politics 427 (1992); Gregory A. Huber & Sanford C. Gordon, *Accountability and Coercion: Is Justice Blind when It Runs for Office*?, 48 American Journal of Political Science 247 (2004). Other studies have found a stronger relationship between electoral pressure and judicial decision making for judges elected on partisan ballots. For example, Alex Tabarrok and Eric Helland find that partisan-elected judges are more likely to redistribute wealth in tort cases from out-of-state businesses to in-state plaintiffs, who also are voters. Alexander Tabarrok & Eric Helland, *Court Politics: The Political Economy of Tort Awards*, 42 Journal of Law and Economics 157 (1999).

Are there any ways in which elected judges differ from legislators (other than the obvious one of deciding cases rather than enacting legislation)? As lawyers involved with the court system, are judges subject to ethical duties or professionalism norms that might constrain their behavior? Are lawyer-legislators subject to similar constraints?

2. Who Benefits?: The surveys cited by the dissent find that many people (and many judges) are concerned about the effect of elections on the incentives of judges. On the other hand, the court rejects such concerns, largely on the ground that the Minnesota restrictions on judicial campaigns at issue in the case are likely to have little effect on public confidence in the courts. If that is so, then why have those restrictions at all? Keep in mind that the campaign restrictions were not enacted by the legislature, but were adopted by the Minnesota Supreme Court. In footnote 9 of the *White* opinion (footnote 6 in this excerpt), the court of appeals observes that "the fruits of Canon 5 appear to bear witness to its remarkably pro-incumbent character." Why might incumbent judges favor those sorts of restrictions?

3. Follow the Money — Campaign Contributions and Judicial Elections: Since the 1980s, judicial elections have grown increasingly competitive and expensive. Throughout the 1990s, only $83.3 million was contributed to state supreme court candidates; in contrast, candidates raised $206.9 million between 2000-2009. Because a substantial campaign war chest is imperative to winning elections, judges seeking reelection have the incentive to issue judicial decisions that will help them to attract much-needed campaign contributions. Numerous empirical studies find that judges tend to favor campaign contributors in their decisions. For example, Shepherd has found that contributions from various interest groups are associated with increases in the probability that state supreme court judges will vote for the litigants whom those interest groups favor. Joanna M. Shepherd, *Money, Politics, and Impartial Justice*, 58 Duke Law Journal 623 (2009). For an extreme example, see Caperton v. A.T. Massey Coal Co., 129 S.Ct. 2252, 2257 (2009) (holding that failure of state Supreme Court justice to recuse himself violated due process when the board chairman and principal officer of the corporate defendant in the case

had made $3 million in campaign contributions in support of the justice's election, "more than the total amount spent by all other . . . supporters [of the justice] and three times the amount spent by [the justice's] own committee").

4. Lawyers and Judicial Elections: Lawyers are one of the interest groups that contribute substantial amounts to judicial election campaigns. As stated in footnote 15 of the *White* opinion (footnote 7 in this excerpt), lawyers and law firms made thirty-two percent of all contributions during the 2004 elections for Minnesota Supreme Court justices. Footnote 9 (footnote 6 in this excerpt) indicates that the percentage of contributions from lawyers was even higher in other judicial elections in the state. In other words, lawyers are yet another interest group seeking favorable rules and rulings. What sorts of legal rules might lawyers favor?

Most interest groups contribute both direct expenditures to candidates' campaigns and independent expenditures for TV and other advertising (that do not go directly to candidates). However, lawyers' contributions are almost exclusively direct campaign contributions. Why would lawyers prefer giving money directly to judges' campaigns instead of spending money independently on advertising?

5. Judges Seeking Reappointment: In many states, judges must be reappointed by the governor or legislature instead of reelected by voters. Like judges seeking reelection, judges seeking reappointment also have incentives to vote strategically. For example, judges facing reappointment by the governor or legislature may feel pressure to vote in ways that favor the executive or legislative branches. The power over judicial reappointment held by the governor or legislature offers the political branches of government direct opportunities to sanction judges for unpopular rulings. Judges who consistently vote against the interests of the other branches of government may hurt their chances for reappointment. Indeed, empirical studies have found evidence suggesting that, in the types of cases in which state governments have a stake, the decision making of judges seeking reappointment is influenced by reappointment concerns. See, for example, Paul Brace, Melinda Gann Hall, & Laura Langer, *Judicial Choice and the Politics of Abortion: Institutions, Context, and the Autonomy of Courts*, 62 Albany Law Review 1265 (1999); Joanna Shepherd, *Are Appointed Judges Strategic Too?*, 58 Duke Law Journal 1589 (2009).

6. The Incentives of Judges with Permanent Tenure: The majority of American state-court judges serve without permanent tenure and must be retained—either by voters, legislatures, or the governor—on a regular basis. In fact, only in a handful of states—Rhode Island, Massachusetts, New Hampshire, and some judges in Kansas — do judges enjoy permanent appointments. U.S. federal judges are similarly granted permanent tenure.

Applying public choice analysis to judges with permanent tenure is more difficult. As Judge Richard Posner has written:

> At the heart of economic analysis of law is a mystery that is also an embarrassment: how to explain judicial behavior in economic terms, when almost the whole thrust of the rules governing the compensation and other terms and conditions of judicial employment is to divorce judicial action from incentives — to take away the carrots and sticks, the different benefits and costs associated with different behaviors, that determine human action in an economic model.

Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 Supreme Court Economic Review 1, 2 (1993). Various elements of a judicial utility

function (i.e., what judges and justices seek to maximize) have been suggested, including the enjoyment of making decisions (or, as Judge Posner puts it, the "pure utility of voting"); prestige and respect from being a judge; the prospects for promotion to a higher court; being averse to reversal; and leisure time. These different elements of the judicial utility function obviously have different implications for judicial behavior, and some have argued that only a "meager harvest" of insights is likely to result from such models. *See* Richard A. Epstein, *The Independence of Judges: The Uses and Limitations of Public Choice Theory*, 1990 BYU Law Review 827.

In at least some contexts, however, judges behave very much as predicted by economic models of rationality. For example, federal judges have tried for years to regulate the process by which judges hire law clerks, delaying hiring until late in the second year or early in the third year of law school. The incentives for judges to comply with rules that delay hiring have been compared to the incentives of competitors that form a cartel to raise prices (indeed, both can be analyzed as forms of the "Prisoners Dilemma" game described in Chapter I). Even if the judges are collectively better off by agreeing to delay hiring, individually each judge has an incentive to hire before the deadline to gain the best available law clerks. The result of such "cheating on the cartel" is that the agreement to delay breaks down altogether — exactly the result economic theory predicts.

7. Interest Groups in the Courts: Interest groups participate in court cases in a variety of capacities, the most direct of which is as a party to the case. In addition, particularly before appellate courts, interest groups may file amicus briefs, containing arguments different from or in addition to those made by the parties. It is unclear how effective such filings are in influencing decisions on the merits of the case, but there is evidence of a positive relationship between the filing of amicus briefs and the likelihood a court will grant discretionary review in a case. *E.g.*, Kevin T. McGuire, The Supreme Court Bar: Legal Elites in the Washington Community 182 (1993) (finding U.S. Supreme Court more likely to grant certiorari in cases with one or more amici supporting the cert petition).

8. Evolution of the Common Law: A well-known theory in law and economics is that the common law, whether consciously or unconsciously, progresses towards efficiency. In the first article applying an evolutionary model to the common law, Rubin argued that because inefficient rules impose a loss on one party that is greater than the gain to the other, litigation becomes more likely when rules are inefficient, and so inefficient rules are subject to greater selection pressure, and more likely to be overturned. Paul H. Rubin, *Why is the Common Law Efficient?*, 6 Journal of Legal Studies 51 (1977).

There have since been countless extensions and modifications of this evolutionary approach. Law and economics scholars have also advanced important counterarguments. In one of the most influential criticisms of evolutionary models, Hirshleifer showed that the law could evolve to favor whichever party could most easily organize and mobilize resources for litigation to overturn unfavorable precedents, even if efficient. Hence, just as with the legislative process, interest groups can push the development of the common law in social welfare-reducing directions. Jack Hirshleifer, *Evolutionary models in Economics and Law*, in Research in Law and Economics (P. Rubin and R. Zerbe eds., 1982).

According to Professor Todd Zywicki, both of these views are partly correct:

> From its inception, an animating insight of the economic analysis of law has been the observation that the common law process appears to have a strong tendency to produce

> efficiency-enhancing legal rules. But many recent commentators have also concluded that recent decades have seen an evolution away from this traditional principle, as the common law appears to increasingly reflect interest-group pressures that have attenuated this traditional evolutionary tendency toward efficiency.

Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 Northwestern University Law Review 1551, 1551 (2003). Zywicki argues that the "fall of efficiency in the common law" is due to changes in what he calls "supply side" characteristics of the legal process, such as stronger adherence to the doctrine of precedent and less competition among courts, as well as doctrinal changes, such as less respect for the freedom of contract and less reliance on custom in deciding cases. *Id.* at 1554.

2. Suit and Settlement

The previous section dealt with the broader institutional question of how public choice theory applies to the courts. The section takes on a narrower topic, looking at why parties litigate a particular case. Very few legal disputes go to trial. In fact, about 95% of cases settle or are resolved on dispositive motions. The decision whether to file a lawsuit is merely a variant of the general economic rule of decision: if the marginal benefits of filing suit exceed the marginal costs of filing suit, then sue!

Economists typically analyze parties' litigation decisions using what is known as the expected value model. Under the model, litigants assign an expected value for possible case outcomes based on each outcome's likelihood and payout. The model includes all of the twists and turns the case may take, the probability the litigant will prevail at each of the necessary steps of the case, and the likely recovery if the litigant does prevail. By combining these factors, each outcome is assigned a number weighted according to its likelihood and potential payout. Between two outcomes with equal payouts, the outcome more likely to occur is weighted more heavily than the outcome less likely to occur in the expected value calculation. For a more detailed explanation of how to calculate expected values, see Chapter VI on Risk.

Assume, for example, that Julia is deciding whether to file suit after being injured in a car accident. Julia consults with her lawyers, who plan to demand a jury trial but believe that the defendant will likely file a motion to dismiss the case for failure to state a claim. Julia's lawyers estimate that if the case makes it to the jury, Julia has a 50% chance of recovering $10,000 and a 50% chance of recovering nothing. In addition, the lawyers estimate that the defendant has a 10% chance of prevailing on the motion to dismiss. If the case makes it to the jury, Julia's expected recovery is $5,000, calculated in the equation (0.5 * $10,000) + (0.5 * $0). In the equation, the first 0.5 represents the 50% chance of recovery and the second 0.5 represents the likelihood of no recovery. $10,000 is the payout that is conditioned upon the 50% chance of recovery. $0 is the payout conditioned on the 50% possibility that Julia will receive nothing. Those numbers are added together to calculate the expected recovery if the case gets to a jury.

Next, the expected recovery given that the case will make it to a jury must be tempered to reflect the 10% probability that the defendant's motion to dismiss will prove successful, Julia has a 90% chance of getting the case to the jury, so Julia's expected recovery if she files suit is $4,500 (0.9 * $5,000). This is calculated by multiplying the 0.9, or 90% chance the case survives the motion to dismiss, by the expected recovery if the case makes it to a jury. So long as her expected costs of litigating the case, also calculated using the expected value model, are less than

$4,500, Julia should sue. In other words, after subtracting the potential expected cost of litigation given various potential outcomes of the case, if the expected value of pursuing litigation is greater than zero, Julia should sue because she has the chance to become better off.

In practice, many attorneys make these sorts of judgments intuitively, but not always.

Kohls v. Duthie

Court of Chancery of Delaware

765 A.2d 1274 (2000)

LAMB, Vice Chancellor

I. INTRODUCTION

This is an application for a preliminary injunction against a management buy-out transaction being sponsored by a third-party venture capital fund. . . .

Plaintiffs argue that the disclosures made in connection with the proposed transaction are deficient and that elements of the valuation work performed on behalf of the Special Committee are materially in error. . . .

* * *

II. FACTUAL BACKGROUND

* * *

A. Kenetech's Liquidity Crisis

Kenetech Corporation ("Kenetech") is a small publicly traded company, operating largely in the electric utility market. . . .

In the mid-1990s, Kenetech faced a serious liquidity crisis when its largest wholly-owned subsidiary, Kenetech Windpower, Inc. ("KWI"), was forced to file for bankruptcy protection. In response, Kenetech began selling assets and reducing its staff size.

B. Kenetech's Search for Strategic Alternatives

[Although] Kenetech . . . weathered its serious liquidity crisis, it did so only by selling most of its operating assets and firing most of its employees. Because of its small equity capitalization and lack of access to financial markets, Kenetech publicly announced in March 1999 its intention to explore strategic alternatives, including going private or seeking a merger or acquisition partners. . . .

C. The Derivative Litigation

In October 1997, Mark Lerdal, president and chief executive officer of Kenetech, was approached by Mark Laskow of The Hillman Company ("Hillman"), the owner of nearly a third of Kenetech's common shares. Laskow told Lerdal that Hillman planned to sell its shares by year-end in order to take a tax loss in 1997. Laskow asked Lerdal if he knew of anyone who might be willing to pay a meaningful amount for the stock. Laskow also told Lerdal that Hillman would, as a last resort, sell its shares at a nominal price and asked if Lerdal might be interested in purchasing them. Lerdal said he would be. The record also reflects that, either in this initial conversation or at a later time, Lerdal and Laskow discussed whether Kenetech could buy the shares and, apparently, agreed that it could not due to its several financial defaults and its apparent capital impairment. . . .

* * *

Laskow called Lerdal again around December 15, 1997 and told him that Hillman had not found a buyer for its shares. He offered to sell Lerdal the stock for either $1,000 or $5,000.

Naturally, Lerdal chose to pay $1,000 for the 12.8 million shares, and the transaction closed December 29, 1997.

This transaction forms the core basis of plaintiffs' claim that Lerdal usurped a corporate opportunity. The complaint alleges that the timing of this purchase by Lerdal renders the transaction suspect. Allegedly, Lerdal knew that [Kenetech would soon be able to pay off all of its debts and regain profitability.] It is also alleged that the other apparent obstacles to Kenetech repurchasing its own shares could have been overcome.

The derivative action was filed on February 3, 2000 and seeks the cancelation of Lerdal's shares. The complaint alleges that, at the time of filing, the shares acquired by Lerdal for $1,000 were worth over $8.2 million. In the context of the current transaction, in which $1.04 is being offered for each share of Kenetech common stock, Lerdal's shares are worth even more.

D. The ValueAct Merger Proposal

In June 2000, Jeffrey Ubben of the venture capital fund, ValueAct Capital Partners, L.P., approached Lerdal with the possibility of taking Kenetech private. Ubben was personally familiar with Lerdal and with Kenetech's search for strategic alternatives.

1. Creation of the Special Committee

Lerdal reported Ubben's contact at a special board meeting held on June 21, 2000. The board decided to pursue the possibility of a ValueAct transaction and, by June 29, a confidentiality agreement was reached between ValueAct and Kenetech. Shortly thereafter, Ubben raised with Lerdal the possibility that Lerdal should take an equity position in the purchaser by contributing his Kenetech shares. Lerdal informed the Kenetech board of this development at a July 5 meeting of the directors. Lerdal then withdrew from the meeting and the remaining directors decided to create a Special Committee for the purpose of evaluating any offers from ValueAct. The resolution creating the committee delegated to it broad powers to control the negotiation of a transaction, including the power to "say no." . . .

* * *

The Special Committee met on July 5, 2000, immediately after its creation, and next met on August 17 for the purpose of hiring the Wilmington, Delaware law firm of Potter, Anderson & Corroon, L.L.P. ("Potter"). The committee also discussed the need to hire a financial advisor and discussed several possible candidates. . . .

2. Negotiations with ValueAct

On August 23, ValueAct made an offer priced at $ 0.95 per share to close before December 31, 2000. . . .

On August 24, the Special Committee retained Houlihan, Lokey, Howard & Zukin Financial Advisors, Inc. to assist in evaluating the ValueAct proposal and negotiating a transaction. . . .

The Special Committee and ValueAct engaged in extensive negotiations over price and other terms of the proposed transaction. After considering a range of alternatives and a presentation by Houlihan, Lokey that described a preliminary range of fairness of $0.93 to $1.27 per share, the Special Committee made a counter-offer priced at $1.17.

* * *

The Special Committee met on October 24 and 25 to review the final agreements. . . . During the course of these meetings, Houlihan, Lokey made its final presentation, explained that it had narrowed its range of fairness to $0.96 to $1.13, and delivered its formal opinion that the

consideration offered in the transaction was fair to the Kenetech stockholders other than Lerdal from a financial point of view. At the conclusion of its meetings, the Special Committee voted unanimously to approve the transaction and to recommend it to the full board of Kenetech. On October 25, the full board, with Lerdal abstaining, approved the merger agreement after receiving advice from the Special Committee, Houlihan, Lokey, and Potter.

Of particular interest on this motion for preliminary injunction is Houlihan, Lokey's $0.01 per share valuation of the derivative claim, formally presented to the Special Committee on October 25, 2000. Houlihan, Lokey based its valuation of that claim on Potter's assessment of the probable outcomes of the litigation. Houlihan, Lokey also estimated the costs associated with the various outcomes and the likely net result to the corporation. It then created a "decision tree" that yielded the expected value. Plaintiffs have criticized Houlihan, Lokey's work for any number of reasons but have not submitted any evidence of their own valuing the litigation. I will discuss plaintiffs' criticisms of Houlihan, Lokey's work later in this opinion.

* * *

III. Legal Analysis

* * *

C. Adequacy of the Disclosures

When proposing a transaction to stockholders for their consideration and approval, directors have a fiduciary obligation to provide full and fair disclosure of all material information within their control. As a general rule, information is considered material if a reasonable investor would have viewed it as altering the total mix of information available. Plaintiffs maintain that defendants have not provided shareholders with adequate disclosure by both omitting facts and misleading shareholders regarding several aspects of the proposed transaction with ValueAct.

After the complaint attacking the proposed transaction was filed, the defendants published extensive supplemental disclosures ("Supplemental Disclosures"), no doubt intended to moot all of plaintiffs' disclosure claims. The Supplemental Disclosures describe the allegations of the second amended complaint, and contain additional detailed information on a number of topics addressed at the scheduling conference on the instant motion. Most significantly, these address issues relating to Houlihan, Lokey's valuation work, including its valuation of the derivative claim. . . .

* * *

The materials sent to stockholders tell them that Houlihan, Lokey valued the derivative action at $0.01 per share. Plaintiffs object both because they take issue with Houlihan, Lokey's methodologies and conclusions and because they say the disclosure materials do not adequately explain what Houlihan, Lokey did.

In his November 22, 2000 deposition, James R. Waldo, Jr., a senior vice president of Houlihan, Lokey who performed the valuation, explained his methodology for valuing the derivative action. He arrived at his conclusion by employing a "decision tree" methodology that allowed him to calculate the expected value of the litigation by taking into account all of the factors he deemed relevant to the calculation, including the likelihood of success on the merits, attorney's fees and other costs, taxes, probability that the suit would be maintained, probability of success, and probability that the cancellation of shares or equivalent damages would be awarded

if successful.[8] In preparing the valuation, Houlihan, Lokey relied on the expert advice of Potter in assessing the probabilities of events occurring. Substantially the same information is found in the Supplemental Disclosures and is adequate disclosure of what Houlihan, Lokey did.

On its merits, the Houlihan, Lokey valuation of the derivative claim appears to be the product of a logical methodology, and plaintiffs provide no alternative to it. They cavil about details of Houlihan, Lokey's work but, on the whole, their objections do not suggest a material deficiency in the result.

* * *

In light of the full disclosures made by the corporation, . . . I see no reason to see why shareholders should not be the final authority on whether this . . . transaction takes place.

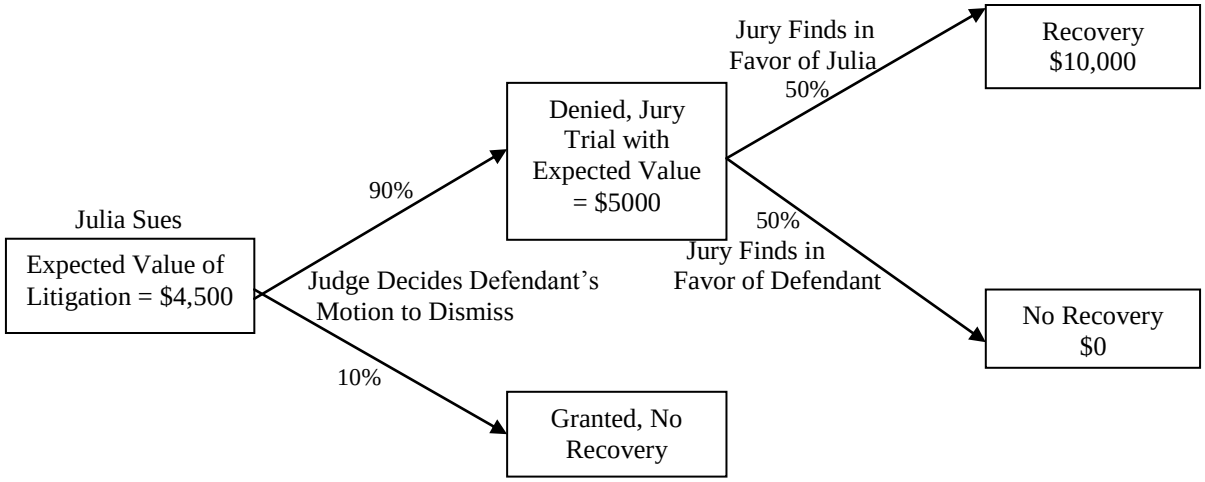
IV. CONCLUSION

For all of the foregoing reasons, the motion for preliminary injunction will be denied. IT IS SO ORDERED.

Notes and Questions

1. ***Decision Trees and Valuing Claims:*** A way that economists map out the potential outcomes and payouts in litigation is through the creation of decision trees. Decision trees represent strategic choices or alternate outcomes graphically (in a tree shape). Each branch of a decision tree represents a potential decision, made by at least one party to the litigation — including the court — and indicates likely outcomes based on each decision. In the example of Julia's unfortunate car accident, her lawyer would calculate the likelihood and payout from each potential outcome and map it in a decision tree, like the one below.

[8] Houlihan, Lokey's analysis is as follows: canceling the shares would be worth $0.4781 per share to the remaining shareholders. With a 25 percent attorney's fee awarded and a corporate tax of 40 percent, this yields an extra $0.2152 per share. Discounting this by a 25 percent chance of success (as suggested by Potter), and a 35 to 40 percent chance that the suit would be maintained by plaintiffs, and factoring the costs associated with the litigation, the valuation of the derivative action comes to $0.0172 to $0.0151 per share.



The process of mapping the potential outcomes of a case is a helpful exercise for lawyers to understand how the case will likely play out. It may serve to inform the lawyer of the range of settlement values that are acceptable at each stage of the case and ultimately may demonstrate whether to sue in the first place. *See also* Saunders v. C.I.R., 136 T.C. 406, 418 (U.S. Tax Ct. 2011) (discussing use of decision trees to value claims for tax purposes: "there are recognized methods of valuing choses in action by assuming various outcomes, assigning probabilities to those outcomes, and quantifying the results").

The facts of *Kohls* are complex, but the most interesting part of the case is the discussion of the value of the shareholders' derivative claim. Footnote 29 (footnote 8 in this excerpt) describes how Houlihan, Lokey came up with the expected value of the claim. The potential recovery from the lawsuit was valued at $0.4781 per share of stock. Of that amount, 25% would go to the plaintiff's attorney under a contingent fee contract, and 40% of the remainder would go to taxes. Subtracting those values from the potential recovery would leave the corporation with a net of $0.2152 per share. As estimated by the corporation's lawyers, there was "a 35 to 40 percent chance that the suit would be maintained by plaintiffs" (reflecting perhaps the director demand requirement), and only a 25 percent chance of plaintiffs winning if the case proceeded to judgment. Houlihan, Lokey estimated that subtracting an unspecified amount of litigation costs left the case with a positive expected value of $0.0151 to $0.0172 (1.5 to 1.7 cents) per share. That is, a (barely) positive expected value.

2. The Plaintiff's Decision Whether to Sue: Under the expected value model, the plaintiff will sue so long as the claim has a positive expected value — in other words, so long as **the expected benefits of suing exceed the expected costs**. In *Kohls* — not considering the complications from the fact that the case involved a shareholder derivative suit — because the claim has a positive expected value, the model predicts that the plaintiffs would file suit.

3. Negative Expected Value Claims: Of course, if the claim has a negative expected value, the model predicts that the claimant will not sue: the expected benefits from suing are less than the expected costs. Because a claim has a negative expected value does not necessarily mean that it is frivolous; it may be a meritorious claim, but one that simply is too expensive to pursue. Although as a general matter one would not expect plaintiffs to file negative expected value suits, under some circumstances it may be rational to do so. For example, an attorney may

be able to develop a reputation for filing negative expected value suits. Rather than incur the litigation costs in such a case, the defendant may go ahead and settle the claim. Other circumstances in which a plaintiff might file a negative expected value claim include when the parties possess differing amounts of information about the claim or when the claimant and defendant incur their litigation costs at different times. Why would a plaintiff file a claim in those situations?

4. A Real Options Alternative: Although the expected value model is the economic approach most commonly used to study civil litigation, it is based on a highly unrealistic assumption. As Bradford Cornell explains:

> In deciding whether to sue or whether to settle, the litigants consider the costs and benefits under the assumption that they must either settle promptly or go to trial. There are no intermediate decisions to be made along the way. Under these conditions, the discounted cash flow model can be used to analyze litigation investments.

Bradford Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 Journal of Legal Studies 173, 173 (1990). In actual litigation, of course, plaintiffs have a number of intermediate points at which they can decide simply to drop their claim (and save the remaining costs of litigating the case) rather than continuing to trial. At each of these intermediate points, the plaintiff has an option to continue with the case (like an option to buy stock or renew a lease) that it can exercise by incurring its costs of litigation. Cornell describes the implications of this "real options approach" as follows:

> These options make a lawsuit a more valuable investment than it would be if the plaintiff had to choose initially between trying the case and not filing suit. . . .
>
> Because the value of an option grows when the variance of the underlying random variable rises, increasing uncertainty regarding court awards will make a lawsuit a more attractive investment. For this reason, the granting of a few huge awards can greatly increase the incentive to sue by making litigation options more valuable. Suits will be filed even when the probability of winning such an award is so small that the discounted cash flow expected value is negative because the plaintiff has the option to drop the case at the optimal moment.

Cornell, *supra*, at 174, 182–83.

Although it generates interesting predictions, the real options model is much more complex than the expected value model. Despite its unrealistic assumptions, the expected value model has proven helpful in understanding the economics of many aspects of the litigation process, and continues to be used in law-and-economics scholarship today.

5. The Economics of Settlement: A settlement agreement is a contract like any other contract for the sale of goods or services. Consider the following example from everyday life. Jim owns a bicycle and Harry wants to buy it. When will the sale happen? The sale will happen when Harry is willing to pay a price that Jim is willing to accept. This will only occur if Harry values the bicycle more than Jim does. For example, if Harry values the bicycle at $200 he is willing to pay any price up to $200 for it. If Jim values the bicycle at $150 he is willing to accept anything more than $150 to sell it. Therefore, a sale is possible at any price between $150 and $200. However, no sale is possible if Jim values the bicycle at $250, since Harry is only willing to pay up to $200.

The same principles apply to settlement. In a settlement, however, it is not the bicycle for

sale; it is the plaintiff's right to sue. The plaintiff owns a legal right to sue the defendant, and a settlement involves the plaintiff selling his right to the defendant. Once the plaintiff has filed suit, the defendant must do its own valuation of the expected value of the claim and determine how to proceed. Because both parties will incur litigation costs to proceed with the case, it may be in their mutual interest to settle the case and save those costs. Indeed, since the vast majority of cases do settle before trial, the parties presumably have very strong incentives to settle rather than try the case.

According to the expected value model, the parties will have an incentive to settle under the following circumstances:

> The necessary condition for settlement is that the plaintiff's minimum offer — the least amount he will take in settlement of his claim — be smaller than the defendant's maximum offer. This is not a sufficient condition: the parties may find it impossible to agree upon a mutually satisfactory settlement price. But we shall assume that settlement negotiations are rarely unsuccessful for this reason and therefore that litigation occurs only when the plaintiff's minimum offer is greater than the defendant's maximum offer. The plaintiff's minimum offer is the expected value of the litigation to him plus his settlement costs, the expected value of the litigation being the present value of the judgment to him if he wins, multiplied by the probability (as he estimates it) of his winning, minus the present value of his litigation expenses. The defendant's maximum offer is the expected cost of the litigation to him and consists of his litigation expenses, plus the cost of an adverse judgment multiplied the probability as he estimates it of the plaintiff's winning (which is equal to one minus the probability of *his* winning), minus his settlement costs.[9]

Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 Journal of Legal Studies 399, 417-18 (1973). If the parties have identical estimates of the likelihood that the plaintiff will win and the amount of the plaintiff's damages, the plaintiff's expected value of the case will be the same as the defendant's expected loss from the case: the plaintiff expects to win what the defendant expects to lose. In such a case, the parties have an incentive to settle: they will save the costs of litigating the case and reach a conclusion that both parties expect. The settlement range in the case (the difference between the defendant's maximum offer and the plaintiff's minimum offer) clearly is positive and will equal the sum of both parties' expected litigation expenses.

The parties have an incentive to settle so long as their settlement range is positive. They may not be able to agree on a settlement amount due to various bargaining failures (each party trying to get too big a piece of the settlement pie), but they have an incentive to do so. However, in some cases there is no settlement range. If, for example, both parties are very optimistic about their chance of winning, the plaintiff may estimate a high expected value for the case while the defendant may estimate a low expected loss. Even taking into account both parties' litigation costs, the settlement range may be negative: the parties have no incentive to settle the case.

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[9] If a party is either risk averse or risk preferring rather than risk neutral the expected utility of litigation may be smaller or larger than its expected value. We assume risk neutrality except where otherwise indicated, but the analysis could easily be modified to take account of the existence of nonneutral attitudes toward risk. . . .

For example, suppose that Andy sues a hotel for negligence after slipping on a sidewalk after a snowstorm. The lawyers for the hotel are considering whether to settle. Assume that Andy's likelihood of success is 60% and that he expects a trial award of $50,000 in damages if he prevails. Also assume that each side will spend $10,000 in litigation costs if the case goes through trial. Can Andy and the hotel settle this lawsuit? If so, what is the settlement range?

Andy will demand a settlement that makes him at least as well off as going to trial. Using the expected value model to compute Andy's expected gain from trial, first multiply the probability of winning by the expected award (0.6 * $50,000) and then subtract the cost of litigation ($10,000) to get Andy's minimum settlement value, or the lowest point at which he should be willing to accept a settlement offer. Here it is $20,000.

Next, find the hotel's maximum amount for which it will settle rather than try the case. To compute the hotel's expect loss from trial, multiply its probability of losing by the amount of damages it will pay (0.6 * $50,000) and then add the hotel's litigation costs ($10,000). Therefore, the hotel should be willing to settle for any amount less than or equal to $40,000.

The settlement range is $20,000 to $40,000 — Andy is willing to accept a settlement as low as $20,000, and the hotel willing to offer as much as $40,000 for a settlement. The two parties should be able to settle, but the exact result will depend on the bargaining power of each side.

6. Settlement and Case Selection Bias: The economic analysis of settlement has given rise to "one of the fundamental results in the law and economic analysis of civil procedure," what is known as "case selection bias." Geoffrey P. Miller, *The Legal-Economic Analysis of Comparative Civil Procedure*, 45 American Journal of Comparative Law 905, 914 (1997). The insight, first developed by George L. Priest and Benjamin Klein in their article *The Selection of Disputes for Litigation*, 13 Journal of Legal Studies 1 (1984), predicts that systematic differences among courts (such as differences among the judges' ideological viewpoints) or laws (such as differences among state laws) will have little or no impact on how often plaintiffs win at trial because of selection effects. The model explains that, because trying a case is costly, both potential litigants would prefer to settle to avoid trial costs and, if they are risk averse, uncertainty. The potential litigants form rational estimates of likely trial outcomes, and settle the simpler, more predictable cases to avoid a costly trial. Thus, the only cases that go to trial are those for which the outcome cannot be easily predicted and in which the parties' expectations diverge. Because the cases with predictable outcomes are settled, the model anticipates that plaintiffs should win approximately 50 percent of the remaining unpredictable cases that go to trial.

For example, assume that state law requires the plaintiff to prove negligence to recover in tort, and that under the negligence rule plaintiffs win 50 percent of the cases that go to trial. The state supreme court, overruling its prior precedent, adopts a rule of strict liability, holding defendants liable in tort even if the defendant wasn't negligent. Surprisingly, plaintiffs continue to win 50 percent of the cases that go to trial. Does that mean that a strict liability rule is no better for plaintiffs than a negligence rule? Certainly not. Although the change in the legal rule did not affect plaintiffs' success rate at trial, it almost certainly affected the terms of the settlements that parties entered into before trial. The only cases that made it to trial under either legal rule were the tough cases — those in which, for example, both sides thought they had a good chance of success, like the mutual optimism scenario described above. However, the tough

cases under a strict liability rule are different from the tough cases under a negligence rule — indeed, they are probably cases that were clear losers under a negligence rule and would never even have made it to trial. Different assumptions about the characteristics of cases can result in different predictions about the expected rate at which plaintiffs and defendants win at trial. But the important insight of case selection bias nonetheless holds: that it can be very difficult to draw conclusions from empirical observations of trial outcomes; the legal rules may have their effects outside of court rather than inside.

7. Markets in Claims: A still small but rapidly growing industry consists of firms that provide funding for legal claims:

> [I]n recent years, a new breed of third-party litigation financing has evolved in the United States. Large litigation finance corporations now exist that provide capital in exchange for a share of a corporate plaintiff's eventual recovery. . . . [T]he new litigation finance corporations routinely loan several million dollars in exchange for shares of recoveries that can be in the billion dollar range. Currently, six corporations invest in commercial lawsuits in the United States. However, only two publicly traded corporations exist primarily to invest in American commercial litigation: Juridica Investments and Burford Capital. Both of these corporations manage investment funds of well over $100 million. Of the remaining four corporations, three are private companies that provide little information about their investments — ARCA Capital, Calunius Capital, and Juris Capital — and the other, IMF Ltd., is publicly traded but invests primarily in litigation outside of the United States. A handful of other corporations, investment banks, and hedge funds have recently formed litigation funding divisions to buy interests in commercial lawsuits.

Joanna M. Shepherd, *Ideal Versus Reality in Third-Party Litigation Financing*, 8 J.L. Econ. & Pol'y 593, 594 (2012). Before deciding whether to invest in a claim, the firms must value the claim and contract with the party asserting the claim. Many legal uncertainties remain, and the practice has been criticized:

> Third-party litigation financing has substantial support from practitioners and legal scholars. The basis of their support is that third-party financing of litigation can reduce barriers to justice that result when risk-averse, financially constrained plaintiffs are pitted against risk-neutral, well-financed defendants. By relieving a risk-averse plaintiff of much of the litigation risk, third-party financing can offset a risk-neutral defendant's bargaining advantage and level the playing field in negotiations. This would improve plaintiffs' compensation and promote more accurate deterrence.
>
> However, the goal of third-party investors is not to improve access to justice for financially constrained or risk-averse plaintiffs. Instead, third-party investors aspire only to maximize the returns from their investments in litigation. Moreover, the cases with the largest potential return are often the cases where the existing substantive law advantages, rather than disadvantages, the plaintiffs. As a result, many of the cases financed by third-party investors are the opposite of the types of cases where financing could improve access to justice for vulnerable plaintiffs. Thus, the reality of third-party financiers' investment strategy directly conflicts with the theoretical ideal of third-party financing.

Id. at 594-95. Is third-party litigation funding another step toward markets in legal claims? Would such a markets be a good thing?

3. The Economics of Court Procedures

Economists have analyzed a wide range of court procedures. This section discusses only two — but two of the most visible and controversial — discovery and class actions.

a. Discovery

Discovery — whether document production, depositions, or interrogatories — is an important characteristic of American litigation. Under modern discovery practice, as the Supreme Court stated in *Hickman v. Taylor*, "no longer can the time-honored cry of 'fishing expedition' serve to preclude a party from inquiring into the facts underlying his opponent's case." 329 U.S. 495, 507 (1947). Discovery benefits the parties and the court system by promoting more accurate outcomes: it enables decisions to be made on the basis of more complete information and reduces the chance for one party to surprise the other at trial. Society also benefits by realizing deterrence gains from greater outcome accuracy and reduced process costs with a higher settlement rate. But discovery has costs as well, as is obvious to anyone who has responded to a document request or attended a deposition (or, worse yet, been deposed!). Discovery also imposes administrative costs when discovery disputes must be resolved judicially, and parties can potentially use discovery for purposes other than legitimate fact-finding. Some forms of discovery are more costly than others; new technologies have only increased the potential costs.

Hagemeyer North America, Inc. v.
Gateway Data Sciences Corp.
United States District Court for the Eastern District of Wisconsin
222 F.R.D. 594 (2004)

DECISION AND ORDER

This matter comes before the Court on a motion to compel discovery. The plaintiff, Hagemeyer North America, Inc. n/k/a Hagemeyer N.A. Holdings, Inc. ("Hagemeyer") seeks to compel production of e-mails, financial statements, employee billing statements, computer backup tapes, and other documents from the defendant, Gateway Data Sciences, also known as Brownshire Holdings, Inc. ("Gateway").

* * *

II. DISCUSSION

* * *

. . . Hagemeyer asked Gateway to search all of its backup tapes for e-mails containing certain search terms. Gateway refused, citing the undue burden and expense involved in restoring the documents and then searching them. Hagemeyer also offered to search the tapes at its own expense, but Gateway refused. Hagemeyer now moves to compel Gateway to restore and search the backup tapes. Gateway argues that Hagemeyer should defray the costs of restoration because they are too burdensome. There are, therefore, "competing hardships" that the Court must balance: Gateway's — for having to search the tapes at great expense — and Hagemeyer's — for being deprived of potentially useful information.

A party may discover "any matter, not privileged, that is relevant to the claim or defense of any party. . . ." Fed. R. Civ. P. 26(b)(1). The Court may limit discovery, however, if it finds

that the discovery request is more easily obtained from another source, including information already collected; that the requesting party has had sufficient opportunity to obtain discovery; or that the request is unduly burdensome or expensive. Fed. R. Civ. P. 26(b)(2). Rule 26(b)(2)(iii) provides five factors to help the Court determine whether the burden or expense of a discovery request is proportional to the needs of the case:

> The frequency or extent of use of . . . discovery . . . shall be limited by the court if it determines that:
>
> ***
>
> (iii) the burden or expense of the proposed discovery outweighs its likely benefit, taking into account [(A)] the needs of the case, [(B)] the amount in controversy, [(C)] the parties' resources, [(D)] the importance of the issues at stake in the litigation, and [(E)] the importance of the proposed discovery in resolving the issues.

There is a presumption that "the responding party must bear the expense of complying with discovery requests. . . ." However, when the request violates the Rule 26(b)(2) proportionality test, the Court may "condition[] discovery on the requesting party's payment of the costs of discovery." The party opposing discovery must show good cause for its refusal and, thus, bears the burden of proof.

1. The Unique Burden of Producing Backup Tapes

Gateway raises the issue of cost shifting by stating that restoring and searching the backup tapes would be "extremely time-consuming and expensive." . . .

Backup tapes record a "snapshot" of the contents of the computer system at the moment the backup is run. *See McPeek v. Ashcroft*, 202 F.R.D. 31, 32 (D.D.C. 2001) ("*McPeek I*"). "The data on a backup tape are not organized for retrieval of individual documents or files, but for wholesale, emergency uploading onto a computer system." In case the system "crashes," and all the information created since the previous backup is lost, the contents of the tape can be loaded onto the system, restoring the lost information. *See Zubulake v. U.B.S. Warburg LLC*, 217 F.R.D. 309, 314 (S.D.N.Y. 2003) ("*Zubulake I*"). Since crashes presumably occur infrequently, backup tapes need not be as convenient to access as, say, a CD-ROM. At the same time, backup tapes must have the capacity to store large amounts of information since they are relied upon to replace all the information contained on a computer system after a crash. It is understandable, then, that backup tapes sacrifice accessibility for storage capacity, since to have both would be impractical and costly. Indeed, one court has revealed a correlation between the inaccessibility of backup tapes and the cost of searching them.

One of the reasons for the high cost of searching backup tapes is that they store more information than most other storage media. To illustrate, a CD-ROM's storage capacity is 650 megabytes, the equivalent of 325,000 typewritten pages; computer networks create backup data measured in terabytes — 1,000,000 megabytes — which is the equivalent of 500 billion typewritten pages.

Additionally, backup tapes require more time and labor to search than other media because of the way data is organized on them; "tape drives . . . are sequential-access devices, which means that to read any particular block of data, you need to read all the preceding blocks." This type of organization is a main reason that each backup tape may take anywhere from several minutes to five days to restore. Adding to the difficulty, each must be restored separately onto a hard drive in order to be searched.

Accordingly, the cost to review the backup tapes can be hundreds of thousands of dollars depending on the number of tapes that are to be searched.

2. Different Approaches to Cost-Shifting

A number of district courts have recognized the unique burden of producing documents stored on backup tapes and, by invoking Rule 26(c) to fashion orders to protect parties from undue burden or expense, have conditioned production on payment by the requesting party. *See, e.g., Zubulake I,* 217 F.R.D. 309; *Rowe Entm't, Inc. v. William Morris Agency, Inc.,* 205 F.R.D. 421 (S.D.N.Y. 2002); *McPeek v. Ashcroft,* 202 F.R.D. 31 (D.D.C. 2001). Although the power to shift the costs of discovery is discretionary, these courts have identified four approaches to help them determine when cost-shifting is proper. The Court of Appeals for this circuit has not addressed this issue.

a. Cost-Benefit Analysis

Cost-benefit analysis is a strict cost-based approach that requires the most primitive cost-shifting analysis: the requesting party always bears the burden of producing computer-generated data. Cost-benefit analysis is based, as its title suggests, on economic principles, most importantly "that an individual will pay what he assumes is a fair value for that which he seeks." Proponents of this approach argue that since the costs of responding to requests for electronic discovery are higher than those for other types of discovery, it is especially fertile territory for abuse. In short, it is in the requesting party's best interest to demand more discovery than it needs in order to increase the responding party's costs of litigation. If the requesting party bears the costs of producing electronically stored documents, it will only request what it needs for the case.

The Court rejects this approach for two reasons: first, it fails to accommodate documents stored on electronic media that are cheaper to produce than paper-based documents and, second, it ignores the presumption that the requesting party pays the costs of production.

b. The Marginal Utility Approach

The marginal utility approach, like the cost-benefit analysis which it rejects, is based on economic principles: "the more likely it is that the backup tape contains information that is relevant to a claim or defense, the fairer it is that the [responding party] search at its own expense." The court in *McPeek I,* which originated the marginal utility approach, delayed deciding whether to shift the costs of restoration until it knew the likely costs and benefits. To that end, the court ordered the responding party to search a sample of the backup tapes and to produce any responsive e-mails from that sample, keeping record of its monetary cost. Besides making the cost-shifting analysis fact-based, the marginal utility approach adheres closely to the Rule 26(b)(2) proportionality test.

c. The* Rowe *Test

The test that was used by the court in *Rowe* balanced eight factors:

(1) the specificity of the discovery requests;
(2) the likelihood of discovering critical information;
(3) the availability of such information from other sources;
(4) the purposes for which the responding party maintains the requested data;
(5) the relative benefit to the parties of obtaining the information;
(6) the total cost associated with production;
(7) the relative ability of each party to control costs and its incentive to do so;

and (8) the resources available to each party.

Although for a time the *Rowe* test was "the gold standard," it has a few shortcomings. First, the *Rowe* test omits two factors specified in Rule 26(b)(2)(iii) of the Federal Rules of Civil Procedure: (1) the amount in controversy and (2) the importance of the issues at stake in the litigation. Second, the fourth factor, i.e., the purposes for retaining the data, has no direct impact on the accessibility of computerized information and is, therefore, nonessential to determining the likely costs of production. Finally, the approach is flawed because "courts have given equal weight to all of the factors, when certain factors should predominate."

d. The* Zubulake *Factors

The court in *Zubulake I,* after identifying the defects in the *Rowe* test, created a new seven-factor test. The *Zubulake* test takes into consideration:

(1) The extent to which the request is specifically tailored to discover relevant information;

(2) The availability of such information from other sources;

(3) The total cost of production, compared to the amount in controversy;

(4) The total cost of production, compared to the resources available to each party;

(5) The relative ability of each party to control costs and its incentive to do so;

(6) The importance of the issues at stake in the litigation; and

(7) The relative benefits to the parties of obtaining the information.

The *Zubulake* factors improved the *Rowe* test because, unlike the *Rowe* test, the *Zubulake* factors are weighed in descending order of importance, not equally. Thus, the first two factors, which mirror the marginal utility test found in *McPeek I,* are the most important. Furthermore, the court in *Zubulake I,* like the *McPeek I* court, ordered the responding party to produce responsive documents from a sample of backup tapes. Therefore, the court was able to base its cost-shifting analysis on facts rather than speculation.

3. Conclusion

In short, *Zubulake* brought the cost-shifting analysis closer to the Rule 26(b)(2) proportionality test by adding two of the factors that *Rowe* had omitted and made the analysis dependent on the facts of the case. For these reasons, the Court is persuaded by the reasoning in *Zubulake* and will adopt the seven-factor *Zubulake* test.

Rule 26(c) of the Federal Rules of Civil Procedure gives the Court broad discretion to create any order that would spare a party undue burden or expense, including orders shifting the costs of production. However, the Court should only issue such an order when a request truly threatens to subject the responding party to undue burden or expense. Therefore, the Court will follow the reasoning of *McPeek* and *Zubulake* and require Gateway to restore a sample of backup tapes and require the parties to make additional submissions addressing whether the burden or expense of satisfying the entire request is proportionate to the likely benefit. The Court will then further address the search of Gateway's backup tapes. . . .

* * *

Notes and Questions

1. Is Discovery Necessary? The assumption underlying the discovery rules is that without legal compulsion, a party will not turn evidence over to the other side. That seems intuitively obvious, but there are at least some circumstances in which parties might voluntarily produce evidence even if not required to do so by the discovery rules. For example, a plaintiff might

reveal evidence favorable to its case to the defendant (or vice versa) to try and persuade the defendant to settle sooner or on better terms. Indeed, the plaintiff might produce even unfavorable evidence, if he or she believes that the defendant views the plaintiff's evidence as worse (i.e., more favorable to the defendant) than it actually is. On the other hand, the value of surprise at trial cuts against disclosure in both types of cases. Certainly a party has little reason to disclose evidence that is unfavorable to it and that the opposing party is unlikely to find out about otherwise. It is this sort of evidence that, at a minimum, the discovery process may make available to the other side — the marginal benefit of the discovery rules, as it were.

2. Discovery and Settlement: How does discovery affect the likelihood that a case will settle? As with many economic questions, the answer is that "it depends." Recall from the discussion above that a case is unlikely to settle when both parties are optimistic about their chances of success; if so, the settlement range may be small or nonexistent. Discovery may promote settlement in such a situation when it requires one party to disclose evidence favorable to its case; that evidence may reduce the optimism of the other side and expand the settlement range (or create one if one does not exist previously). But as Judge Posner writes: "if discovery may reduce mutual optimism by inducing the communication of information that causes a party to reduce his estimate of his chances of prevailing, so may it reduce mutual pessimism, and hence increase the likelihood of litigation, by generating information about the opponent's case that causes a party to become more optimistic." Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 Journal of Legal Studies 399, 423 (1973). In both cases, the greater the costs of discovery, the greater the incentive to settle to avoid those costs.

3. Discovery Abuse: Much has been written about abuses of the discovery process, with one party making burdensome discovery requests to impose substantial costs on the other. In cases like *Hagemeyer*, the burdens of producing the requested material can be substantial: searches through back-up computer tapes for possibly responsive electronic documents or e-mail messages. A 2012 RAND Institute study of e-discovery costs found total expenditures in a sample of cases ranging "from a seemingly modest $17,000 (in an intellectual property matter) to $27 million (in a product-liability case), with a median value of $1.8 million." *See* RAND Institute for Civil Justice, Where the Money Goes: Understanding Litigant Expenditures for Producing Electronic Discovery 17 (2012).

The court in *Hagemeyer* describes a number of competing approaches other courts have considered in determining who should bear the cost of such burdensome discovery. The default, as noted by the court, is for the party responding to the request to bear the costs. The court describes a number of tests for identifying cases in which the costs will be shifted to the requesting party. Two of the tests are explicitly economic in their formulation. The first, which the opinion calls "cost-benefit analysis," imposes the cost of producing back-up tapes on the requesting party. The second, which the opinion calls the "marginal-utility approach," balances the likely benefits of the search against its costs, and imposes the costs on the requesting party unless the benefits of the search are sufficiently high relative to the costs. How are these different approaches to cost allocation likely to affect the parties' behavior? Is the Coase Theorem relevant?

b. Class Actions

Another common (and often controversial) procedural device is the class action, whereby individual claims are aggregated into a single lawsuit pursued on behalf of the class by a representative plaintiff or plaintiffs. Class actions have a number of potential benefits. They may permit plaintiffs to achieve economies of scale in litigating their case and thus reduce litigation costs. For claims too small to be worth pursuing on an individual basis, aggregating the claims into a class action may be the only way to make the suit economical to bring (although other means, such as fee-shifting statutes, may give plaintiffs the incentive to sue even for small claims). Without such small-claims class actions, defendants might well escape liability altogether for actions that cause small harms to many victims. But class actions have potential costs as well.

In re: Bridgestone/Firestone, Inc.

United States Court of Appeals for the Seventh Circuit

288 F.3d 1012 (2002)

Easterbrook, *Circuit Judge.*

Firestone tires on Ford Explorer SUVs experienced an abnormally high failure rate during the late 1990s. In August 2000, while the National Highway Transportation Safety Administration was investigating, Firestone recalled and replaced some of those tires. Ford and Firestone replaced additional tires during 2001. Many suits have been filed as a result of injuries and deaths related to the tire failures. Other suits were filed by persons who own (or owned) Ford Explorers or Firestone tires that have so far performed properly; these persons seek compensation for the risk of failure, which may be reflected in diminished resale value of the vehicles and perhaps in mental stress. The Judicial Panel on Multidistrict Litigation transferred suits filed in, or removed to, federal court to the Southern District of Indiana for consolidated pretrial proceedings under 28 U.S.C. § 1407(a). Once these have been completed, the cases must be returned to the originating districts for decision on the merits. In an effort to prevent retransfer, counsel representing many of the plaintiffs filed a new consolidated suit in Indianapolis and asked the judge to certify it as a nationwide class action, which would make all other suits redundant. The district court obliged and certified two nationwide classes. . . . More than 60 million tires and 3 million vehicles fit [within the classes].

No class action is proper unless all litigants are governed by the same legal rules. Otherwise the class cannot satisfy the commonality and superiority requirements of Fed. R. Civ. P. 23(a), (b)(3). Yet state laws about theories such as those presented by our plaintiffs differ, and such differences have led us to hold that other warranty, fraud, or products-liability suits may not proceed as nationwide classes. The district judge, well aware of this principle, recognized that uniform law would be essential to class certification. Because plaintiffs' claims rest on state law, the choice-of-law rules come from the state in which the federal court sits. The district judge concluded that Indiana law points to the headquarters of the defendants, because that is where the products are designed and the important decisions about disclosures and sales are made. Ford and Firestone engaged in conduct that was uniform across the nation, which the district court took to imply the appropriateness of uniform law. This ruling means that all claims by the Explorer class will be resolved under Michigan law and all claims by the tire class will be resolved under Tennessee law. . . .

Both Ford and Firestone petitioned for interlocutory review under Fed. R. Civ. P. 23(f).

We granted these requests because . . . the suit is exceedingly unlikely to be tried. Aggregating millions of claims on account of multiple products manufactured and sold across more than ten years makes the case so unwieldy, and the stakes so large, that settlement becomes almost inevitable — and at a price that reflects the risk of a catastrophic judgment as much as, if not more than, the actual merit of the claims. Permitting appellate review before class certification can precipitate such a settlement is a principal function of Rule 23(f). Another function is permitting appellate review of important legal issues that otherwise might prove elusive. The district court's conclusion that one state's law would apply to claims by consumers throughout the country — not just those in Indiana, but also those in California, New Jersey, and Mississippi — is a novelty, and, if followed, would be of considerable import to other suits. Our review of this choice-of-law question is plenary, so we start there.

* * *

. . . If recovery for breach of warranty or consumer fraud is possible, the injury is decidedly where the *consumer* is located, rather than where the seller maintains its headquarters. A contract for the sale of a car in Indiana is governed by Indiana law unless it contains a choice-of-law clause, and plaintiffs do not want to enforce any choice-of-law clause. . . . It follows that Indiana's choice-of-law rule selects the 50 states and multiple territories where the buyers live, and not the place of the sellers' headquarters, for these suits.

* * *

Because these claims must be adjudicated under the law of so many jurisdictions, a single nationwide class is not manageable. Lest we soon see a Rule 23(f) petition to review the certification of 50 state classes, we add that this litigation is not manageable as a class action even on a statewide basis. About 20% of the Ford Explorers were shipped without Firestone tires. The Firestone tires supplied with the majority of the vehicles were recalled at different times; they may well have differed in their propensity to fail, and this would require sub-subclassing among those owners of Ford Explorers with Firestone tires. Some of the vehicles were resold and others have not been; the resales may have reflected different discounts that could require vehicle-specific litigation. Plaintiffs contend that many of the failures occurred because Ford and Firestone advised the owners to underinflate their tires, leading them to overheat. Other factors also affect heating; the failure rate (and hence the discount) may have been higher in Arizona than in Alaska. Of those vehicles that have not yet been resold, some will be resold in the future (by which time the tire replacements may have alleviated or eliminated any discount) and some never will be resold. Owners who wring the last possible mile out of their vehicles receive everything they paid for and have claims that differ from owners who sold their Explorers to the second-hand market during the height of the publicity in 2000. Some owners drove their SUVs off the road over rugged terrain, while others never used the "sport" or "utility" features; these differences also affect resale prices.

Firestone's tires likewise exhibit variability; that's why fewer than half of those included in the tire class were recalled. . . . There are other differences too, but the ones we have mentioned preclude any finding "that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy." Fed. R. Civ. P. 23(b)(3). Regulation by the NHTSA, coupled with tort litigation by persons suffering physical injury, is far superior to a suit by millions of *uninjured* buyers for dealing with

consumer products that are said to be failure-prone.

The district judge did not doubt that differences within the class would lead to difficulties in managing the litigation. But the judge thought it better to cope with these differences than to scatter the suits to the winds and require hundreds of judges to resolve thousands of claims under 50 or more bodies of law. Efficiency is a vital goal in any legal system — but the vision of "efficiency" underlying this class certification is the model of the central planner. Plaintiffs share the premise of the ALI's *Complex Litigation Project* (1993), which devotes more than 700 pages to an analysis of means to consolidate litigation as quickly as possible, by which the authors mean, before multiple trials break out. The authors take as given the benefits of that step. Yet the benefits are elusive. The central planning model — one case, one court, one set of rules, one settlement price for all involved — suppresses information that is vital to accurate resolution. What is the law of Michigan, or Arkansas, or Guam, as applied to this problem? Judges and lawyers will have to guess, because the central planning model keeps the litigation far away from state courts. (Ford asked us to certify legal questions to the Supreme Court of Michigan, to ensure that genuine state law was applied if Michigan's law were to govern the whole country; the plaintiffs stoutly resisted that proposal.) And if the law were clear, how would the facts (and thus the damages per plaintiff) be ascertained? One suit is an all-or-none affair, with high risk even if the parties supply all the information at their disposal. Getting things right the first time would be an accident. Similarly Gosplan or another central planner *may* hit on the price of wheat, but that would be serendipity. Markets instead use diversified decisionmaking to supply and evaluate information. Thousands of traders affect prices by their purchases and sales over the course of a crop year. This method looks "inefficient" from the planner's perspective, but it produces more information, more accurate prices, and a vibrant, growing economy. See Thomas Sowell, *Knowledge and Decisions* (1980). When courts think of efficiency, they should think of market models rather than central-planning models.

Our decision in *Rhone-Poulenc Rorer* made this point, and it is worth reiterating: only "a decentralized process of multiple trials, involving different juries, and different standards of liability, in different jurisdictions" (51 F.3d at 1299) will yield the information needed for accurate evaluation of mass tort claims. Once a series of decisions or settlements has produced an accurate evaluation of a subset of the claims (say, 1995 Explorers in Arizona equipped with a particular tire specification) the others in that subset can be settled or resolved at an established price.

No matter what one makes of the decentralized approach as an original matter, it is hard to adopt the central-planner model without violence not only to Rule 23 but also to principles of federalism. Differences across states may be costly for courts and litigants alike, but they are a fundamental aspect of our federal republic and must not be overridden in a quest to clear the queue in court. Tempting as it is to alter doctrine in order to facilitate class treatment, judges must resist so that all parties' legal rights may be respected.

The motion to certify questions of law to the Supreme Court of Michigan is denied as unnecessary in light of this opinion. The district court's order certifying two nationwide classes is reversed.

Notes and Questions

1. Class Actions and Settlement: The court of appeals states that class actions are

"exceedingly unlikely to be tried" because "aggregating millions of claims on account of multiple products manufactured and sold across more than ten years makes the case so unwieldy, and the stakes so large, that settlement becomes almost inevitable." Given our discussion earlier of the economics of suit and settlement, that isn't surprising. The high litigation costs of class actions create a large settlement range, which, all else equal, makes settlement more likely.

2. "Blackmail Settlements"?: The court is concerned about more than merely the likelihood of settlement. It asserts that settlement is likely to take place "at a price that reflects the risk of a catastrophic judgment as much as, if not more than, the actual merit of the claims." In other words, given the potential for huge liability, risk averse defendants will likely settle rather than litigate even what they see as a meritless claim. Judge Posner made this point in his well-known opinion in *Rhone-Poulenc*:

> Suppose that 5,000 of the potential class members are not yet barred by the statute of limitations. And suppose the named plaintiffs . . . win the class portion of this case to the extent of establishing the defendants' liability under either of the two negligence theories. It is true that this would only be prima facie liability, that the defendants would have various defenses. But they could not be confident that the defenses would prevail. They might, therefore, easily be facing $25 billion in potential liability (conceivably more), and with it bankruptcy. They may not wish to roll these dice. That is putting it mildly. They will be under intense pressure to settle. . . . Judge Friendly, who was not given to hyperbole, called settlements induced by a small probability of an immense judgment in a class action "blackmail settlements." Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973).

In re Rhone-Poulenc Rorer, Inc., 51 F.3d 1293, 1298 (7th Cir. 1995).

Not all scholars are persuaded, however. Professors Bruce Hay and David Rosenberg note that plaintiffs, too, face an "all-or-nothing gamble" in a class action, which "exerts pressure on risk-averse class counsel and class members to settle for less than the value of the class claim." Bruce Hay & David Rosenberg, *"Sweetheart" and "Blackmail" Settlements in Class Actions: Reality and Remedy*, 75 Notre Dame Law Review 1377, 1403 (2000). Moreover, plaintiffs — but not defendants — face the same problem in the litigation of an individual case: "trial is an all-or-nothing event for the plaintiff; a loss may be catastrophic. But it is not an all-or-nothing event for the defendant firm; a loss means paying only one plaintiff." *Id.* at 1404 n.53. How are these differing dynamics likely to affect settlement negotiations?

3. Back to the USSR? Class Actions and the "Central Planning Model": A related cost of class actions identified by the court is the cost of errors: if a class action goes to trial and the judge or jury makes a mistake, that mistake affects every claim. If each case is litigated separately, a mistake affects primarily that one case, subject to application of the doctrines of res judicata and collateral estoppel. (Of course, if the class action gets it right, then all parties are subject to the single, correct result.) Judge Easterbrook argues that "the vision of 'efficiency' underlying this class certification is the model of the central planner" — bringing up visions of the former Soviet Union at its worst — while comparing individually litigated cases to sellers in a market. According to Judge Easterbrook, "when courts think of efficiency, they should think of market models rather than central-planning models." Is the comparison an apt one? Like markets, multiple proceedings provide information that is unavailable in a single case. But is there competition among courts the same way there is among sellers in a market? Is there reason to

think the results in a series of cases will tend to converge to a single outcome? If so, are the benefits worth the costs?

Lane v. Facebook, Inc.
United States Court of Appeals for the Ninth Circuit
696 F.3d 811 (2012)

Hug, Circuit Judge:

The question presented is whether the district court abused its discretion in approving the parties' $9.5 million settlement agreement as "fair, reasonable, and adequate," either because a Facebook employee sits on the board of the organization distributing cy pres funds or because the settlement amount was too low. We hold that it did not.

I

Facebook is an online social network where members develop personalized web profiles to interact and share information with other members. . . .

In November of 2007, Facebook launched a new program called "Beacon." . . . The program operated by updating a member's personal profile to reflect certain actions the member had taken on websites belonging to companies that had contracted with Facebook to participate in the Beacon program. Thus, for example, if a member rented a movie through the participating website Blockbuster.com, Blockbuster would transmit information about the rental to Facebook, and Facebook in turn would broadcast that information to everyone in the member's online network by publishing to his or her personal profile.

Although Facebook initially designed the Beacon program to give members opportunities to prevent the broadcast of any private information, it never required members' affirmative consent. As a result, many members complained that Beacon was causing publication of otherwise private information about their outside web activities to their personal profiles without their knowledge or approval. Facebook responded to these complaints (and accompanying negative media coverage) first by releasing a privacy control intended to allow its members to opt out of the Beacon program fully, and then ultimately by discontinuing operation of the program altogether.

Unsatisfied with these responses, a group of nineteen plaintiffs filed a putative class action in federal district court against Facebook and a number of other entities that operated websites participating in the Beacon program. The class-action complaint alleged that the defendants had violated various state and federal privacy statutes. . . . The plaintiffs sought damages and a variety of equitable remedies for the alleged privacy violations.

* * *

[A]fter two mediation sessions and several months of negotiations, Facebook and the plaintiffs arrived at a settlement agreement. In September of 2009, plaintiff Sean Lane submitted the parties' finalized settlement agreement to the district court for preliminary approval.

The terms of the settlement agreement provided that Facebook would permanently terminate the Beacon program and pay a total of $9.5 million in exchange for a release of all the plaintiffs' class claims. Of the $9.5 million pay-out, approximately $3 million would be used to pay attorneys' fees, administrative costs, and incentive payments to the class representatives. Facebook would use the remaining $6.5 million or so in settlement funds to set up a new charity organization called the Digital Trust Foundation ("DTF"). The stated purpose of DTF would be

to "fund and sponsor programs designed to educate users, regulators[,] and enterprises regarding critical issues relating to protection of identity and personal information online through user control, and the protection of users from online threats." The parties' respective counsel arrived at the decision to distribute settlement funds through a new grant-making organization, rather than simply give the funds to an existing organization, at the suggestion of the private mediator overseeing their negotiations. Neither Facebook's nor the plaintiffs' class counsel was comfortable with selecting in advance any particular non-profit or non-profits to receive the entirety of the settlement fund, so they acceded to the mediator's suggestion that Facebook set up a new entity whose sole purpose was to designate fund recipients consistent with DTF's mission to promote the interests of online privacy and security.

According to DTF's Articles of Incorporation, DTF would be run by a three-member board of directors. [One of] [t]he initial three directors [was] . . . Timothy Sparapani, Facebook's Director of Public Policy and former counsel for the American Civil Liberties Union. The Articles of Incorporation further provided that all of DTF's funding decisions had to be supported by at least two members of the three-member board of directors but that the plan for succession of directors required unanimous approval. Finally, the Articles of Incorporation provided that DTF would be strictly a grant-making organization and could not engage in lobbying or litigation.

The settlement agreement also provided for the creation of a Board of Legal Advisors within DTF, which would consist of counsel for both the plaintiff class and Facebook. The purpose of the Board of Legal Advisors would be to advise and monitor DTF to ensure that it acted consistently with its mission as articulated in the settlement agreement.

* * *

Following a final settlement approval hearing in which the district court heard from both the parties and Objectors, the district court entered an order certifying the settlement class and approving the class settlement. . . .

Objectors now appeal, contending that the district court abused its discretion in approving the parties' settlement. We have jurisdiction pursuant to 28 U.S.C. § 1291, and we affirm.

II

A district court's approval of a class-action settlement must be accompanied by a finding that the settlement is "fair, reasonable, and adequate." Fed.R.Civ.P. 23(e). Appellate review of the district court's fairness determination is "extremely limited," and we will set aside that determination only upon a "strong showing that the district court's decision was a clear abuse of discretion."

* * *

The settlement in this case provides for a cy pres remedy. A cy pres remedy, sometimes called "fluid recovery," is a settlement structure wherein class members receive an indirect benefit (usually through defendant donations to a third party) rather than a direct monetary payment. As we recently recognized, the "cy pres doctrine allows a court to distribute unclaimed or non-distributable portions of a class action settlement fund to the 'next best' class of beneficiaries." For purposes of the cy pres doctrine, a class-action settlement fund is "non-distributable" when "the proof of individual claims would be burdensome or distribution of damages costly." The district court's review of a class-action settlement that calls for a cy pres remedy is not substantively different from that of any other class-action settlement except that

the court should not find the settlement fair, adequate, and reasonable unless the cy pres remedy "account[s] for the nature of the plaintiffs' lawsuit, the objectives of the underlying statutes, and the interests of the silent class members...."

III

Objectors challenge the district court's conclusion that the settlement in this case was "fair, reasonable, and adequate" within the meaning of Rule 23(e). . . .

* * *

Objectors' first and strongest objection to the settlement goes to the structure of DTF, the organization that would distribute cy pres funds under the settlement agreement. Objectors contend that the presence of Tim Sparapani, Facebook's Director of Public Policy, on DTF's board of directors creates an unacceptable conflict of interest that will prevent DTF from acting in the interests of the class.

* * *

We find no substance in Objectors' claim that the presence of a Facebook employee on DTF's board of directors categorically precludes DTF from serving as the entity that will distribute cy pres funds. . . . Here, in exchange for its promise to pay the plaintiff class approximately $9.5 million, Facebook insisted on preserving its role in the process of selecting the organizations that would receive a share of that substantial settlement fund by providing that one of its representatives would sit on DTF's initial board of directors, and the plaintiffs readily agreed to this condition. That Facebook retained and will use its say in how cy pres funds will be distributed so as to ensure that the funds will not be used in a way that harms Facebook is the unremarkable result of the parties' give-and-take negotiations, and the district court properly declined to undermine those negotiations by second-guessing the parties' decision as part of its fairness review over the settlement agreement.

* * *

Objectors' second argument on appeal is that the district court did not sufficiently evaluate the plaintiffs' claims and compare the value of those claims with the class's $9.5 million recovery in the settlement agreement. Objectors contend that the value of the plaintiffs' claims was in fact greater than the $9.5 million the plaintiffs settled for, in large part because some unidentified number of the class members may have a claim under the Video Privacy Protection Act ("VPPA"). The VPPA prohibits any "video tape service provider" from disclosing "personally identifiable information" about one of its consumers, and it provides for liquidated damages in the amount of $2,500 for violation of its provisions. 18 U.S.C. §§ 2710(b) and 2710(c)(2). . . .

* * *

The record here convincingly establishes that the district court accounted for the potential value of the VPPA claims of some class members, and the district court's review of the circumstances surrounding the settlement was sufficiently comprehensive to ensure that class representatives and their counsel did not throw absent class members under the proverbial bus to secure a disproportionate benefit for themselves. That review was accordingly compliant with this circuit's requirement that the district court apply heightened review to a class-action settlement reached before formal certification. This is particularly manifest in that the district court's detailed approval order included the specific factual finding that the settlement agreement "was only achieved after intense and protracted arm's-length negotiations conducted in good

faith and free from collusion." Objectors have not made any showing, let alone a "strong" one, that this or any of the district court's other findings was erroneous or amounted to a "clear abuse of discretion."

* * *

AFFIRMED.

Kleinfeld, Senior Circuit Judge, dissenting:

I respectfully dissent. This settlement perverts the class action into a device for depriving victims of remedies for wrongs, while enriching both the wrongdoers and the lawyers purporting to represent the class.

* * *

The class action rule was designed to facilitate lawsuits where individuals' or small groups' judgments would not add up to enough money to justify hiring lawyers, but judgments for large numbers of similarly situated victims of misconduct would….

This procedural device has obvious attendant risks, because class counsel's "clients" are not clients at all in the traditional sense; they do not hire the lawyer, they do not agree on a fee with him, and they do not control whether he settles their case. They are in no position to prevent class counsel from pursuing his own interests at their expense. The named plaintiffs, those who actually have some chance of directing their lawyers, typically get amounts of cash without much relation to their individual damages, so their incentives align more with class counsel than with their fellow class members.

Defendant and class counsel, in any class action, have incentives to collude in an agreement to bar victims' claims for little or no compensation to the victims, in exchange for a big enough attorneys' fee to induce betrayal of the interests of the purported "clients." The defendant's agreement not to oppose some amount for the fee creates the same incentive as a payment to a prizefighter to throw a fight. A real client may refuse a settlement that is bad for him but benefits his lawyer, but a large class of unknown individuals lacks the knowledge or authority to say no. It is hard to imagine a real client saying to his lawyer, "I have no objection to the defendant paying you a lot of money in exchange for agreement to seek nothing for me." "The absence of individual clients controlling the litigation for their own benefit creates opportunities for collusive arrangements in which defendants can pay the attorneys for the plaintiff class enough money to induce them to settle the class action for too little benefit to the class (or too much benefit to the attorneys, if the claim is weak but the risks to the defendants high)."

Rule 23 protects against these risks much as the courts have traditionally protected against similar risks when attorneys represent children, estates of deceased persons, and unknown persons, by requiring judicial approval of settlements. Approval and review, though, are a weak substitute for real clients, because judges know little about the case beyond what the lawyers tell them. That works much better when the lawyers are on different sides than when they are on the same side. Judges also may face an incentive problem, where a heavy docket cannot easily withstand the additional weight of a huge lawsuit that does not settle. Objectors provide a critically valuable service of providing knowledge from a different point of view, but one that is too often not used effectively. Our review process is supposed to assure that settlement of a class action, despite the risk of perverse incentives, is "fair, reasonable, and

adequate" and that notice is given "in a reasonable manner" so that those bound by the settlement have an opportunity to be heard.

In this case, the process has failed. The attorneys for the class have obtained a judgment for millions of dollars in fees. The defendant, Facebook, has obtained a judgment that bars claims by millions of people victimized by its conduct. . . . The victims, on the other hand, have obtained nothing. Under the settlement, Facebook even preserved the right to do the same thing to them again.

* * *

Strikingly, the settlement here goes even further than coupon settlements, where class members get only discounts if they buy again from the defendant claimed to have wronged them before, while their purported lawyers get huge amounts of money. Here the Facebook users get nothing at all, not even coupons. Every nickel of the remainder of the $9,500,000 after class counsel's cut, administrative costs, and incentive payments to the named plaintiffs, goes not to the victims, but to an entity partially controlled by Facebook and class counsel. The new entity, dressed to look good in old law French with its "cy pres" award and "non-profit" status, can spend the money to "educate" people about privacy on the internet, perhaps via some instructional videos on how to use all the privacy features available in Facebook.

* * *

The majority approves ratification of a class action settlement in which class members get no compensation at all. They do not get one cent. They do not get even an injunction against Facebook doing exactly the same thing to them again. Their purported lawyers get millions of dollars. Facebook gets a bar against any claims any of them might make for breach of their privacy rights. The most we could say for the cy pres award is that in exchange for giving up any claims they may have, the exposed Facebook users get the satisfaction of contributing to a charity to be funded by Facebook, partially controlled by Facebook, and advised by a legal team consisting of Facebook's counsel and their own purported counsel whom they did not hire and have never met.

Facebook deprived its users of their privacy. And now they are deprived of a remedy.

Notes and Questions

1. Agency Costs and Class Actions: In class actions involving small claims, no plaintiff has enough at stake to monitor the lawyers handling the case. Even in class actions involving larger claims, individual claimants have an incentive to free ride on the monitoring efforts of others, potentially resulting in deficient monitoring. As a result, class actions tend to be run by what Professor John Coffee has called "entrepreneurial lawyers" who sometimes may put their own interests ahead of the interests of their clients. John J. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in a Large Class Action*, 54 University of Chicago Law Review 877, 882 (1987).

2. "Sweetheart Settlements": One manifestation of the agency cost problems facing class actions is a concern that the defendant and the plaintiff's lawyers will cut a deal that benefits themselves at the expense of the class, a so-called "sweetheart settlement." The potential divergence of interests between attorneys and clients — particularly when it comes to settlement — is of course not limited to class actions (see Chapter V); as Judge Henry Friendly put it, "a juicy bird in the hand is worth more than the vision of a much larger one in the bush." *Alleghany*

Corp. v. Kirby, 333 F.2d 327, 347 (2d Cir. 1964). The problem is particularly pronounced in the class action setting, however, precisely because of the lack of incentives for clients to monitor their lawyer. Stated bluntly, the fear is that lawyers will sell out their putative clients, agreeing to settle cases on terms that provide significant benefits to the attorneys (in the form of fees) but little or no benefit to the clients. The requirement of court approval for class action settlements is designed to prevent such shenanigans, but does not always seem to succeed.

Class action settlements in which consumers get a coupon towards a future purchase of the defendant's product are often cited as examples. The value of the settlement to each class member is minuscule, while the defendant is released from all liability and the plaintiffs' attorneys receive millions of dollars in fees. Indeed, some class action settlements, while resulting in sizable fees for the attorneys, may actually make the plaintiff class worse off. *See, e.g.*, Kamilewicz v. Bank of Boston, 92 F.3d 506, 508 (7th Cir. 1996) (identifying one class member (who later tried unsuccessfully to attack the settlement collaterally) who recovered $2.19 on his claim but had to pay $91.33 in attorneys' fees). Several provisions of the Class Action Fairness Act of 2005, 119 Stat. 4 (2005), seek to remedy these types of problems — by restricting the award of attorneys' fees in coupon settlements and by requiring greater court supervision of the settlement itself. But the dissenting judge in the *Facebook* case certainly does not see the problem as resolved.

3. So Which Is It, Sweetheart Settlements or Blackmail Settlements?: One criticism of settlements in class actions is that defendants pay too much to settle the case (i.e., blackmail settlements). Another criticism is that defendants pay too little, at least to the plaintiff class (i.e., sweetheart settlements). Are these criticisms consistent? Can both apply to the same case? Do they apply to different kinds of cases? Or does one undercut the other?

4. Other Procedural Issues: For a good introduction to the economics of civil procedure, as well as more detailed discussions of these and other procedural rules and doctrines, see Robert G. Bone, Civil Procedure: The Economics of Civil Procedure (2003).

4. Arbitration

Not all dispute resolution takes place in the courts. Very much the contrary — for example, private adjudication (that is, arbitration) is the predominant means of resolving international commercial disputes, and in recent years has become an increasingly common means of resolving domestic commercial disputes, including employment and consumer disputes. In arbitration, the parties hire a private judge (an arbitrator) to make a binding decision that resolves their dispute. Both federal law and the law of virtually all states make arbitration agreements and arbitration awards enforceable for most types of contracts.

The most common way for a dispute to end up in arbitration is for the parties to agree to arbitrate before a dispute arises — i.e., to enter into pre-dispute arbitration agreement. For consumers and employees, the arbitration clause typically is included in a standard form contract prepared by the business or employer. Challenges to the enforceability of arbitration agreements by consumers and employees often rely on the doctrine of unconscionability; much of what was said about the doctrine in Chapter II applies here as well.

Carbajal v. H&R Block Tax Services, Inc.

United States Court of Appeals for the Seventh Circuit

372 F.3d 903 (2004)

EASTERBROOK, *Circuit Judge*.

In 1999 H&R Block prepared Roy Carbajal's 1998 federal tax return. Its calculations showed that Carbajal could expect a refund of $5,001. Carbajal applied for what Block calls a "rapid refund," a transaction that couples a loan with the assignment of the refund as security for repayment. The documents underlying this refund-anticipation loan provide that the lender also may use the money to retire any earlier year's loan (a balance due could exist if the actual refund was less than anticipated and the taxpayer did not return the excess), and that any dispute between the parties will be arbitrated. After Carbajal signed on the dotted line, he received about $1,800 in cash; the balance was used to pay off an earlier loan that a lender in Block's program contended was outstanding. Carbajal filed this suit under the Fair Debt Collection Practices Act, plus other federal and state laws, contending that he had been snookered. Block and the other defendants asked the district court to refer the dispute to arbitration.

[The district judge] dismissed [the suit] in reliance on the arbitration clause. An outright dismissal in favor of arbitration is a "final decision," see *Green Tree Financial Corp. v. Randolph*, 531 U.S. 79, 148 (2000), entitling Carbajal to appeal under 28 U.S.C. § 1291.

Paragraph 6 of the refund-anticipation loan (RAL) agreement [included an arbitration clause, under which Carbajal "agree[d] that any claim or dispute (whether in contract, tort or otherwise) in any way relating to the Agreements or such similar agreements for prior years involving the same parties or relating to the relationships of such parties, including the validity or enforceability of this arbitration provision or any part thereof (collectively the "Claim"), shall be resolved, upon the election of either party, by binding arbitration pursuant to this arbitration provision and the Code of Procedure of the National Arbitration Forum. . . ."]

It would be hard to draft a broader clause. This covers all claims "relating to" the 1999 loan plus all disputes "relating to" any earlier tax year and any preceding refund-anticipation loan. It also covers any dispute about "the validity or enforceability of this arbitration provision or any part thereof" — a clause evidently tailored to come within the rule that people may agree to arbitrate whether a given dispute is arbitrable. If so, this litigation is pointless. Even if we indulge the district court's assumption that the court determines arbitrability, Carbajal still must arbitrate.

* * *

Is enforcement of this clause unconscionable? How could it be? Arbitration is just a forum; people may choose freely which forum will resolve their dispute. This is so when the agreement concerns venue within a judicial system, see *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991), and equally so when the agreement specifies a non-judicial forum.

The whole deal, including ¶ 6, was offered on a take-it-or leave-it basis, which leads Carbajal to call it a "contract of adhesion," but few consumer contracts are negotiated one clause at a time. Forms reduce transactions costs and benefit consumers because, in competition, reductions in the cost of doing business show up as lower prices (here, a slightly lower rate of interest on the loan). The forum selection clause in *Carnival Cruise Lines* was printed on the back of a ticket, and the Court nonetheless enforced it — just as the terms of limited warranties and many other provisions not negotiated separately are enforced routinely. . . .

Section 2 of the Federal Arbitration Act says that an agreement to arbitrate "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the

revocation of any contract." Thus arbitration specified in a form contract must be treated just like any other clause of the form. Unless Delaware (whose law applies) would refuse to enforce limited warranties, clauses curtailing the time available to file suit, and the like, then this arbitration clause must be enforced. Carbajal does not offer any reason to think that Delaware generally refuses to enforce details on the back of an auto-rental contract or equivalent form; thus this agreement to arbitrate is valid. The cry of "unconscionable!" just repackages the tired assertion that arbitration should be disparaged as second-class adjudication. It is precisely to still such cries that the Federal Arbitration Act equates arbitration with other contractual terms. People are free to opt for bargain-basement adjudication — or, for that matter, bargain-basement tax preparation services; air carriers that pack passengers like sardines but charge less; and black-and-white television. In competition, prices adjust and both sides gain. "Nothing but the best" may be the motto of a particular consumer but is not something the legal system foists on all consumers.

As for the contention that portions of this clause are incompatible with federal law — because, say, they require the parties to bear their own costs, while the FDCPA entitles prevailing litigants to recover attorneys' fees — there are two problems. First, the arbitrator rather than the court determines the validity of these ancillary provisions. Second, no general doctrine of federal law prevents people from waiving statutory rights (whether substantive or procedural) in exchange for other things they value more, such as lower prices or reduced disputation. Whether any particular federal statute overrides the parties' autonomy and makes a given entitlement non-waivable is a question for the arbitrator.

AFFIRMED

Notes and Questions

1. Opting Out of the Legal System: By agreeing to arbitrate their disputes, parties opt out of the public legal system — except to the extent one of the parties relies on the public courts to enforce the arbitration agreement or the arbitrator's award. Why do parties choose private adjudication over the public courts? The answer, of course, depends on the type of contract involved. For international contracts, two reasons commonly given for the widespread use of arbitration clauses are that arbitration provides a neutral forum (rather than having the case proceed in the national courts of one of the parties) and that arbitration awards are more readily enforceable than court judgments. For consumer and employment contracts, reasons commonly cited include having an arbitrator rather than a judge or jury deciding the case, the ability to tailor the process (such as by limiting the discovery available), the greater degree of confidentiality in arbitration than in court, the lack of class actions in arbitration (albeit with some exceptions), and so forth. Do those reasons benefit both parties to the arbitration agreement or just the business or employer? Under what circumstances might consumers and employees benefit from arbitration?

2. The Incentives of Arbitrators: As noted above, an important difference between arbitration and the courts is who makes the decisions, an arbitrator or a judge or jury. Because they are dependent on being selected by the parties to serve, arbitrators have very different incentives in deciding cases than do judges or juries. Judges get paid the same regardless of how many cases they decide or the quality of their decisions. While the parties can select the court in which the case will proceed, they have very limited ability to select the judge. Juries get paid virtually nothing and are selected essentially randomly. By contrast, the parties select the

arbitrator or arbitrators, who get paid only when selected and only for the work they do on the case. Thus, arbitrators have a much greater incentive to decide cases in ways that benefit the parties ex ante. In some cases, however, arbitral incentives may be counterproductive, such as when the outcome of the arbitration affects some third party who is not a party to the contract (e.g., a child in the case of a family law dispute). In such cases, judges rather than arbitrators may be the preferred decision maker.

3. Baptists, Bootleggers, and Arbitration Law: Recall the earlier description of the "Baptist and Bootlegger" theory of regulation: that regulations are most likely to be enacted when supported by some groups on policy or moral grounds and by other groups who benefit economically from the regulation. How does the theory apply to legislation that would limit or preclude pre-dispute arbitration clauses in consumer and employment contracts? Groups that favor the laws include consumer and employee groups (the Baptists who support the laws on policy grounds) and plaintiffs' lawyers (the Bootleggers who would benefit economically from the laws by having more cases remain in court). Interestingly, the only federal law restricting arbitration bars pre-dispute arbitration clauses in motor vehicle franchise agreements, that is, contracts between car manufacturers and car dealers. One does not usually think of car dealers as a group that needs protection from unfair contract terms, certainly not as compared to other groups, such as individual car buyers. Yet no law precludes car dealers from including arbitration clauses in contracts with their customers, and increasingly car dealers are doing so.