REFORMING STATE CONSUMER PROTECTION LIABILITY: AN ECONOMIC APPROACH

Henry N. Butler*
Jason S. Johnston†

State Consumer Protection Acts (CPAs) were adopted in the 1960s and 1970s to protect consumers from unfair and deceptive practices that would not be redressed but for the existence of the acts. In this sense, CPAs were designed to fill existing gaps in market, legal, and regulatory protections of consumers. CPAs were designed to solve two simple economic problems: 1) individual consumers often do not have the incentives or means to pursue individual claims against mass marketers who engage in unfair and deceptive practices; and 2) because of the difficulty of establishing elements of either common law fraud or breach of promise, those actions alone are too weak an instrument to deter seller fraud and deception. The most striking lesson of our analysis is that the typical state CPA—with relaxed rules for establishing liability, statutory damages, damage multipliers, attorneys' fees and costs, and class actions—solves the basic economic problem that CPAs were intended to address several times over. The effect of this redundancy is that CPAs can deter the provision of valuable information to consumers and, thus, harm consumers. That is, as currently applied, state CPAs harm consumers. This need not be the case. A few modest

* Senior Lecturer, Executive Director, Searle Center on Law, Regulation, and Economic Growth, Northwestern University School of Law. We received helpful comments from participants in workshops at Case Western, Harvard, and the 2008 meeting of the American Law and Economics Association, and are especially grateful to Steven Shavell for very helpful comments and suggestions. Excellent research assistance was provided by Jeff Jarosch, Adam Luetto, Elise Nelson, Fern English Richardson, Matthew Siberly and Samantha Zyontz.

† Robert G. Fuller, Jr. Professor of Law and Director, Program on Law, Environment and Economy, University of Pennsylvania Law School.

reforms would dramatically improve the impact of CPAs on consumer welfare.

I. INTRODUCTION

With its submission of proposed legislation creating a new Consumer Financial Protection Agency,[1] the Obama Administration has put consumer protection regulation at the forefront of its regulatory reform effort. As indicated by the stated statutory objectives, the proposed new agency is motivated in large part by the perception that consumers have not been getting understandable information that they

[1] Consumer Financial Protection Act of 2009, Title X, H.R. 3126, 111th Cong., *available at* http://www.financialstability.gov/docs/CFPA-Act.pdf. The proposed CFPA is controversial. *See, e.g.*, Joshua D. Wright & Todd J. Zywicki, Three Problematic Truths About the Consumer Financial Protection Agency Act of 2009, Lombard Street, (Sept. 14, 2009), http://www.finreg21.com/lombard-street/three-problematic-truths-about-consumer-financial-protection-agency-act-2009; David Evans, Why Now is Not the Right Time to Revamp Consumer Financial Protection (7 Jan. 2010), http://www.finreg21.com/blogs/why-now-is-not-right-time-revamp-consumer-financial-protection.

can use to make "responsible" decisions about consumer financial products or services, and that they are inadequately protected from "abuse, unfairness, deception and discrimination."[2] The proposed Consumer Financial Protection Agency Act preserves a very broad role for state consumer protection law, providing, perhaps most importantly, that any rule adopted by the new federal agency will not preempt state law if that agency determines that state law provides greater protection for consumers than does federal law.[3] In its recent decision in *Riegel v. Medtronic*, Inc.,[4] the Supreme Court was similarly deferential to the role of state law damage actions in supplementing federal consumer protection regulation. A crucial question for both federal courts in their preemption jurisprudence and the proposed new federal consumer protection agency will be the degree of protection afforded consumers by existing state consumer protection laws. In this article, we argue that many state consumer protection laws not only fail to provide more protection than would be provided under both existing and proposed federal consumer protection laws, but in fact, when enforced through private actions, actually harm consumer welfare and are therefore directly in conflict with the ostensible goals of the potentially expansive federal role in consumer protection.

At first glance, it might appear that state consumer protection acts (CPAs) are extremely protective of consumers. Widely adopted during the 1960s and 1970s, state CPAs resulted from the perception that the cost and complexity of the common law left individual consumers with no incentive to pursue small but meritorious claims. A resulting enforcement gap left consumers exposed to false and deceptive selling practices that caused widespread but diffuse harm.[5] To overcome this perceived enforcement gap,

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[2] Consumer Financial Protection Act of 2009, *supra* note 1, § 1021.

[3] *Id.* § 1041.

[4] 552 U.S. 312 (2008).

[5] *See* MICHAEL M. GREENFIELD, CONSUMER LAW: A GUIDE FOR THOSE WHO REPRESENT SELLERS, LENDERS, AND CONSUMERS 64 (1995). *But see* Michael S. Greve, *Consumer Law, Class Actions, and the Common Law*, 7

state CPAs adopted what amounts to a statutory shotgun approach, typically providing for statutory minimum damages, treble and/or punitive damages, attorneys' fees, and class actions. Moreover, in their original form, the CPAs of some states—most notoriously California—failed to even require the plaintiff to show actual injury in order to establish a cause of action.

The law in California has been amended by popular referendum to require plaintiffs to show actual injury and reliance (in the case of an allegedly false or deceptive practice).[6] However, in other jurisdictions, egregious cases continue to be brought, such as the $54 million action under the District of Columbia CPA law against a dry cleaner for losing a pair of pants.[7] Given the promise of expansive awards made under relaxed liability standards offered by state CPAs, it is hardly shocking that private actions under state CPAs have become one of the great growth areas of American litigation. Between the years 2000 and 2007, the number of reported decisions involving a state CPA claim in state appellate courts increased by over forty-three percent, while those decided in federal courts almost tripled.[8]

CHAP. L. REV. 155, 156 ("While unknown before the 1970s, modern 'consumer law' does not govern a single transaction that is not also covered by traditional common law doctrines. However, where tort law required an actual injury as an essential element of a cause of action; consumer law dispenses with that requirement and others like it, such as inducement and detrimental reliance. Where the common law matched the seller's duty to steer clear of fraud and misrepresentation with the contractual principle of 'buyer beware,' consumer law substitutes a unilateral duty of disclosure on the seller.").

[6] For a brief review of this referendum, see Victor E. Schwartz & Cary Silverman, *Common Sense Construction of Consumer Protection Acts*, 54 U. KAN. L. REV. 1, 5 (2005).

[7] D.C. Code § 28-3901 et seq. (2001). The case, Docket No. 05-CA-4302B, was dismissed. Chris Conway, *Determining Who's Gotten Satisfaction*, N.Y. TIMES, July 1, 2007, at 42.

[8] Searle Civil Justice Institute, State Consumer Protection Acts: An Empirical Investigation of Private Litigation (preliminary report) (December 2009), http://www.law.northwestern.edu/searlecenter/uploads/CPA_Proof_113009_final.pdf. As this study notes, at pages 36–40, the

To some commentators, the upsurge in CPA litigation is not only of little concern, but is actually a sign that state CPA laws are succeeding in their stated goal of consumer protection. One leading consumer advocate, for example, has described CPAs as "popular,"[9] and even suggested that the reasoning and interpretation of state CPAs should be applied more broadly to expand the common law's understanding of fraud.[10] On the other hand, according to leaders of the tort reform movement, this massive upsurge in state CPA litigation does not reflect some new wave of false and deceptive consumer marketing practices. Rather it is a tide of, at best, highly doubtful claims brought by private class action attorneys seeking a big payday, a tide of litigation that is symptomatic of a broader litigation crisis.[11] Overly broad judicial interpretation of state CPAs has long been of concern to commentators,[12] and economic criticism of judicial expansion as to what constitutes actionable conduct under CPAs has become increasingly intense.[13] Indeed, a leading law and economics scholar has questioned the need for any form of CPA liability, arguing that consumers do not need the kind of specific information about products that consumer advocates demand from sellers, and that market forces, such as a seller's desire to maintain a reputation for

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increase in federal court state CPA actions accelerated in 2005, when the Class Action Fairness Act pushed many class actions into federal court.

[9] Jean Braucher, *Deception, Economic Loss and Mass-Market Customers: Consumer Protection Statutes as Persuasive Authority in the Common Law of Fraud*, 48 ARIZ. L. REV. 829, 832 (2002).

[10] *Id.* at 830.

[11] *See, e.g.*, AMERICAN TORT REFORM ASSOCIATION, PRIVATE CONSUMER PROTECTION LAWSUIT ABUSE: WHEN CLAIMS ARE DRIVEN BY PROFIT-DRIVEN LAWYERS AND INTEREST-GROUP AGENDAS, NOT THE BENEFIT OF CONSUMERS (2006), http://www.atra.org/reports/consumers/consumer_protection.pdf.

[12] The current controversy has arisen in the absence of significant changes in most state CPAs. Indeed, most CPAs were not controversial during their first twenty years. However, the potential for problematic applications of CPAs was recognized earlier. *See, e.g.*, Marshall A. Leaffer and Michael H. Lipson, *Consumer Actions Against Unfair or Deceptive Acts or Practices: The Private Uses of Federal Trade Commission Jurisprudence*, 48 GEO. WASH. L. REV. 521, 534 (1980).

[13] Schwartz & Silverman, *supra* note 6, at 3–4.

honesty and quality, sufficiently discipline companies and drive out false and deceptive practices.[14]

Absent from the literature on state CPAs has been a sustained, systematic analysis of the behavioral incentives created by such laws. Such an analysis is seriously needed. After all, states enacted CPAs in reaction to the common law system's failure to create credible enforcement threats against false or deceptive conduct. As noted earlier, the Administration's proposal for a new Consumer Financial Protection Agency assumes that state CPAs can be relied upon to provide the optimal deterrence that the common law did not. The question is whether state CPAs optimally supplement other enforcement mechanisms, or whether state CPA liability creates the wrong kind of incentives. The deference the Administration and Supreme Court afford state liability schemes[15] may be misplaced if state CPA liability more likely hurts consumers than benefit them. If state CPA liability hurts consumers, then either state policies should be reformed along the lines suggested in Part IV below or—if states fail to reform their laws—broad federal preemption of consumer protection liability might be appropriate (although, as discussed below, federal regulation has been far from perfect).

The core of this Article uses the tools of economic analysis to begin an answer to these questions by unpacking the incentives that state CPA liability creates. However, to carry out the economic analysis, we must first have a precise understanding of the kind of liability system created by state CPAs. Part I provides an overview of state CPAs in which we identify the two economically crucial features of the current CPA landscape: statutory provisions that offer enormous potential rewards to even dubious lawsuits that

[14] *See* Posting of Daniel Dorris to the University of Chicago Faculty Blog (Student Blogger), The Myths of Consumer Protection Law, http://uchicagolaw.typepad.com/faculty/2009/02/the-myths-of-consumer-protection-law.html (Feb. 26, 2009, 10:42 EST) (summarizing the annual Ronald H. Coase lecture delivered by Professor Omri Ben-Shahar of the University of Chicago Law School).

[15] *See, e.g.*, Riegel v. Medtronic, 552 U.S. 312 (2008).

are likely brought to secure settlements; and vague substantive standards of liability that the courts have interpreted so expansively that even the most straightforward and informative marketing practices can trigger potential CPA liability.

Part I then develops an economic framework in which we analyze the impact of these two crucial features of state CPA law on seller behavior. As we argue, state CPA law as currently configured is likely to significantly over-deter the targeted practices. The CPA liability regime likely often attaches liability even to socially desirable selling practices, thereby creating an incentive for sellers to withhold socially valuable information from consumers. Moreover, the most certain economic impact of overly expansive state CPAs may be an effective excise tax on every sale of a consumer good or service, increasing prices and lessening consumer welfare with no benefit in terms of deterring socially undesirable seller behavior.

In Part II, we situate state CPA liability within the broader landscape of institutions for consumer protection. These institutions include the market, the common law, and federal consumer protection regulation by the Federal Trade Commission. We analyze how the market, as supplemented by the common law of fraud and warranties, does indeed provide significant checks against deceptive consumer selling practices and advertising.[16] However, we note two serious shortcomings—from the point of view of optimal deterrence—in the market/common law regime: imperfect determination of liability, and costs of liability determination that are disproportionate to the loss suffered by an individual consumer.

These shortcomings of the market/common law regime provide an economic justification for regulation (either federal or state) that balances the benefits and costs of such intervention. In fact, the Federal Trade Commission now

[16] On market forces for consumer protection, see generally Gillian K. Hadfield, Robert Howse & Michael J. Trebilcock, *Information-based Principles for Rethinking Consumer Protection Policy*, 21 J. CONSUMER POL'Y 131 (1998).

uses a cost-benefit standard[17] to identify legally actionable "unfair" consumer product marketing practices under Section 3 of the FTC Act.[18] This standard—under which the FTC declares consumer marketing practices "unfair" only if it finds a "reasonable basis to conclude that the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers"[19]—clearly seeks to balance the costs and benefits of regulation.[20] It also reflects the underlying philosophy that the ultimate objective of consumer protection is consumer welfare and that the role of consumer protection laws is to supplement market forces, rather than to entirely displace them.[21] Significantly, the Administration's proposed new Consumer Financial Protection Agency would follow precisely the same standard for the determination of "unfair" practices, and would be required to "consider the potential benefits and costs to consumers"[22] of regulatory alternatives. Thus it seems that the Administration does not mean to jettison the FTC's longstanding focus on consumer welfare.

However, enforcement of state CPAs through private litigation rarely reflects the economic sophistication of the FTC in implementing the consumer welfare standard. For this reason, we conclude that whatever the shortcomings of

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[17] *See* J. Howard Beales III, Director, Bureau of Consumer Protection, The FTC's Use of Unfairness Authority: Its Rise, Fall, and Resurrection (May 30, 2003), http://www.ftc.gov/speeches/beales/unfair0603.shtm.

[18] The current FTC definition of an unfair act is one that "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or competition." *See* Federal Trade Commission Act Amendments of 2006, Pub. L. No. 109-455, § 3, 120 Stat. 3372 (codified at 15 U.S.C. § 45 (n)).

[19] Consumer Financial Protection Act of 2009, *supra* note 1, § 1031.

[20] *See, e.g.*, Timothy J. Muris, *The Federal Trade Commission and the Future Development of U.S. Consumer Protection Policy* 4-5 (George Mason University School of Law, Law & Economics Research Paper No. 04-19, 2004), *available at* http://ssrn.com/abstract_id=545182; Beales, *supra* note 17.

[21] *See, e.g.*, Muris, *supra* note 20; Beales, *supra* note 17.

[22] Consumer Financial Protection Act of 2009, *supra* note 1, § 1022.

regulatory enforcement by the FTC, state CPAs, as currently structured and interpreted, have encouraged private actions that go far beyond what is necessary to optimally supplement the FTC enforcement regime. In Part III, we set out the detailed implications of our analysis for the reform of state CPAs and their interpretation by the courts. First, courts and legislatures should recognize that many provisions of CPAs are redundant. Many CPA provisions are designed to make it easier and more economical for individual consumers to recover their losses, yet many of these provisions are not necessary to incentivize plaintiffs to pursue consumer class actions. Thus, courts and legislatures should recognize the fundamental differences between the two types of actions. Second, just as a common law plaintiff must show reliance, causation, and harm, so too should consumer protection class action plaintiffs be required to plead and prove these basic elements. Third, private class actions should be required, as a threshold matter, to satisfy a consumer welfare standard akin to that under which the FTC operates in enforcing the FTC Act. In applying a consumer welfare standard to CPAs, state courts could rely on FTC interpretations for guidance. Finally, consumer welfare would be enhanced if state legislatures amended their CPAs to limit the scope of private actions to those that satisfy a consumer welfare standard.

II. NO HARM, NO FAULT, YET MASSIVE POTENTIAL LIABILITY: THE STRUCTURE AND ECONOMIC CONSEQUENCE OF STATE CONSUMER PROTECTION ACTS

CPAs have recently received harsh criticism from business groups and tort reform advocates.[23] The core of their critique is that the broad language of state CPA statutes and liberal judicial interpretations have led to massive amounts of litigation, disproportionately large damage awards and settlements for unharmed plaintiffs, and overcompensation for plaintiffs' attorneys. Later in the

[23] *See, e.g.*, AMERICAN TORT REFORM ASSOCIATION, *supra* note 11.

paper, we provide an economic foundation for this critique. But to do so, we must first set out the salient structural features of state CPAs. The first set of features regards statutory provisions that have the general effect of opening the courthouse doors to private CPA lawsuits. These features might be called procedural. The second vital aspect of CPA litigation is substantive, and concerns the way in which courts have interpreted generally vague statutory CPA prohibitions of "false and deceptive" practices to allow even the most seemingly straightforward and informative marketing communications to trigger potential CPA liability.

A. Historical Background and Purpose of State Consumer Protection Acts

Every state in the nation has some kind of consumer protection statute. Many have more than one statutory framework for consumer protection. About thirty states have in place legislation that tracks the Uniform Deceptive Trade Practices Act or Uniform Consumer Sales Practice Acts.[24] These laws typically have rather long and detailed lists of prohibited practices (such as advertising goods with the intent not to sell them as advertised).[25] Nine states have "consumer fraud" statutes that make unlawful broad categories of acts including "fraud," "deception," and "false promise" in the "sale or advertisement" of goods when done with an "intent that others rely" upon the act.[26] Finally, as encouraged by the FTC and in tune with the explosive growth of federal regulation during the 1970s, "Little FTC Acts"[27]—which typically contain identical language to the FTC Act forbidding "unfair competition and deceptive acts

[24] Alan S. Brown & Larry E. Hepler, *Comparison of Consumer Fraud Statutes Across the Fifty States*, 55 FED'N DEF. & CORP. COUNS. Q. 263, 266 (2005).

[25] *Id.* at 266-67.

[26] *Id.* at 268.

[27] Jeff Sovern, *Private Actions Under the Deceptive Trade Practices Acts: Reconsidering the FTC Act as Rule Model*, 52 OHIO ST. L.J. 437, 446 (1991).

and practices"—were adopted in every state by 1981.[28] These statutes are typically very short, broadly prohibiting conduct that is "false or deceptive" and granting private parties very broad standing to sue.[29] Importantly, these statutes often overlap. California, for example, has both an Unfair Competition Law[30] modeled after the FTC Act and an Unfair Practices Act[31] that tracks the Uniform Deceptive Trade Practices Act.

There is a long list of public interest reasons[32] for the adoption of CPAs,[33] including:

1. The prohibitive costs to individual consumers to litigate these matters in state courts;
2. The difficulty for consumers to prevail in state common law actions for fraud, misrepresentation, and warranty;
3. The disparity in bargaining power between individual consumers and businesses;
4. The necessity of private attorneys general to supplement public enforcement actions, due to the federal and state governments' inability to enforce all actions; and

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[28] *Id.*

[29] Brown & Hepler, *supra* note 24, at 269. California Business and Professions Code Section 17200, for example, prohibits "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising."

[30] CAL. CIV. CODE § 17200 et. seq.

[31] *Id.* § 1770 et. seq.

[32] The enactment of CPAs is often described in terms of a logical gap filling made necessary by the inability of the common law to deal with problems of a mass marketed national economy. Such public interest rhetoric should be met with skepticism. Perhaps the intent of CPAs should be inferred from their effect. Attorneys who file actions on behalf of consumers are vocal opponents of reform efforts. However, the fact that they expect to be losers if CPAs are reformed does not demonstrate that they were the intended winners when the acts were passed. Regardless, even if the CPAs had a more benign intent, it is clear that they have created interest groups in their wake.

[33] *See, e.g.*, Mark D. Bauer, *The Licensed Professional Exemption in Consumer Protection: At Odds with Antitrust History and Precedent*, 73 TENN. L. REV. 131, 144, 146 (2006).

5. The realization that private enforcement actions may be necessary to carry out the legislative intent when pro-business (or anti-consumer) interest groups control the executive branch.[34]

In spite of the role of the FTC in encouraging the adoption of CPAs, there are major differences between the FTC Act and state CPAs. These differences indeed define the economically crucial features of state CPAs.

B. Opening the Courthouse to Private Suits: Procedural Provisions of State CPA Laws

As a general matter, relative to both the common law and other default rules of procedure, state CPA statutes effect a remarkable expansion in the private ability to sue.

1. Broad Private Standing to Sue with No Injury or Causation Requirement

The majority of state CPAs can be enforced both by the state Attorney General and by private plaintiffs.[35] While in many states, a private CPA plaintiff must prove that she suffered an injury as a result of the statutory violation—the false or deceptive practice—in others, the plaintiff may prevail simply by showing that the act or practice was likely to be misleading or had a tendency to deceive consumers.[36] Many courts have interpreted the damage requirements of their state's statute to be a very low standard that is easily met.[37] Some states even allow an admittedly non-injured

[34] This argument is similar to the argument used for private actions under state and federal environment statutes.

[35] Brown & Hepler, *supra* note 24, at 270; Schwartz & Silverman, *supra* note 6, at 16. Only Iowa relies exclusively on its attorney general to enforce the state's consumer protection laws. *See* Molo Oil Co. v. River City Ford Truck Sales, Inc., 578 N.W.2d 222, 228 (Iowa 1998).

[36] Brown & Hepler, *supra* note 24, at 272; Schwartz & Silverman, *supra* note 6, at 17–21.

[37] Schwartz & Silverman, *supra* note 6, at 22.

person to bring a suit on behalf of the general public or on behalf of other consumers.

Several courts have adopted a broad definition of injury that is *per se* satisfied on the occurrence of a misrepresentation. For example, in *Aspinall v. Philip Morris*, the Massachusetts Supreme Court stated: "We reject the proposition that the purchase of an intentionally falsely represented product cannot be, by itself, an ascertainable injury under our consumer protection statute."[38] Consistent with this broad interpretation, the Massachusetts court also dispensed with the traditional reliance requirement, stating "[a] successful action based on deceptive acts or practices does not require proof that the plaintiff relied on the representation."[39]

Although a seemingly countervailing force to the "no injury" cases can be found in the expansion of the economic loss rule to state CPAs, application of that doctrine has not strongly been advocated.[40] For example, Professor Braucher identifies the case of *Werwinski v. Ford Motor Co.*, in which the Third Circuit applied the economic loss rule to Pennsylvania's CPA, yet subsequent Pennsylvania state and district courts refuse to follow the holding.[41] The disparate outcomes in Pennsylvania are indicative of the courts' discretion in whether or not to expand the economic loss doctrine in this unsettled part of the law.

Hence under many state CPA statutes, a private party can bring suit in a purely private attorney general role, alleging only that certain practices were likely to harm the general consuming public, without any requirement of proving actual injury or causation.[42] This private enforcement is a substitute for administrative enforcement,

[38] Aspinall v. Philip Morris Cos., 813 N.E.2d 476, 486 (Mass. 2004).

[39] *Id.*

[40] Ellen M. Bublic, *Economic Torts: Gains In Understanding Losses*, 48 ARIZ. L. REV. 693, 700 (2006).

[41] Braucher, *supra* note 9, at 847–48 (citing Samuel-Bassett v. Kia Motors Am., Inc., 357 F.3d 392, 400 & 401 n.5 (3d Cir. 2004)).

[42] *See, e.g.*, D.C. CODE ANN. § 28-3905(k)(1) (2001); COLO. REV. STAT. § 6-1-113 (2004).

and it is often suggested that private enforcement is relied upon because states do not adequately fund consumer protection agencies. [43] This assertion begs the question of why state legislatures do not provide adequate funding. Regardless, private actions under CPAs often do not require a public-interest impact as is required of the FTC under the FTC Act.[44]

2. Potentially Expansive Remedies

The remedies available to a successful CPA plaintiff vary greatly, not only across the states but also across different types of state CPAs. Under California's Unfair Competition Law and the Uniform Deceptive Trade Practices Act of several other states only equitable relief is available.[45] Equitable relief, however, includes not only injunctions but also restitutionary, restorative monetary awards. At least in California, restitution is "not limited to the return of money or property that was once in the possession of the person," but is "broad enough to allow a plaintiff to recover money or property in which he or she has a vested interest."[46]

In a few other states, a CPA plaintiff's remedies are limited to the recovery of actual damages.[47] Much more

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[43] *See* Sovern, *supra* note 27, at 448 ("State and local consumer agencies lack sufficient resources to pursue every consumer fraud vigorously, and so, like the FTC, face strong incentives to confine their activities to cases likely to have a broad impact. To plug the holes in consumer fraud enforcement, nearly every state has now extended to injured consumers the power to sue merchants who engage in deceptive practices.").

[44] Braucher, *supra* note 9, at 829 n.1; *see also* 15 U.S.C. § 53(b) (2000) (requiring the Commission to find that bringing an action in federal court to enjoin a violation of the FTC Act is in the public interest).

[45] Brown & Hepler, *supra* note 24, at 277, Schwartz & Silverman, *supra* note 6, at 22.

[46] Juarez v. Arcadia Fin., Ltd., 61 Cal. Rptr. 3d 382, 400 (2007) (citing Korea Supply Co. v. Lockheed Martin Corp., 29 Cal. 4th 1134, 1149 (Cal. 2003)); *see also* Lozano v. AT&T Wireless Servs. Inc., 504 F.3d 718, 733 (9th Cir. 2007) (citing *Korea Supply Co.*, 29 Cal. 4th at 1149).

[47] Brown & Hepler, *supra* note 24, at 278; Schwartz & Silverman, *supra* note 6, at 22.

commonly, however, state CPAs grant the plaintiff the option of choosing the greater of actual or statutory damages. Generally, these statutory damages range from $100 to $500, but in New Hampshire they are $1000 and in Kansas $5000, while for flagrant or repeated violations in Idaho, the plaintiff's statutory damages are $1000 plus punitive damages.[48]

In addition to statutory damages, state CPAs that allow plaintiffs to recover actual damages also typically authorize the recovery of treble damages.[49] About two-thirds of state laws provide for treble damages to punish a defendant for wrongful conduct.[50] Several states double or treble damages regardless of the egregiousness of the defendant's conduct.[51] In nine states treble damages are available only if the defendant acted intentionally, willfully, knowingly, or in bad faith.[52] In New Jersey and Ohio, and under California's Deceptive Practices Act, treble damages are actually mandatory.[53] And in Colorado, the District of Columbia, and Hawaii, the plaintiff can choose the greater of treble damages or statutory damages.[54]

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[48] Brown & Hepler, *supra* note 24, at 278–79; Schwartz & Silverman, *supra* note 6, at 23.

[49] Brown & Hepler, *supra* note 24, at 280–81; Schwartz & Silverman, *supra* note 6, at 23.

[50] *See generally* Schwartz & Silverman, *supra* note 6.

[51] *See, e.g.*, ALASKA STAT. § 45.50.531(a) (2008); D.C. CODE § 28-3905(k) (2007); HAW. REV. STAT. § 480-13 (2005); IND. CODE ANN. § 24-5-0.5-4(b) (1996); N.J. STAT. ANN. § 56:8-19 (West 2008); N.C. GEN. STAT. § 75-16 (2003); WIS. STAT. ANN. §§ 100.18(11)(b)(2) & 100.20(5) (West 2004).

[52] COLO. REV. STAT. § 6-1-113(2)(a)(III) (2003); GA. CODE ANN. § 10-1-399(c) (2000); MASS. GEN. LAWS ch. 93A, § 9(3) (2004); N.H. REV. STAT. ANN. § 358-A:10 (1995); N.M. STAT. ANN. § 57-12-10(B) (West 2005); N.Y. GEN. BUS. LAW § 349(h) (McKinney 2004); S.C. CODE ANN. § 39-5-140(a) (1985); TENN. CODE ANN. § 47-18-109(a)(3) (2009); VA. CODE ANN. § 59.1-204(A) (2006); TEX. BUS. & COM. CODE ANN. § 17.50(b)(1) (2005).

[53] Brown & Hepler, *supra* note 24, at 280; Schwartz & Silverman, *supra* note 6, at 24.

[54] Brown & Hepler, *supra* note 24, at 280; Schwartz & Silverman, *supra* note 6, at 24.

Consistent with treble damage provisions, most states have CPAs that at least permit punitive damages.[55] Many state CPAs require the plaintiff to show a heightened level of fault, such as a showing of malicious or aggravated fraud, in order to recover punitive damages.[56] Still, other state CPAs cap punitive damages.[57]

3. Class Actions and Attorneys' Fees

While some state CPAs explicitly prohibit class actions, the laws of at least fourteen states and those of the District of Columbia expressly permit class actions.[58] State CPAs modeled after the FTC Act are silent on the availability of class actions, but courts have commonly found that class action relief is available under such statutes.[59]

As for attorneys' fees, state CPAs are a dramatic exception to the default "American" rule, under which each party bears its own attorneys' fees. Nearly half of the state CPAs require an award of reasonable attorneys' fees to the prevailing plaintiff, and there are indeed only a few states that follow the "American" rule in CPA cases.[60]

C. The Economic Consequences of the State CPA Process

Not every state CPA combines every procedural feature just described. However, the three key features we have highlighted—relaxed standing for private lawsuits, potentially expansive remedies, and the availability of class actions and attorneys' fees—combine to greatly increase the payoff that a private attorney can expect from a CPA lawsuit

[55] Brown & Hepler, *supra* note 24, at 279; Schwartz & Silverman, *supra* note 6, at 24.

[56] Brown & Hepler, *supra* note 24, at 279; Schwartz & Silverman, *supra* note 6, at 24.

[57] Brown & Hepler, *supra* note 24, at 279.

[58] Some of these laws have specific limitations on the form of relief that may be obtained. *See* Schwartz & Silverman, *supra* note 6, at 29.

[59] *Id.*

[60] *Id.* at 26–27.

relative to some other sort of case. The fundamental economics of private litigation predict that the procedural features highlighted above will systematically distort private incentives, such that CPA lawsuits have been and will continue to be brought that bear little relation to the deterrence of socially harmful deceptive practices.

Consider first the impact of eliminating or lessening the requirement that the plaintiff show injury, reliance and causation—that she saw or heard the defendant's communication and relied upon it in deciding to buy the defendant's product. This means that the plaintiff need not stand in any particular relationship to the product or the alleged false or deceptive practice; all she needs to allege is that some consumers were likely to be misled by the false or deceptive practice, not that she even saw or heard it.[61] This

[61] Unsurprisingly, as the plaintiff need not stand in any particular relationship to a state CPA defendant, many state courts have held that typical common law contract defenses do not apply in CPA actions. Such defenses include: the statute of frauds, *see, e.g.*, McClure v. Duggan, 674 F. Supp. 211, 224 (N.D. Tex. 1987) (statute of frauds not applicable under Texas deceptive trade practices act), warranty disclaimers, *see, e.g.*, Attaway v. Tom's Auto Sales, Inc., 242 S.E.2d 740, 742 (Ga. Ct. App. 1978), the doctrine of substantial performance, *see, e.g.*, Smith v. Baldwin, 611 S.W.2d 611, 616 (Tex. 1980) ("A primary purpose of the enactment of the DTPA was to provide consumers a cause of action for deceptive trade practices without the burden of proof and numerous defenses encountered in a common law fraud or breach of warranty suit."), the parol evidence rule, *see, e.g.*, Teague Motor Co. v. Rowton, 733 P.2d 93, 96 (Or. Ct. App. 1987) (parol evidence may be used in Oregon consumer protection cases); Weitzel v. Barnes, 691 S.W.2d 598, 600 (Tex. 1985) (parol evidence may be used in Texas consumer protection cases); Capp Homes v. Duarto, 617 F.2d 900, 902 n.1 (1st Cir. 1980) (parol evidence may be used in Massachusetts consumer protection cases), the common law merger doctrine, *see generally* Raren S. Guerra, Note, *DTPA Precludes Use of Merger Doctrine and Parol Evidence Rule in Breach of Warranty Suit: Alvarado v. Bolton*, 41 BAYLOR L. REV. 373 (1989), contractual limitations on liability or remedies, *see, e.g.*, International Nickel Co. v. Trammel Crow Distrib., 803 F.2d 150, 155–56 (5th Cir. 1986) (contractual limitations inapplicable in suit under Texas "Little FTC Act"); Corral v. Rollins Protective Serv. Co., 732 P.2d 1260, 1271 (Kan. 1987) (same under Kansas law); Reliance Universal, Inc. v. Sparks Indus. Servs., Inc., 688 S.W.2d 890, 892 (Tex. Ct. App. 1985) (same under Texas law), and privity

is a major change in the law, and a step that the FTC has been unwilling to take.[62] At least under those state CPAs where class actions are permitted, eliminating the requirements of injury and reliance (causation), essentially makes actionable almost any seller communication that is sent to a large enough number of consumers.

Not only is the legal standard easy for plaintiffs to meet under these laws, but plaintiffs are incentivized to bring claims under the law due to state CPAs' near-uniform authorization of attorneys' fees. With the prospect of recovering attorneys' fees for succeeding merely in showing that the challenged practice might well have misled some consumers, the typical incentive of a class attorney to select cases based, at least in part, on the amount of harm suffered by the individual plaintiffs is significantly weakened. Instead, regardless of whether *any* consumer actually suffered harm, plaintiffs' attorneys will have an incentive to roll the dice and bring class actions simply on the chance that they succeed in showing that some consumers were misled by a particular practice, entitling them to attorneys' fees.

This problem is far from theoretical. California's Unfair Competition Law provides only equitable remedies and does not permit the recovery of damages. However, that same law authorizes attorneys' fees and equitable relief, and prior to the passage of reform legislation in 2004,[63] did not require plaintiffs to show that they had suffered injury. By the time of the 2004 legislative reform, California's Unfair Competition Law had acquired national notoriety as breeding litigation that the State Attorney General himself

of contract requirements, *see generally* Lotte Bostick, Note, *The DTPA and Privity: Let the Buyer Beware Becomes Let the Buyer Recover*, 39 BAYLOR L. REV. 787 (1987).

[62] As discussed above, the FTC requires reasonable reliance in its definitions of both unfair and deceptive practices.

[63] Proposition 64, passed November 2, 2004, and codified as amendments to Cal. Civ. Code § 17200.

eventually called "extortionate."[64] In a mounting cascade of litigation, plaintiffs' attorneys sued defendants large and small, bringing class action suits based on allegedly deceptive practices that seemingly harmed no one: against software makers for putting software in boxes that were "too big," allegedly tending to deceive consumers into thinking that there were more than just one or two disks;[65] against auto shops for years-old technical regulatory violations—such as failure to give a customer a copy of an estimate—that had not resulted in fines but which were still recorded on the Bureau of Automotive Repair's website;[66] against nail salons for allegedly deceptively using the same bottle of nail polish on multiple customers, even though that is a practice regarded by the State Board of Barbering and Cosmetology as standard in the industry;[67] and against grocery stores for putting tags with both the actual and suggested retail price on cosmetics, watches, and wallets.[68] According to the California Attorney General, many such lawsuits reflected a pattern in which plaintiffs' firms would file complaints and simultaneously send letters demanding settlements from the targeted defendants.

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[64] *See* Jonathan D. Glater, *California Says State Law Was Used as Extortion Tool*, N.Y. TIMES, Apr. 5, 2003, at A8; Complaint for Injunction, Restitution and Other Equitable Relief, People of the State of California v. Trevor Law Group, LLP, No. BC 290989 (Cal. Super. Ct. Feb. 26, 2003), *available at* http://www.omm.com/files/Publication/ef3f39cc-d03b-44f8-ba28-9c881732da40/Presentation/PublicationAttachment/94b902ad-9c39-48c4-ae51-bf1641501248/complaint%5B1%5D.pdf.

[65] Civil Justice Association of California (CJAC), Examples of Unfair Competition Lawsuits Filed by Private Attorneys, http://www.cjac.org/newsandresearch/prop64/examples-of-unfair-competition.php (last visited Nov. 21, 2009).

[66] John H. Sullivan, President, Civil Justice Association of California, California's Notorious "17200"—Written by Lewis Carroll, Adapted by Stephen King? (Oct. 24, 2002), http://www.cjac.org/notorious.pdf; *see also* Glater, *supra* note 64.

[67] Center For Individual Freedom, Shakedown in the 'Golden State' (Feb. 20, 2003), http://www.cfif.org/htdocs/legislative_issues/federal_issues/hot_issues_in_congress/legal_reform/california_u_c_l.htm.

[68] CJAC, Examples of Unfair Competition Lawsuits Filed by Private Attorneys, *supra* note 65.

After years of criticism of such suits, in November 2004 the citizens of California passed Proposition 64 by referendum. Proposition 64 amended certain provisions of California's Unfair Competition Law and its False Advertising Law by restricting private actions to persons who had suffered injury in fact.[69] As subsequent judicial opinions have interpreted it, after Proposition 64, it is no longer possible for a plaintiff in an Unfair Competition Law claim in California to merely allege that some consumers would likely have been misled by the defendant's marketing practices or advertisements. Instead, a plaintiff must allege that she in fact relied upon the practice or advertisement and suffered concrete injury as a result of such reliance.

By adding such a requirement to California CPA law, Proposition 64 has had the salutary effect of making the legal proof of harm at least relevant to potential liability under that state's CPA regime. However, as we show in the Appendix, it remains the case that by allowing class actions with attorneys' fees for successful plaintiffs and restitutionary recovery that may be very costly to defendants, California's CPA still makes it potentially profitable for class action attorneys to bring lawsuits with very low probabilities of eventual success. In other words, even if Proposition 64 has made it harder for plaintiffs to succeed—because now they must prove that they have been injured by the allegedly false or deceptive practice—CPA

[69] After Proposition 64, CAL. BUS. & PROF. CODE § 17204 (West 2009) now provides that "[a]ctions for relief pursuant to this chapter shall be prosecuted . . . by a person who has suffered injury in fact and has lost money or property as a result of the unfair competition." The corresponding provision of the False Advertising Law, CAL. BUS. & PROF. CODE § 17535, was amended to require that

> Actions for injunction under this section may be prosecuted by . . . any person who has suffered injury in fact and has lost money or property as a result of a violation of this chapter. Any person may pursue representative claims or relief on behalf of others only if the claimant meets the standing requirements of this section and complies with Section 382 of the Code of Civil Procedure . . . .

actions will still be relatively attractive to plaintiffs' attorneys. As we also show, the incentive for suit would be even greater in a regime that granted compensatory relief and punitive or treble damages.

From an economic point of view, the problem with state CPAs is that they were crafted to offset a problem that has largely been dealt with by other means. As put by a leading consumer law scholar of the little FTC era, the problem addressed by state CPAs was that

> [t]heoretically, of course, most consumers could eventually redress their rights by bringing a lawsuit. But from a practical standpoint the costs of investigation and litigation bulk very large in comparison with the damages which might be obtained. Hence, personal injury litigation is rarely an effective remedy for consumer injustice under the present rules of the game in most states.[70]

As we discuss in greater detail below, this problem—inadequate private incentives for suit—is a real one. It can indeed lead to underdeterrence of truly fraudulent and deceptive marketing practices (in that they fool consumers into buying things that they would not buy if they knew their true quality and characteristics). Ironically, however, at almost the same time that states were passing their little FTC Acts, 1967 to 1972,[71] they were also following the standard set by Federal Rule of Civil Procedure 23 by promulgating rules authorizing class actions in state court.[72] The class action procedural device allows the aggregation of

[70] William A. Lovett, *Private Actions for Deceptive Trade Practices*, 23 ADMIN. L. REV. 271, 273 (1970).

[71] William A. Lovett, *State Deceptive Trade Practice Legislation*, 46 TULANE L. REV. 724, 730 (1971).

[72] *See* Stephen B. Burbank, *The Class Action Fairness Act of 2005 in Historical Perspective: A Preliminary View*, 156 U. PA. L. REV. 1439, 1500–01, 1544–51 (2008) (demonstrating that the majority of states adopted a version of Rule 23 between 1966 and 1979). California took the view that class actions had been authorized by its 1872 Field Code, but follows Rule 23 and Rule 23 case law. *Id.* at 1544–51. Only Mississippi and Virginia do not allow class actions. *Id.*

precisely the kind of small consumer claims that would otherwise not be economically viable. Provided that successful plaintiffs' attorneys can receive either court awarded attorneys' fees or a share of the total award recovered on behalf of the class as a whole, by aggregating the small damages suffered by many plaintiffs into a single recovery fund, the class action itself provides very strong incentives for plaintiffs' attorneys to bring consumer protection suits. That is, to make consumer protection suits viable and ensure adequate deterrence, there is no need for the statutory or enhanced—trebled or more general punitive —damages that are found in a large number of state CPAs.

Given the oftentimes very broad interpretation of "harm" under state CPAs, even a formal requirement that the plaintiff plead and prove that she was harmed by the defendant's conduct does not guarantee that plaintiff actually was made worse off by virtue of the defendant's allegedly false or deceptive practice. And, of course, a plaintiffs' attorney has no obligation whatsoever to ensure that the CPA cases she pursues are in the public interest. Indeed, studies of private class actions have made it unmistakably clear that class actions achieve deterrence that would otherwise be lost, but at a cost: potentially collusive settlements between class attorneys and defendants that transfer large sums to class attorneys but relatively little to class members, effectively allowing defendants to escape total liability by paying a settlement amount that is small relative to the harm the defendants have caused.[73]

[73] *See* DEBORAH R. HENSLER, ET AL., CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 79–99 (2000) (discussing evidence for, and varieties of, such collusive settlements). *See also* Theodore Eisenberg & Geoffrey Miller, *Attorney-Fees in Class Action Settlements: An Empirical Study*, 1 J. EMPIRICAL LEGAL STUD. 27 (2004) (reviewing class action awards from 1993 to 2002 and finding that the average award was $139 million and that the average award in the top ten percent of awards was $1.08 billion). There are several reasons to believe that the Eisenberg-Miller numbers underestimate the true magnitude of class action judgments and settlements. *See* George L. Priest, *What We Know, And Don't Know About Modern Class Actions: A Review of the*

It is not surprising that class actions under California's CPA have come to be perceived as intended merely to induce settlement, rather than deter truly harmful practices. As Professor George Priest explains:

> [A] principal concern regarding the operation of class actions is that the certification of a class itself, often based upon satisfaction of relatively undemanding procedural requirements, will bludgeon a defendant into a massive settlement. . . .Commentators unanimously concede that virtually every mass tort class action that has been successfully certified has settled out of court rather than been litigated to judgment. . . . We have recently observed settlements in class actions at enormous sums of money where there appears to be no substantive basis for defendant liability.[74]

In this unfortunate strategic game—what we call the "settlement holdup game"—defendants even settle cases that they would probably win on the merits. The game is played, successfully, against both large and small companies. Small companies often settle when they believe they have a good chance of winning at trial because they cannot risk the potential loss of their business and everything they own; large firms settle because settlements remove the specter of potential liability that depresses market value.[75]

As noted earlier and explained in more detail below, the FTC Act requires the Commission to consider the public interest (which is now manifest in the consumer welfare

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Eisenburg-Miller Study, MANHATTAN INSTITUTE CIVIL JUSTICE REPORT 9, Feb. 2005, at 4, *available at* https://www.policyarchive.org/bitstream/handle/10207/11705/cjr_09.pdf.

[74] Priest, *supra* note 73, at 4 (footnotes omitted).

[75] *See* H.R. Rep. No. 106-320, at 8 (1999) ("Too frequently, corporate decisionmakers are confronted with the implacable arithmetic of the class action: even a meritless case with only a 5% chance of success at trial must be settled if the complaint claims hundreds of millions of dollars in damages.") (citing *Mass Torts and Class Action Lawsuits Before the Subcomm. On Courts and Intellectual Property of the H. Comm. on the Judiciary*, 105th Cong. (1998) (statement of John L. McGoldrick, Esq., Senior Vice President and General Counsel, Bristol-Myers Squibb Co.)).

standard) in deciding whether to challenge a practice as false or deceptive. By contrast, only a few states attempt to discipline the incentives of private attorneys by including a public interest requirement for private CPA actions.[76] However opaque may be the mix of professional and political concerns that motivate FTC Commissioners, consumers and private attorneys who enforce state CPAs are simply not bound by the same practical and legislative constraints that apply to FTC regulators.[77] The great divergence in incentives in filing suit between private and public law enforcers is illustrated by California's experience with the allegedly extortionate practices of some notorious class action firms that sued hundreds, even thousands, of small businesses for technical regulatory violations (e.g. auto shops sometimes forgetting to give customers copies of their estimates, nail salons using the same nail polish bottle more than once). As the regulatory net has become increasingly dense and overwhelming for business, there are more and more technical regulatory violations that typically lead to little or no harm. Presumably one reason why the legislatures of California, and other states, have vested

[76] *See* Hall v. Walter, 969 P.2d 224, 234 (Colo. 1998) (holding that the practice challenged by an individual under COLO. REV. STATE. § 6-1-113 (1998) must significantly impact the public as actual or potential consumers); Zeeman v. Black, 156 Ga. App. 82, 84 (Ga. Ct. App. 1980) (stating that unless the defendant's actions had or has potential harm for the consumer public they are not directly regulated by the Georgia Fair Business Practices Act); Ly v. Nystrom, 615 N.W.2d 302, 314 (Minn. 2000) (holding that public interest must be demonstrated to state a claim under the private attorney general statute relating to the Consumer Fraud Act, Minn. Stat. § 325F.68 et. seq.); Nelson v. Lusterstone Surfacing Co., 605 N.W.2d 136, 139 (Neb. 2000) (stating that to be actionable under the CPA the unfair or deceptive act must have an impact on the public interest); Jefferies v. Phillips, 451 S.E.2d 21, 23 (S.C. Ct. App. 1994) (stating that to be actionable under South Carolina Unfair Trade Practices Act, S.C. Code § 39-5-20, "unfair or deceptive practices must adversely affect the public interest"); Hangman Ridge Training Stables, Inc. v. Safeco Title Ins. Co., 719 P.2d 531, 533 (Wash. 1986) (holding that a private litigant must establish a public interest impact to establish a prima facie case under the CPA, Rev. Code Wash. § 19.86.010 et seq.).

[77] *See, e.g.*, Sovern, *supra* note 27, at 452.

direct regulatory enforcement authority in public agencies is because those legislatures trust the agencies to use their discretion in the public interest, refraining from enforcing against violations that cause *de minimis* harm and are truly technical in nature. Class action attorneys are not guided by the same principles of discretion, and indeed are incentivized by the restitutionary remedial schemes and the prospect of recovering attorneys' fees offered by state CPAs to bring actions that are grounded in precisely the sort of technical regulatory violations that public regulators would overlook. Such private actions carry with them a very real likelihood of inefficient over-enforcement: enforcement that is not justified by the value of deterring the practices that are targeted for enforcement, because those practices cause little or no harm.[78]

D. Expansive Judicial Interpretation of the Concept of "Unfair and Deceptive" and the Potentially Chilling and Taxing Impact of State CPA Liability

Although it is conceivable that the private interests of CPA class action litigants will further the public interest as if guided by an "invisible hand," achievement of such a public interest goal ultimately hinges in large part on what kinds of practices can trigger liability under a state CPA. Assuming, as we do throughout this Part, that some form of CPA liability is necessary to supplement the common law and market forces that discipline deceptive and misleading practices in marketing consumer goods, it remains important

[78] As aptly stated by Stephen B. Burbank, *Aggregation on the Couch: The Strategic Uses of Ambiguity and Hypocrisy*, 106 COLUM. L. REV. 1924, 1930 (2006),

> Although the concept of inefficient over-enforcement is a tool of economic analysis of law, when applied to a particular statute, it surely must start with the level of enforcement sought by the legislature, which may be inferable from the legislature's attention or inattention to the background or ancillary rules and institutions that determine the real value of legal rights.

that the CPA liability process effectively focuses liability on truly misleading and deceptive practices. From the point of view of optimally deterring false and misleading consumer marketing practices, problems arise both from an under-inclusive CPA liability regime and one that is over-inclusive —threatening CPA liability for marketing and advertising which is, on balance, informative and socially desirable (or at least innocuous).

As currently interpreted by the courts, the problem of over-inclusive CPA liability is, we believe, very real, with potentially seriously deleterious consequences not only for companies that make and market consumer products and services but for consumers themselves. In the FTC Act and "little FTC" acts, both Congress and the state legislatures left the definitions of "unfair" and "deceptive" vague, but they chose different paths to determining the meaning of the terms. Congress empowered the FTC to use its expertise to determine the meaning of "unfair" and "deceptive",[79] while most state legislatures have chosen to not have effective administrative agencies that develop expertise in the definition and enforcement of illegal acts. Instead, state legislatures have relied on judicial interpretation through private litigation to define the terms. The FTC has, by regulation, adopted a method of determining whether a practice is "false, unfair and deceptive" that takes account of the costs and benefits of regulatory relief and quite openly seeks to maximize consumer welfare.[80] State courts are highly unlikely to exhibit the same degree of expertise in interpreting statutory language as a specialized federal agency.[81] Yet, many states seem to have ignored this crucial difference and did not provide the courts and, perhaps more importantly, businesses with needed guidance as to what

[79] Wheeler-Lea Act of 1938, Pub. L. No. 75-447, § 3, 52 Stat. 111, 111 (codified as amended at 15 U.S.C. § 45(a) (2006)).

[80] *See* discussion *infra* Part III.C.1.

[81] *See, e.g.*, Muris, *supra* note 20, at 16 ("[A]dministrative agencies, like the FTC, have developed areas of expertise, such as interpreting implied claims in advertising, that provide an advantage over courts when ruling on consumer matters involving certain complex issues.").

constitutes an unfair or deceptive practice. The result of this drafting is a freewheeling set of interpretations that are difficult to reconcile with consumer welfare. In the next section, we provide examples of some such interpretations, and then explain in more detail the adverse economic consequences from these interpretations.

1. The Expansive Interpretation of "Unfair and Deceptive" Under State CPAs

The types of lawsuits filed under state CPAs are the stuff of newspaper headlines and nightly news stories: former administrative law judge Roy Pearson Jr.'s $54 million suit brought under the District of Columbia CPA against a family-owned dry cleaning store for losing his pants, causing its "Satisfaction Guaranteed" sign to constitute a false and deceptive practice;[82] a suit, also under the District of Columbia's CPA, on behalf of people who consumed milk without knowing that they were lactose intolerant alleging that it was false and deceptive for sellers of milk to fail to warn them of the adverse effects that lactose intolerant people suffer when they drink milk;[83] suits brought under California's CPA against auto dealers for technical regulatory violations, such as using the abbreviation "APR" instead of "Annual Percentage Rate";[84] a suit alleging that a Fresno, California fast food restaurant engaged in an unfair practice by placing a restroom mirror an inch higher than is permitted under the federal Americans with Disabilities Act.[85] The allegations in these and many other such suits depict either trivial regulatory violations, marketing communications that are very general and imprecise and unlikely to deceive any typical consumer, or a failure to communicate information that should be obvious to any consumer who knows his or her own personal characteristics.

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[82] Pearson v. Chung, 961 A.2d 1067, 1070 (D.C. Ct. App. 2008).

[83] Mills v. Giant of Maryland, LLC, 441 F. Supp. 2d 104, 105 (D.C. 2006).

[84] AMERICAN TORT REFORM ASSOCIATION, *supra* note 11, at 9.

[85] *Id.*

They seem clearly to fall short of meeting almost any sensible standard of what might constitute a "false and deceptive" practice.

To their credit, courts have often dismissed such lawsuits on their pleadings, refusing to permit plaintiffs to get anywhere near a jury.[86] Yet dismissals of even such seemingly egregious cases are at least sometimes appealed.[87] Such appeals are far from frivolous, because it is easy to find cases that are just as far-fetched on their factual allegations that have survived not only dismissal, but appeal. In *Johnson v. Hewlett Packard Co.*,[88] for example, the plaintiff alleged that Hewlett Packard brochures that described its printers as including a free "economy" ink cartridge were deceptive because the free cartridges contained only half as much ink as a normal cartridge, forcing consumers to have to buy replacement cartridges sooner than they expected. The trial court granted summary judgment for the defendant, finding that the company had truthfully disclosed that the free cartridge was an "economy" cartridge, but the appellate court reversed on the ground that there was a triable issue of fact over how most buyers would have understood the phrase "economy cartridge."[89]

Similarly, in one of the most highly publicized recent CPA cases in California, *Benson v. Kwikset Corp.*,[90] the plaintiff alleged that although the deadbolts, doorknobs, and door handle sets (a category referred to as "locksets") sold by Kwikset were assembled in its U.S. plants, because some of

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[86] *See, e.g.*, *Mills*, 441 F. Supp. 2d at 105; *Pearson*, 961 A.2d at 1079. *See also* Bivens v. Gallery Corp., 134 Cal. App. 4th 847 (2006) (upholding dismissal of complaint alleging that a newspaper advertisement for twin mattresses showing a woman on a mattress, stating a unit price, and also stating both "TWIN EA. PC" and "SOLD IN SETS ONLY" was misleading because it failed to give the total price for twin sets).

[87] See cases cited *supra* note 62.

[88] No. CX-01-1641, 2002 WL 1050426 (Minn. Ct. App. May 22, 2002).

[89] This description is taken from Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere*, 92 VA. L. REV. 565, 614–15 (2006).

[90] Benson v. Kwikset Corp., 24 Cal. Rptr. 3d 683 (Ct. App. 2005), as modified on denial of rehearing 62 Cal. Rptr. 3d 284 (Ct. App. 2007).

Kwikset's products included some screws or pins made in Taiwan and a latch part made at its plant in Mexico, labels on Kwikset products stating "Made in U.S.A." or "All American Made" constituted an "unlawful" and "unfair" business practice under the California CPA.[91] This claim made it to a bench trial, where the plaintiff presented witnesses who testified that because they interpreted a "Made in U.S.A." label to mean that "all of the parts and all of the labor used to manufacture the product occurred" in the U.S., they felt deceived by the labels on Kwikset products.[92] The trial judge found that "a lockset incorporating a latch assembly that was sub-assembled in Mexico is deceptively labeled with either designation" and that "locksets that incorporate only a few screws or pins made in Taiwan are not deceptively labeled with a 'Made in U.S.A.' label, but are deceptively labeled with an 'All American Made' label."[93] The trial court enjoined Kwikset's use of the supposedly misleading labels, ordered it to allow retailers to return the "mislabeled" locksets for either a refund or replacement, and awarded plaintiff statutorily authorized costs plus attorneys' fees.[94] Thus, although *Kwikset* might seem to be a case that at least pushes the boundaries of what could reasonably be considered false or misleading mass market consumer communications, it is a case that the plaintiff actually won.

Although California's Proposition 64—establishing an injury requirement for plaintiffs to establish standing under California's unfair competition and false advertising laws—was passed during the pendency of Kwikset, that Proposition

[91] In particular, California's unfair competition law creates a right to restitutionary and injunctive relief against any "unlawful, unfair or fraudulent business act or practice . . . ." CAL. BUS. & PROF. CODE § 17200. Plaintiff also alleged that such labels violated a provision of California's false advertising law that makes in unlawful to sell products that are labeled with "the words 'Made in U.S.A.,' 'Made in America,' 'U.S.A.' or similar words when the merchandise or any article, unit, or part thereof, has been entirely or substantially made, manufactured, or produced outside of the United States." CAL. BUS. & PROF. CODE § 17533.7.

[92] *Benson*, 24 Cal. Rptr. 3d at 691.

[93] *Id.* at 692.

[94] *Id.* at 690.

seems unlikely to affect the outcome: after a trial, the judge found that at least one of the labels was misleading to consumers in general, a group in which the plaintiff could easily include himself.[95] Indeed, although there has already been a large number of reported decisions in which Proposition 64's injury requirement has led to the early dismissal of patently frivolous suits,[96] in many cases that seem equally far-fetched, plaintiffs have managed to at least satisfactorily plead injury, leaving judicial interpretation and implementation of the substantive standard of "unfair, false and deceptive" as the key determinant of whether such claims are dismissed quickly or become fodder for the class action settlement hold-up game described above.

For example, in *Paduano v. American Honda Motor Co.*, the plaintiff said that in deciding to purchase a 2004 Honda Civic Hybrid, he read and relied upon a number of allegedly misleading claims about fuel economy made in the sales brochure.[97] These claims included a highlighted EPA estimate of 51 mpg for the manual transmission version of the hybrid, an image of text reading "51 mpg" in large yellow font, with smaller foreground text beginning "with impressive fuel economy of 51 mpg," and statements in the brochure stating "just drive the Hybrid like you would a conventional car and save on fuel bills," and "IS THERE ANYTHING SPECIAL YOU HAVE TO DO? You just have to love saving money and getting terrific gas mileage."[98] Since the EPA estimate for this make and model was indeed 51 mpg, and since the brochure clearly stated that this was for the manual transmission—not the automatic that Paduano bought—the trial court had no difficulty in concluding as a

[95] More precisely, in Benson v. Kwikset, 62 Cal. Rptr. 3d 284, 290–91 (2007), Benson was allowed to amend his complaint so as to plead facts satisfying Proposition 64's standing requirement.

[96] *See, e.g.*, O'Brien v. Camisasca Auto. Mfg., Inc., 73 Cal. Rptr. 3d 911 (Ct. App. 2008) (plaintiff alleged that license plate frames were falsely labeled as "Made in U.S.A." but failed to plead that he ever saw such a label before he purchased his frame).

[97] 88 Cal. Rptr. 3d 90, 97 (Ct. App. 2009)

[98] *Id.* at 97, 104–105.

matter of law that there was nothing false or misleading in Honda's advertising statements that identified the EPA estimated mileage.[99] However, the trial court found that Paduano raised a triable issue of fact with his assertion that Honda had misled him by stating that a consumer could achieve the EPA mileage just by "driv[ing] the Hybrid like. . .a conventional car." These fact issues were raised, according to the trial court, by evidence that a Honda representative told him that the mileage tests used to derive EPA estimates "were developed over 30 years ago and do not reflect real driving situations, let alone driving habits of consumers in the modern day" and that another Honda representative told him that to get the high advertised fuel efficiency, "one would have to drive a hybrid vehicle in a manner quite different from the manner in which one would drive a conventional vehicle."[100] Remarkably enough, on appeal, the trial court decision to deny summary judgment was upheld by the majority.

What is most remarkable about the *Paduano* decision is that it has apparently been well-known for many years that EPA mpg ratings may systematically overstate the mileage that drivers will obtain, and not just from hybrids.[101] Moreover, apparently both Honda and Toyota had become aware—through customer complaints—that their hybrids were not getting the EPA-estimated mileage and had in fact contacted the EPA to try to get revised EPA estimates that were more in line with the mileage that customers were actually reporting.[102] At its most essential level, the *Paduano* case got past summary judgment on the strength of

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[99] *Id.* at 105.

[100] *Id.* ("[T]he tests do not take Hyrid vehicles into consideration, and Hybrid vehicle estimates are inflated based on the test procedures. Honda told [Paduano that] Hybrid vehicles are more dramatically affected by outside influences such as air conditioning, driving habits, windows up/down, and vehicle load than normal combustion engines. Only after purchase did Honda [tell Paduano that] Hybrids require a particular driving style in order to be fuel efficient, and short trips penalize hybrid efficiency more so than regular cars.").

[101] *See* Craswell, *supra* note 89, at 588.

[102] *Paduano*, 88 Cal. Rptr. 3d at 97.

the argument that Honda failed to tell drivers that hybrids were new and different and that the methodology used by the government to get its mileage estimates would not necessarily be accurate. But as the dissenting appellate judges (Haller and O'Rourke) in *Paduano* powerfully argued, this is a far cry from finding that what Honda did say was misleading or deceptive:

> [T]he Honda brochure's assertion as to driving the Hybrid conventionally and saving on fuel bills is true and basically definitional. By its nature, a hybrid vehicle "save[s] on fuel" (i.e., gasoline) because there are times while driving that the gasoline engine cuts off. The brochure itself points out that the electric motor adds its power to the output of the gasoline engine while accelerating, and also that "At a stop, the engine cuts off automatically under most conditions to reduce fuel use and emissions, thanks to the idle-stop feature. It restarts itself when you're ready to go." Paduano himself admitted in his deposition that any car's gas mileage would decrease with aggressive driving. His own deposition testimony bolsters the conclusion that Honda's suggestion about driving the hybrid Civic like a conventional car is not likely to mislead a reasonable consumer . . . . [T]he statement, "Just drive the car like you would a conventional car and save on fuel bills" relates not to driving style (i.e., aggressive versus non-aggressive driving) but to the absence of any need to plug the car into an outlet. Nevertheless, the majority's theory—that the brochure is misleading because it suggests a person can drive the car in a 'normal' or conventional manner and still get fuel economy close to the EPA estimate. . .necessarily depends on plaintiff's reliance on the accuracy of the EPA estimates set forth in the brochure. But as the majority holds, such a claim is not actionable![103]

[103] *Id.* at 127–28 (citation omitted).

2. Economic Consequences of the Highly Uncertain and Expansive State CPA Substantive Liability Standard

The incentive effects created by state CPA liability are a function of two things: the probability that such a suit will be brought, and the relationship between manufacturer/marketer behavior and the probability of liability if suit is brought. We argued earlier that, especially when coupled with the class action procedural device, even CPA suits with a relatively low probability of success on the merits may be economically worthwhile for plaintiffs' attorneys to file. The likelihood of success on the merits—and, more precisely, how the manufacturer's ex ante choices influence its probability of ex post liability—is a fundamental determinant of the ex ante incentives created by any legal liability system. In the case of CPAs, liability under the substantive "unfair and deceptive" standard is likely so expansive and uncertain that its likely effect is to both chill and tax socially desirable manufacturer/marketer communication to consumers.

In this section, we explain why this is so. We begin by recalling some basic results from the law and economics literature on the incentive effects of alternative types of liability regimes in the classic tort case, where a potential injurer (car driver, manufacturer) is choosing how careful to be to reduce the probability of harm. A mass marketer's choice about how and what to communicate to consumers is, however, quite different than the choice of precautions that is the focus of the canonical law and economics model. This difference is likely to lead to a socially undesirable chilling of mass market consumer communication. Importantly, unlike the generic precautions typically considered in the canonical economic model of legal incentives, a consumer product marketer does not necessarily lower its liability by doing more—by disclosing more information in greater detail—in its communication to consumers. For this reason, CPA liability may well amount to an inescapable, but risky, tax that accompanies any mass market consumer communication.

a. The Model of Precautions[104]

We begin by reviewing some of the basic law and economics of tort law incentives. At one extreme, one can imagine an economically ideal fault-based liability system. Such a system is one in which the manufacturer would face a one-hundred percent chance of liability if its behavior was economically suboptimal, and a zero-percent chance of liability if its behavior was economically optimal. At the other extreme, one can imagine a regime of absolute fault, in which the manufacturer is liable for damages in the event the consumer suffers harm regardless of what the manufacturer said or did.

One of the earliest and most fundamental results in law and economics is that both regimes—economically ideal fault-based liability and absolute liability—create an incentive for potential injurers to take optimal care to lower the probability of accidental harm.[105] Essentially, under either regime, the manufacturer internalizes the full social costs of its choices if it takes less than optimal care, and so both regimes equate private and social costs for less than optimal care. The difference between the two regimes comes in the distribution of the cost of accidents given optimal care by the manufacturer: under absolute liability, the manufacturer bears the cost of accidents even if it takes optimal care, while under ideal fault-based liability, the manufacturer takes optimal care but, given that choice, is never found liable and so victims are left bearing their own costs.

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[104] *See, e.g.*, Robert D. Cooter, *Unity in Tort, Contract and Property: The Model of Precaution*, 73 CAL. L. REV. 1 (1985); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 91–93 (1987).

[105] *See* STEVEN SHAVELL, *supra* note 104, at 73–79, 91–93; Robert D. Cooter and Thomas Ulen, *An Economic Case for Comparative Negligence*, 61 N.Y.U. L. REV. 1067 (1987).

These two regimes—ideal fault-based liability and absolute liability—are highly simplified, theoretical liability regimes. Fault-based liability is not ideal. Rather than a regime in which the manufacturer perceives zero-percent chance of liability if it takes optimal care and a one-hundred percent chance of liability if it fails to take optimal care, the more realistic situation is likely to be one in which a manufacturer perceives that there may always be some probability of liability, no matter what it does, but that the probability of liability will decrease with more careful ex ante behavior. Such a regime is, from an economic point of view, imperfect, but nonetheless rational more careful ex ante behavior will lead to a lower probability of ex post liability. However rational, such a regime creates too many incentives for manufacturer precautions. The manufacturer (or more generally, injurer) gets what is effectively a double marginal benefit from care-taking: it lowers the probability that a consumer suffers harm and also lowers its chances of being found liable if such harm occurs. Economic theory predicts that under very general conditions, this double marginal benefit leads to excessive precautions.[106] This theoretical prediction has been confirmed by empirical work in the medical malpractice area. There is evidence that uncertain malpractice liability has caused physicians to practice defensive medicine: excessive levels of treatment that are ordered primarily to lower the risk of liability, rather than to improve patient outcomes.[107]

Importantly, such imperfect fault-based liability regimes are quite similar to strict liability, in that they generally leave a manufacturer facing some positive probability of

[106] For this result, see John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984); Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279 (1986); Jason S. Johnston, *Bayesian Fact-Finding and Efficiency: Toward an Economic Theory of Liability Under Uncertainty*, 61 S. CAL. L. REV. 137, 181 (1987).

[107] *See* Daniel P. Kessler & Mark B. McClellan, *Do Doctors Practice Defensive Medicine?*, 111 Q.J. ECON. 353, 356, 385–88 (1996) (concluding that, absent limitations on liability, doctors provide excessively costly treatment).

liability no matter what its choice. Like strict liability, therefore, the incentive effects of fault-based liability regimes are highly sensitive to the damage measure. In an ideal fault-based liability regime, where a manufacturer is sure that it will not be held liable if it does the "reasonable" thing, the measure of damages is—in equilibrium—irrelevant, because the manufacturer's ex ante behavior is always economically optimal (which is equivalent to legally "reasonable" in an economically optimal legal regime) and therefore the manufacturer doesn't pay damages anyway. But in a more realistic, imperfect fault-based regime, the manufacturer is generally too careful, but still faces a positive chance of liability. Under such an imperfect regime, the prospect of paying extraordinary damages (statutory damages greater than actual harm, double or treble damages, or punitive damages) will add to the risk of over-deterrence. Only if one is sure that there is little or no risk that economically reasonable behavior will be punished with punitive damages can one assume that imposing punitive damages in an imperfect fault-based regime will not lead to significant over-deterrence.

b. The Model of Precautions Extended to CPA Liability for "False" and "Misleading" Selling Practices and Communications

The perceptive reader may have asked herself whether the simple economic model of precautions that we have just described can be applied to the kind of behavior that subjects manufacturers and mass consumer marketers to potential liability under CPAs. After all, the typical CPA case does not involve the question of whether the defendant mass marketer took reasonable precautions to lower the risk of a harmful accident, but rather asks whether the mass marketer's communications (or marketing practices more generally) were "deceptive" or "unfair." In this section, we extend the economic analysis of incentives under fault-based liability regimes to the choices that potentially trigger liability under CPAs.

A wide variety of conduct has the potential to trigger CPA liability. Here we are interested in two categories of conduct: selling practices and marketing communications (including advertising). In the category of selling practices, we place choices such as how big a box in which to put consumer software, or whether or not to reuse nail polish. In the category of communications, we place behavior ranging from simple "Satisfaction Guaranteed" signs to claims about the mpg rating of a Honda hybrid made in product brochures. Also included in the communication category are cases in which it is alleged that too little was said, as opposed to a communication being misleading. These cases include those such as the plaintiffs' claim that milk producers had violated the District of Columbia CPA by failing to warn lactose-intolerant people of the adverse side effects they would incur from drinking milk.

The harm that CPAs seek to avoid occurs when consumers are deceived or misled into buying products (or services) that are not those that they believed they were buying. Hence the question when the economic model of precautions is applied to the CPA context is how potential CPA liability influences sellers' incentives to take action in order to reduce the probability that their selling practices or communications will cause consumers to be misled.

The kinds of selling practices that are amenable to attack under state CPAs seem to be limited only by the imaginations of class action attorneys. If putting software disks in boxes and reusing nail polish can be misleading, then it is because of a background assumption about what consumers are thinking: that there is not a lot of extra space in a box with software disks (that it is more or less full of disks) and that every time a nail salon does a customer's nails, it is using a new bottle of nail polish. Whether these assumptions are reasonable reflections of what any consumer actually thinks cannot be determined ex ante. Cases like these tell firms that sell consumer products or services that virtually anything they do could trigger potential CPA liability. If virtually any selling practice can trigger liability, then there is no particular "precautionary" selling practice that a seller can adopt to lessen the chance of liability. If this is so, then the only effective precaution that can be taken to reduce potential liability for selling practices is to get out of the business of selling directly to consumers. For firms who stay in the business of selling to consumers, CPA liability acts like a tax that accompanies every decision to sell directly to consumers.

Consider next the model of precautions as applied to consumer communications. Here the problem is that there is potential CPA liability for saying too much—as about the EPA-estimate mpg for Honda hybrids—and saying too little —as in failing to warn lactose intolerant people that they will suffer adverse physical effects if they drink milk. Moreover, there is also potential liability if statements are insufficiently complete—as in saying that a doorknob is "Made in the U.S.A." when it contains screws made in Taiwan. The standard case presumed in the economic model of precautions is one in which, by taking more precautions, the actor lowers the risk of both social harm and that it will incur private liability. But with CPA liability, firms do not necessarily lower their liability by saying more in their consumer communications. Nor do they necessarily lower their liability by saying less, or even by saying nothing (since there may be a duty to disclose under the CPAs). Perhaps it is only by making extremely detailed and highly cautionary disclosures—to the effect that certain consumers may find that the product or service is not to their liking, for various and sundry enumerated reasons—could a seller actually shape its marketing communications and advertising so as to lower its risk of CPA liability. The problem confronting a seller who is honestly trying to devise advertising disclosures that inform but do not mislead consumers is a hard one. Recent studies have shown, for example, that prominently disclosing one product attribute may reduce consumers' understanding or recall of other information disclosed in the very same advertisement.[108] Consistent with this evidence from the marketing literature, as we explain in detail in the

[108] Craswell, *supra* note 89, at 583.

next section, in an economically relevant sense, such highly qualified and conditional seller communications may actually lessen the dissemination of useful information to consumers.[109]

To our knowledge, there is no systematic empirical evidence that details the extent to which CPA liability has a chilling effect on consumer communications and advertising. However, there are well-known cases in which CPA liability has had precisely the effect that we predict. Perhaps the most famous is *Nike, Inc. v. Kasky*.[110] In the late 1990s, Nike

[109] For an analysis that suggests that a CPA statute that broadly defines "deceptive" and "unfair" behavior may excessively restrict the dissemination of useful information to consumers see Thomas Holdych, *Standards for Establishing Deceptive Conduct Under State Deceptive Trade Practices Statutes That Impose Punitive Remedies*, 73 OR. L. REV. 235, 270 (1994) ("[A]pplying a pure negligence standard to determine the liability of an information source for causing false beliefs to be derived from ambiguous or vague communications may result in overdeterrence and reduce the amount of information produced or cause excessive care."). When a statute fails to clearly distinguish between deceptive and non-deceptive conduct, the latter may be punished when to do so would be inappropriate. The fear that consumer protection statutes will deter useful commercial activity has led some courts to become hostile to consumer protection claims. *See* Sovern, *supra* note 27, at 457. Critics argue that a statutory regime that imposes punitive remedies for offenses defined so broadly is too harsh. Merchants who engage in false advertising by virtue of an honest mistake or typographical error may be punished unduly. *See, e.g.*, Geismar v. Abraham & Strauss, 439 N.Y.S.2d 1005, 1008 (N.Y. Dist. Ct. 1981). *See also* Muris, *supra* note 20, at 33 ("Unduly expansive principles of deception can impede vigorous competition . . . .").

[110] *See* Nike v. Kasky, 539 U.S. 654 (2003). This case is a prime example of consumer protection statutes being used to infringe on a merchant's right to free speech. In the late 1990s, Nike was besieged by accusations that its products were manufactured in overseas sweatshops. Nike responded in a flurry of press releases, letters to the editors, and also commissioned a former UN ambassador to write a report on the labor conditions in Nike's overseas factories. Mike Kasky, a California resident, filed a lawsuit against Nike on behalf of the general public alleging that Nike's statements about the treatment of its workers amounted to a violation of California's deceptive trade practices law. Theodore B. Olson, then Solicitor General, argued to the Supreme Court that the fundamental principle of free speech was put in jeopardy when the "self-limiting principles" of common law actions are disregarded. *See* Brief for the

was besieged by accusations that its products were manufactured in overseas sweatshops. Nike not only responded with a flurry of press releases and letters to the editor, but also commissioned a former U.N. ambassador to write a report on the labor conditions in Nike's overseas factories. Labor activist Mark Kasky filed a suit against Nike under California's Unfair Competition and False Advertising laws on behalf of the general public, alleging that Nike's statements about its treatment of its workers amounted to a violation of California's deceptive trade practices law. Nike argued that the application of these California CPA laws to its commercial speech infringed the First Amendment. This challenge was rejected by the California Supreme Court,[111] and although the Supreme Court of the United States originally took certiorari on the First Amendment issue, a majority of the Court later changed their minds and reversed the grant.[112] After this, the case settled, with Nike agreeing to pay several million dollars to a D.C.-based international labor rights non-governmental organization. For present purposes, what is most important about *Kasky* is the immediate chilling impact it had upon Nike's communications: as soon as the case was filed, Nike stopped issuing its annual Corporate Social Responsibility reports[113] and making claims regarding its labor and environmental practices. This self-imposed speech moratorium lasted several years, and when Nike resumed communications regarding its labor practices, it

United States as Amicus Curiae Supporting Petitioners at 12, Nike v. Kasky, 539 U.S. 654 (2003) (No. 02-575).

[111] Kasky v. Nike, Inc., 45 P.3d 243 (Cal. 2002), *cert. granted*, 537 U.S. 1099 (2003), *cert. denied as improvidently granted*, 539 U.S. 654 (2003).

[112] *Id.*

[113] Nike asserted without contradiction that due to Kasky's suit, it had already begun to restrict "severely" its communications on social issues that could reach California consumers, refused "dozens of invitations...to speak on corporate social responsibility issues," delayed release of its annual Corporate Social Responsibility Report, and decided against trying to get its stock listed on the Dow Jones Sustainability Index (an index used by socially responsible and "green" mutual funds in screening stocks for inclusion in their portfolios). *Nike*, 539 U.S. at 682.

was careful not to assert anything about labor conditions, but instead simply posted an on-line list with its suppliers' names and locations.[114]

Another example of the chilling effect of potential CPA liability on communications with consumers is provided by *Benson v. Kwikset*.[115] As soon as Benson filed his CPA suit in 2000, Kwikset "ceased all use of the U.S.A. designation on all of their locksets."[116] As we explain below, when firms are deterred by CPA liability from communicating information to consumers, both firms and consumers suffer adverse consequences in the form of lost sales that would have generated positive gains from trade for both.

There is a final impact of potential CPA liability under the expansive construction of "false and deceptive" that becomes clear when we recognize that in the case of consumer products and services, precautions are two-sided. It is not only what the seller says or how it markets its goods and services that determines what consumers know or do not know about the product before they buy it; before they make a purchase, consumers also have an opportunity to, in effect, take precautions by becoming informed about the product or service, the seller, and the seller's reputation. There is a fundamental tradeoff between providing remedies to allegedly deceived consumers and giving consumers the incentive to investigate and protect themselves.[117] If consumers expect to be made whole when ill-advised decisions have bad consequences, then they have less incentive to be reasonably cautious.[118] The FTC clearly

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[114] *See* Michael Skapinker, *Nike Ushers in a New Age of Corporate Responsibility*, FIN. TIMES, Apr. 20, 2005, at 11.

[115] 62 Cal. Rptr. 3d 284 (Ct. App. 2007).

[116] *Id.* at 292.

[117] *See* Hadfield et al., *supra* note 16, at 147 ("Other contract doctrines protective of consumer interests generate tradeoffs in terms of the creation of incentives for consumers to become informed. Consumer information up front may be a more efficient way to avoid bad bargains than ex post relief and yet relief for various forms of mistake or misrepresentation may create inadequate incentives for consumers to bear the costs of becoming informed.").

[118] Hadfield et al., *supra* note 16, at 145.

recognizes these concerns in its definitions of unfair and deceptive. Unfortunately, there is no mechanism to tradeoff costs and benefits under state CPAs.

c. The Impact of Uncertain CPA Liability on Consumer Welfare

From the previous discussion, there are at least two serious impacts of expansive and uncertain potential CPA liability on the market for consumer goods and services. First is the imposition of what is effectively a tax on every good or service sold to consumers; second is the imposition of potential liability for consumer communications and advertising—liability that may well have the effect of either chilling informative communication and/or inducing sellers to make such communications both much more detailed and much more cautionary and discouraging. In this section, we trace the consequences for consumer welfare of these two effects.

> "Perhaps the most important insight coming from the analysis of information in markets again relates to transactions costs. Information is costly and so consumers rationally make choices between being better informed and settling for a less-informed but less (transaction) costly option. Consumer protection policy that is intended to alleviate the information problems that run through consumer markets, then, must address this underlying tradeoff. Protective measures that are as costly as the self-protective measure of gathering more information do not go to the heart of the problem; nor do regulatory techniques in which the cost of regulation (both direct costs and the indirect costs implied by the strategic response to the regulation) exceeds the cost of becoming informed and thus, by hypothesis, the value to a consumer of a more informed choice. In general, the transaction cost insight is that information costs are endemic to both markets and regulatory techniques; wise regulation must be designed with a clear understanding of the relative costs of the problem and the solution."

Id.

(i) The Welfare Loss from CPA Liability as an Excise Tax

First, and most simply, is the direct impact CPA liability has in imposing what is essentially an excise tax on each and every consumer sale. Generally speaking, excise taxes are imposed on luxury goods and on goods whose consumption the government wishes to reduce, such as cigarettes. Excise taxes reduce consumption because such taxes increase seller costs, which lead to an increase in price and reduction in quantity demanded and consumed. In the case of competitive markets, the excise tax has two consequences for the economic welfare of sellers and consumers. These consequences are depicted in Figure 1 below. Figure 1 depicts the consequences of imposing expected CPA liability in the amount L on every sale of a generic good or service.[119] As shown by Figure 1, the market effects of imposing this liability/tax is a shift up the supply curve, to S + L, thereby reducing the equilibrium market quantity consumed from Q_0 to Q_L and increasing the equilibrium price from P_0 to P_L.

The first consumer welfare consequence of the CPA liability as an excise tax is to simply price some consumers out of the market for the product. Consumers whose willingness to pay is bigger than P_0 but less than P_L are those who would buy the product if expected CPA liability is not added to its cost, but who will not when CPA liability is imposed.

[119] This analysis classically was presented by Robert L. Bishop, *The Effects of Specific and Ad Valorem Taxes*, 82 Q.J. ECON. 198 (1968).

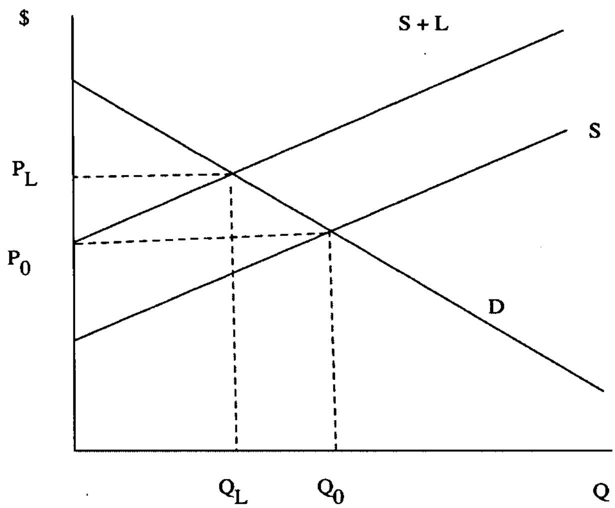

Figure 1

Since virtually any product or service sold to consumers carries with it the risk of CPA liability, at least with respect to items for which consumer demand is in the short run inelastic, it is consumers who are likely to bear the bulk of the cost of CPA liability, not firms. Especially for everyday goods and services—for which consumers do not shop out of state or online—states that have especially egregious CPA liability regimes are likely to be imposing most of the cost right back on the very same consumers whose welfare is supposed to be furthered. Moreover, it is well established in the public finance literature that excise taxes tend to be regressive—lower income consumers pay a larger portion of their income in excise taxes than do higher income consumers.[120]

[120] Depending upon the purchase decisions of consumers of differing income, excise taxes can also be highly regressive, tending to tax the poor more than the rich. *See* J. Fred Giertz, *Excise Taxes*, THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 111–13 (Joseph J. Cordes, Robert D. Ebel, & Jane G. Gravelle eds., 1999). The tendency for private CPA actions to be filed against businesses that provide basic goods and services, such as auto

Importantly, the cost imposition and welfare loss from this regressive tax (higher prices) is likely to be highly disproportionate to whatever benefits CPA liability may generate. That is, the normal case for products liability—that consumers may pay more but at the same time are made better off from the safer products that liability induces—has little application to CPA liability. While it is true that the threat of CPA liability will deter some actors from engaging in practices that truly are "unfair" or "deceptive," liability under the substantive "unfair" or "deceptive" standard is so arbitrary and uncertain that any and every seller faces potential CPA liability, even those whose selling practices are actually providing valuable information to consumers. Indeed, as many of the most unscrupulous sellers may be judgment proof, it is precisely those sellers who are most stable and enduring in the marketplace who are most at risk from CPA liability.

(ii) The Welfare Loss When CPA Liability Chills Informative Advertising

With many selling practices, it may be that CPA liability is so unpredictable that sellers can do nothing to avoid it, so that the excise tax analysis just presented gives us a fairly complete picture of the consumer welfare loss from CPA liability. But when it comes to CPA liability triggered by product labeling and advertising, both theory and anecdotal evidence suggest that sellers will interpret the CPA system as sending a clear signal that the way to reduce expected CPA liability is to either simply not advertise or communicate about certain product characteristics at all, or to do so in a highly qualified and conditional way. In this section, we show that such restrictions on informative advertising can clearly harm consumer welfare.

To understand how consumer welfare can suffer when CPA liability chills sellers' incentive to advertise and

repair, which are likely to constitute a large proportion of poor consumers' spending, tends to suggest that CPA liability may amount to a highly regressive excise tax.

communicate with consumers, it is necessary to review briefly the economics of advertising. There are a number of different economic explanations for advertising.[121] On one set of theories, advertising is simply directed to persuading consumers to buy a particular brand over others by influencing consumer tastes or preferences. On these theories, advertising usually tends to be socially wasteful, as it is simply a zero-sum game where firms compete for a fixed set of consumers that ends up only increasing costs and creating barriers to entry.[122] Other economic theories explain how by conveying information to consumers, advertising can have the socially desirable effect of lowering consumer search costs and/or facilitating mutually beneficial market transactions that would otherwise not occur.[123] Economists have furthermore recognized that advertising can convey information about products both directly—through content that provides information about product characteristics, location, function or price—and indirectly.

That advertising can be indirectly informative is a consequence of the general effect of advertising in expanding demand for the advertised product. When high-quality firms also are efficient, with low marginal cost and therefore more to gain by investing in demand-expanding costly advertising, and consumers know this, then advertising signals high quality.[124] Another content-independent mechanism by

[121] For an excellent overview of the historical evolution of economic theories and evidence about advertising as well as a detailed exposition of the most recent theoretical approaches, see Kyle Bagwell, *The Economic Analysis of Advertising* (Columbia Univ. Dep't of Econ. Discussion Paper Series, Paper No. 0506-01, 2005), *available at* http://app.cul.columbia.edu:8080/ac/bitstream/10022/AC:P:468/1/fulltext.pdf.

[122] *See id.* at 9-16. For an influential analysis of the negative welfare consequences of such taste-altering advertising, see Avinish Dixit & Victor D. Norman, *Advertising and Welfare*, 9 BELL J. ECON. 1 (1978).

[123] The foundation for theories of advertising as information was provided by George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

[124] This theory of how advertising may be informative, as well as the germ of virtually all the main theories of informative advertising, may be found in Philip Nelson, *Advertising as Information*, 82 J. POL. ECON. 729

which advertising can convey information to consumers is especially important for experience goods, where the consumer learns the actual quality of the good after buying and using it, and where consumers can be repeat buyers. For such goods, the value of an initial sale is likely to be higher for high-quality firms because consumers who buy the high-quality good will become repeat purchasers. In such a market, high-quality firms gain more from advertising than low-quality firms, and, therefore high-quality firms will use high advertising expenditures to distinguish themselves. Advertising content per se is not important in such a model.[125]

A final and especially important way that advertising can be informative is by helping match consumers with varying tastes to products with varying characteristics. While such matching is not strictly dependent upon advertising content (it can, under some circumstances, be accomplished by targeting costly advertising only at particular types of consumers[126]), most match-type advertising has content that informs consumers about the product characteristics, function and location.

Such models perceive a basic economic tradeoff in providing information about product characteristics: on the one hand, by informing consumers as to whether it is worth their while to incur the cost of searching further and buying a particular product, such advertising generates a sure social benefit by expanding markets and increasing the number of mutually beneficial transactions that occur. On the other hand, as advertising content becomes more detailed and extensive, when a consumer who sees such an advertisement proceeds to a store to buy the product she thereby reveals to the firm that she has a very strong preference for the

(1974). For an exegesis of the conditions under which advertising has the indirect or signaling effect, see Bagwell, *The Economic Analysis of Advertising*, *supra* note 121, at 84–90.

[125] For an especially elegant demonstration of this, see Richard E. Khilstrom & Michael H. Riordan, *Advertising as a Signal*, 92 J. POL. ECON. 427, at 428–29 (1984).

[126] See the discussion in Bagwell, *supra* note 121, at 95–100.

product—there is a good match between her preferences and product characteristics—information that the firm will wish to use by charging a high price. Informative advertising content thus has two fundamental but conflicting effects: it generates better consumer/product matches and bigger markets, but also reduces sales due to higher prices.[127] Essentially, firms are faced with a dilemma: if they provide too fine-grained information about the product, then consumers know that they will have to pay a relatively high price for the product (as the ad has told them so much that the only consumers who show up to buy perceive that the product is really what they want). If they provide too little and it is costly for consumers to search and shop, then too few consumers will show up to purchase. The profit maximizing solution for the firm is to provide some information about product characteristics, but not such extensive or detailed information about product characteristics that only consumers with a very high willingness to pay arrive to buy the product.[128] Somewhat non-intuitively, it is when search costs are high and the firm's profit maximizing price is low relative to search costs that a (monopoly) firm's private interest in attracting consumers can correspond perfectly with the social interest if which a consumer buys if and only if trade results in consumer surplus that exceeds her search costs. For lower search costs, the firm's price is high relative to search costs so some consumers may not buy even though their value is above the cost of search.

The crucial result in this recent economic literature on advertising is that both consumers and firms can benefit from mass market communications that convey *only partial or incomplete information*. CPAs, however, put firms in the position of either saying virtually everything that they can

[127] For this terminology and a summary of the advertising as matching models, see Bagwell, *supra* note 121, at 95–98.

[128] This result is established by Simon P. Anderson & Regis Renault, *Advertising Content*, 96 AM. ECON. REV. 93 (2006).

imagine about a product, or else saying nothing.[129] For example, the dairy industry has been attacked under CPAs for stating that milk products can promote weight loss while failing to label dairy products with warnings of the effects of lactose for those who are or may become lactose intolerant.[130] Automobile insurers have similarly been sued under CPAs for failing to tell consumers that they were requiring automobile repair shops to use generic (non-OEM) auto replacement parts despite state regulations allowing—even sometimes requiring—the use of generic parts.[131] Cases such

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[129] Consumers are forced to either make a less-informed choice when purchasing a product or engage in a protracted and costly inquiry in order to acquire information regarding product or service attributes such as price, quality, service, and warranties. In many cases, consumers require little or no information at all when contracting for the purchase products or services, sometimes relying on price alone to inform their decision. Consumer protection statutes that require certain disclosures or present a threat of liability motivate sellers to devote additional time and resources toward providing extensive information to consumers, in order to ensure statutory compliance or minimize their exposure to liability. Consequently, consumers are bombarded with information, much of which may be confusing or simply irrelevant for the purpose of adequately informing their purchase decisions. The time it takes consumers to effectively sift through the excess of information contributes to the total cost, in time and resources, dedicated to a particular transaction. Therefore, as a result of overall increase in information that a seller presents due to CPAs, consumer transaction costs increase. Professor Jeff Sovern has recognized that CPAs often cause transaction costs to increase but argues that what is needed is more regulation to prevent merchants from passing on these costs to consumers. Jeff Sovern, *Toward a New Model of Consumer Protection Statutes: The Problem of Increased Transaction Costs*, 47 WM. & MARY L. REV. 1635, 1705–09 (2006).

[130] Cases discussed and cited in Schwartz & Silverman, *supra* note 6, at 38, n.203. One must wonder if any regulations can protect lactose intolerant individuals who have not figured out that they have a problem with milk.

[131] Avery v. State Farm Mut. Auto. Ins. Co., 746 N.E.2d 1242 (Ill. App. Ct. 2001), *rev'd*, 835 N.E.2d 801 (Ill. 2005); *see also In re* Great Southern Life Ins. Co. Sales Prac. Litig., 192 F.R.D. 212 (N.D. Tex. 2000) (where failure to disclose the methods behind financial projections used in a marketing tool for a "vanishing premium" policy was a basis for a claim); Boswell v. Liberty Nat. Life Ins. Co., 643 So.2d 580 (Ala. 1994) (where

as these indicate to firms that unless they convey virtually every piece of discouraging information about a product imaginable, then they face possible punitive liability. Even worse, as in the examples above—the unsuitability of milk for people who are lactose intolerant, the use of generic parts—such information pertains to product characteristics that are obscure. A consumer may not understand precisely how the presence or absence of such a characteristic really impacts her likely utility from consumption.

There is no hard evidence about how such forced negative disclosure affects different types of consumers. There are two theoretically relevant distinctions. One possibility is that the negative disclosures have their greatest impact on the search and purchase decisions of consumers who, based on the match information that the firm voluntarily advertises, have already decided not to shop for the product. In this case, the disclosures induced by the risk of punitive CPA liability would have little impact on market equilibria because they would merely reinforce the firm's interest in deterring low value consumers from incurring search costs.

If the negative disclosures that CPA liability forces are most likely to impact the search and purchase decisions of consumers who would otherwise be high value then CPA liability will have seriously impacted the economic function of match advertising. If firms cannot send partial information in their advertising, but must include bizarre negative information of unclear meaning or relevance to consumers or else incur potentially large liability, then firms may not provide any product characteristic information. For goods with low search costs, the social loss will be relatively low: consumers will search for such goods even if they don't know very much about whether the product suits their preferences. But for goods with higher search costs, the impact of CPA liability in deterring advertising may be such that there is too little information to justify consumer

misrepresentation that a new policy provided additional coverage was the basis for a claim).

searches, and markets with such high search costs may unbundle.

III. THE PROPER ROLE FOR STATE CPAS AMONG THE INSTITUTIONS OF CONSUMER PROTECTION

The economic analysis of state CPAs presented in the previous part of this Article has shown that the current state CPA regime likely has seriously adverse consequences for the welfare of the very group that such laws are designed to help: consumers. But showing that the current regime is fundamentally flawed does not by itself indicate what should be done to fix it. From an economic point of view, the prescription for fixing the state CPA mess begins with understanding the proper role for CPA liability within the broader institutional landscape of consumer protection. As aptly put recently by Professor Timothy J. Muris, former Chairman of the U.S. Federal Trade Commission, these institutions are interdependent:

> One can envision the American system of consumer protection as a three-legged stool: a first leg of competition based on free enterprise with a second leg the legal structure of contract, property and other private law that largely focuses on the relative rights of particular parties. A two-legged stool will not be very stable. Likewise, markets and private legal rights, while indispensable to the American economic system, may falter in key respects. These legs can better support the American economic system when buttressed by a third leg. Public agencies—entrusted to promote consumer welfare by preserving competition and protecting consumers—work as this third leg, reinforcing the other two.[132]

As Professor Muris suggests, state CPA liability should be understood as supplementing the protection that consumers get from markets and the common law on the one hand, and from enforcement under the FTC Act on the other. In this Part, we argue that there is indeed a potential role for state

[132] Muris, *supra* note 20, at 4–5.

CPAs in supplementing markets, the common law, and FTC enforcement, and derive the proper role for state CPAs from the limitations of the market, common law, and FTC enforcement.

A. Market Forces for Consumer Protection—and How Private Litigation Under State CPAs Interferes with Those Forces

Even if there were no laws or regulations protecting consumers against false and misleading seller practices, under certain conditions, the market itself generates strong incentives for sellers to inform consumers about product quality. Consumers have every incentive to become informed about not only the goods that they buy but about the sellers from whom they buy them; and sellers have strong incentives to develop and maintain a reputation for making truthful and informative claims about the goods and services that they sell. A traditional—indeed in some sense *the* traditional—economic criticism of consumer protection regulation, whether by the FTC or CPAs, is that market forces such as reputation can have a stronger, and more precise, disciplining effect on seller misbehavior than any lawsuit.[133] We agree with the argument that market forces for consumer protection are much stronger than many advocates of consumer protection laws tend to believe. However, the role of the market is much more nuanced than some law and economics scholars seem to assume. As we now explain, the strength of market incentives for consumer protection depends on several factors: both seller and buyer type; the ability of repeat sellers to identify their product to consumers via pricing, branding and advertising; the extent to which consumers are repeat purchasers; and the cost and

[133] Omri Ben-Shahar took this position in delivering the annual Coase Lecture at the University of Chicago. *See* Dorris, *supra* note 14; *see also* Hadfield et al., *supra* note 16 (arguing that in many consumer markets there are "well-developed reputation mechanisms permitting other consumers to monitor the extent to which a merchant lives up to its promises.")

speed with which consumers obtain information about product quality. As we also explain, in their current form, state CPAs may actually hinder rather than assist market forces for consumer protection.

1. The Lemons Market Problem

As an analytical benchmark, consider first the extreme case in which consumers are omniscient. In this case, even without taking any sort of costly action, consumers have perfect information about the price and characteristics of every product or service. With such free and perfect information, it is almost a tautology that consumers cannot be misled by anything that a seller might say about their product or service. Consumers might still be subject to monopoly pricing, but this would be due to a lack of competition, not misleading or deceptive practices by manufacturers or distributors.

Once we move to the more realistic case—where at least some consumers are at best imperfectly informed about the product or service—imperfect information has potentially serious consequences for consumer welfare. If consumers can acquire perfect information about all of a product's characteristics, including price, but have a positive cost of search, then market prices will generally exceed the competitive level.[134]

With incomplete consumer information about product quality, market existence itself becomes an issue. In the standard model of such markets, it is assumed that information is asymmetric. While sellers of goods or services know the actual quality of the goods or services they sell,

[134] More precisely, there is a general tendency for market prices to increase to the monopoly level, as consumer search costs increase. *See* A. Sadanand & Louis Wilde, *A Generalized Model of Pricing for Homogeneous Goods Under Imperfect Information*, 49 REV. ECON. STUD. 229 (1982); Stephen Salop & Joseph Stiglitz, *Bargains and Rip-offs: A Model of Monopolistically Competitive Price Dispersions*, 44 REV. ECON. STUD. 493 (1977). As is well known, monopoly prices exceed the social marginal cost of production, leading to socially suboptimal levels of consumption and a distortion in the allocation of capital.

buyers only know their average quality. Under such informational conditions, if high-quality sellers cannot credibly identify themselves, buyers will think every seller's good is of average quality, and they will not pay more than the value of average quality. If high cost, high-quality sellers cannot charge more than this average-quality price, then they cannot make a profit. But when the very highest quality sellers drop out of the market, the average quality falls and the new highest quality sellers may lose money, causing them to leave the market, leading to market disequilibrium. This result—that asymmetric information can cause markets to unravel, with low-quality goods in effect driving out high-quality goods—is known as the lemons market problem, its name corresponding to the problem caused by automobiles that are poor quality "lemons."[135]

2. Overcoming Lemons Markets Through Voluntary Disclosure: The Unraveling Result

In reality, lemons problems rarely cause markets to fail. Lemons markets are overcome because producers and consumers have strong incentives to communicate and obtain credible and accurate information as to product quality. Because consumers will pay more for a high-quality good or service, a high cost/high quality seller generally has a very strong incentive to inform consumers about the quality of her product. It has been demonstrated that when consumers cannot costlessly and perfectly verify ex ante the truth of seller claims about product quality, then they will assume that quality is the worst possible consistent with a particular seller disclosure. Such consumer expectations in turn generate an equilibrium in which the highest quality seller-type perfectly and exactly reveals quality, causing the next highest quality seller to also perfectly reveal quality, and so on, in a process where seller private information completely unravels and rational consumers are fully and

[135] George A. Ackerlof, *The Market for Lemons: Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

completely informed about product quality.[136] Such voluntary disclosure eliminates the lemons market problem, because good sellers can easily distinguish themselves from bad sellers just by making truthful and fully informative disclosures. As such, good sellers will enter the market and effectively drive out the lowest quality sellers.[137]

The world posited by the unraveling result is one in which consumers are perfectly rational (in that they fully understand the relevant incentives and can deduce market equilibria) and can perfectly and costlessly verify seller statements about product quality. In such a world, the question is not whether sellers will lie about product quality —they cannot, by assumption—but how much they will reveal about product quality.[138] The unraveling result is that in such a world, rather than issuing vague statements about product quality—such as "fish weighing at least ten and as much as twenty pounds"—sellers will issue precise statements about product quality—such as "fish weighing 11.2 pounds."

The assumptions underlying the unraveling result are severe, and although some assumptions turn out not to be crucial to the result of full quality disclosure (e.g., the result holds under monopolistic as well as competitive product markets),[139] others are required.[140] In particular, when a

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[136] This is known as the "unraveling" result on quality disclosure, and was developed independently by Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461 (1981) and Paul R. Milgrom, *Good News and Bad News: Representation Theorems and Applications*, 12 BELL J. ECON. 380 (1981). The result is explicated and its limitations discussed in JOSEPH FARRELL, VOLUNTARY DISCLOSURE: ROBUSTNESS OF THE UNRAVELING RESULT, AND COMMENTS ON ITS IMPORTANCE, IN ANTITRUST AND REGULATION 91 (Robert E. Grieson ed., 1986).

[137] *See* J. Howard Beales III et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 502 (1981).

[138] Grossman, *supra* note 136, at 462.

[139] *See* Grossman, *supra* note 136.

[140] If, for example, disclosure itself is costly, then sellers disclose if and only if quality is above some threshold level. Boyan Jovanovic, *Truthful Disclosure of Information*, 13 BELL J. ECON. 36 (1982). Similarly, if it is

sufficiently large number of consumers cannot understand the disclosure—because it contains somewhat technical data regarding the product, for example—then voluntary disclosure of quality may not occur.[141] As we argued earlier, in Part II.D, the very expansive and uncertain construction of what might constitute an "unfair" or "deceptive" practice under state CPA laws actually creates an incentive for sellers to make precisely these kind of long and technically detailed disclosures. These disclosures are precisely the kind that many consumers cannot understand, and which may destroy the possibility of avoiding lemons market problems through voluntary disclosure. This is, indeed, an extraordinarily perverse result—private litigation under state CPAs (by reducing voluntary disclosure) may trigger calls for mandatory disclosure.

3. Consumer Search, Product Use, and Seller Reputation

As explained below, when we cannot rely on voluntary disclosure because seller claims about product quality cannot be costly and perfectly verified by consumers, the common law of contracts and fraud become important supplements to market incentives for product quality disclosure. But consumers need not rely solely on seller statements for information about product quality. Consumers may learn about product quality by searching for and observing

costly for sellers to become informed about their product quality, then sellers become informed only if the cost of doing so is low, and disclose only if the information that they learn is favorable. *See, e.g.*, FARRELL, *supra* note 136; Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994).

[141] Michael J. Fishman & Kathleen M. Hagerty, *Mandatory Versus Voluntary Disclosure in Markets with Informed and Uninformed Customers*, 19 J.L. ECON. & ORG. 45, 46–47 (2003). Additionally, when firms sell differentiated, multi-attribute products to consumers with varying preferences over those attributes, firms may not voluntarily disclose because disclosure may increase the price elasticity of demand with respect to some products. V. Joseph Hotz & Mo Xiao, *Strategic Information Disclosure: The Case of Multi-Attribute Products with Heterogeneous Consumers* (NBER, Working Paper No. W11937, 2006).

products (trying on a coat, for example) before purchase, or by purchasing and using the good (buying and then using a television, for example). Consumer search, observation, and product use are all very important market mechanisms that not only restore equilibrium in markets with imperfectly informed consumers, but also discipline deceptive selling practices.

In the economics literature, goods whose quality the consumer can identify by simply examining the good are known as search goods, while goods whose quality can be determined by consumers only after purchasing and using the good are known as experience goods.[142] With search goods, consumers can learn about quality, and reward high-quality providers with higher prices if the cost of searching and observing quality is sufficiently low that they will continue to search—by moving on to another store—if they observe unexpectedly low quality.[143] Indeed, with search goods, high prices may themselves signal high quality, since provided that search costs are not too high, consumers will always continue to shop if they observe low quality but high prices at a particular seller.[144]

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[142] *See, e.g.*, Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973); Michael Spence, *Competitive and Optimal Responses to Signals: An Analysis of Efficiency and Distribution*, 7 J. ECON. THEORY 296 (1974).

[143] This result also establishes the existence of markets in heterogeneous search goods (so that the lemons market nonexistence problem is overcome). *See* Birger Wernerfelt, *Selling Formats for Search Goods*, 13 MARKETING SCI. 298 (1994); Alan Schwartz & Louis L. Wilde, *Competitive Equilibria in Markets for Heterogeneous Goods under Imperfect Information: A Theoretical Analysis with Policy Implications*, 13 BELL J. ECON. 181 (1982).

[144] For this result, see Paul W.J. De Bijl, *Entry Deterrence and Signaling in Markets for Search Goods*, 16 INT'L J. INDUS. ORG. 1 (1997). More generally, when some consumers are informed about product quality and some are not, high and declining prices may be a credible signal of high quality. The reason is that the loss of sales volume caused by high prices is relatively less costly to high-cost, high-quality sellers, and the loss of sales volume is in any case greater for low-quality sellers, who lose more sales from informed consumers. *See* Kyle Bagwell & Michael H. Riordan, *High and Declining Prices Signal Product Quality*, 81 AM. ECON. REV. 224 (1991).

With experience goods, it is generally much more costly for the consumer to actually judge quality, since judging quality requires buying and using the product for some time period. For durable goods, moreover, the required period of use may be quite long.[145] With experience goods, the power of the market as a force disciplining low-quality sellers depends crucially on how long it takes consumers to actually learn the quality of the good or service through consumption. As one would expect, therefore, existing empirical evidence shows that consumer experience good learning varies with the type of good. For some goods, such as laundry detergent, it seems that consumers already know everything at the time of purchase (such goods are actually search goods).[146] For other goods and services—yogurt, (some) pharmaceuticals, and auto vehicle inspections—empirical evidence shows that consumers learn quickly about product quality and quickly adjust their purchases according to what they learn.[147] For a final category of goods—automobile

[145] For this reason, the composition of the consumer pool for an experience good changes over time following the introduction of a new good, and sales generate not only revenue for sellers, but also an increasingly large number of informed consumers. In light of these two effects, economists have shown that pricing for experience goods is generally dynamic, with prices sometimes starting high and then falling (with so-called mass market goods, where most consumers are quite sure even before consumption that they value the good highly), and sometimes starting low and then rising (for so-called niche goods, where consumers are not as optimistic about the value of the good ex ante). For this result, and a very clear summary of the theoretical literature on experience good pricing with imperfectly informed consumers, *see* Dirk Bergemann and Juulo Välimäki, *Dynamic Pricing of New Experience Goods*, 114 J. POL. ECON. 713 (2006).

[146] Tulin Erdem & Michael P. Keane, *Decision-Making Under Uncertainty: Capturing Dynamic Brand Choice Processes in Turbulent Consumer Goods Markets*, 15 MARKETING SCI. 1 (1996).

[147] *See* Daniel A. Ackerberg, *Advertising, Learning, and Consumer Choice in Experience Good Markets: An Empirical Examination*, 44 INT'L ECON. REV. 1007 (2003); Gregory S. Crawford & Matthew Shum, *Uncertainty and Learning in Pharmaceutical Demand*, 73 ECONOMETRICA 1137 (2005); and Thomas N. Hubbard, *How Do Consumers Motivate Experts? Reputational Incentives in an Auto Repair Market*, 45 J.L. & ECON. 437 (2002).

insurance—it seems that the opportunities for consumer experience learning are too infrequent, and switching costs perhaps too high, for experiential learning to have much of an impact on consumer buying behavior.[148]

Thus for experience goods—a large and important category that includes many or perhaps most consumer durable goods—the ability of consumers to learn about quality and then base their future purchase choices on such information is likely to vary systematically with the type of good, and in particular with the speed at which consumers learn information about quality and the cost to them of switching purchases. In other words, the ability of repeat customers to punish sellers who have deceived them by simply taking their business elsewhere is indeed a market force favoring high-quality experience goods and deterring deceptive claims about such goods, but its strength is not likely to be the same for all kinds of experience goods.[149]

From the point of view of sellers, for either search or experience goods (or services), sellers of high-quality goods have an incentive to identify themselves to repeat purchasers through brand names and trademarks so as to earn and keep their business. Sellers who sell low-quality merchandise may enjoy some short-term profits by charging relatively high prices for low cost and low quality goods, but in the longer term, the ability of consumers to discern product quality through use, and to identify and reward sellers of high-quality products, can make it economically rational for sellers to invest in producing high cost, high-quality products.[150]

Strictly speaking, however, the withdrawal of possible repeat business is not always sufficient for such reputational

[148] *See* Mark Israel, *Services as Experience Goods: An Empirical Examination of Consumer Learning in Automobile Insurance*, 95 AM. ECON. REV. 1444 (2005).

[149] *See, e.g.*, Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980).

[150] *See generally* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

sanctions to effectively drive out cheating or disreputable sellers. Reputation can provide a perfect discipline against low-quality or deceptive sellers only if *all* future buyers (including those who do not have first-hand experience) have knowledge of a seller's failure to deliver on its promise of high quality.[151] Some such general reputational information is provided by the increasingly important word-of-mouth communication conduit. But consumer demand for information about past seller performance elicits more than queries of other consumers. To satisfy this demand for information, the market itself, through sources such as "Consumer Reports" and "Angie's List," provides information about sellers to consumers. Such profit-driven information intermediaries provide the information about product quality that is necessary for market reputation to discipline and restore equilibrium in consumer markets for experience goods.[152]

Such intermediaries are an even more important market response to imperfect consumer information with another category of goods and services called "credence goods." Credence goods are goods for which quality cannot be determined by the consumer even after consuming the product.[153] For example, even repeat purchases and consumption cannot determine the accuracy of a seller's

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[151] *See* W. Bentley MacLeod, *Reputations, Relationships and Contract Enforcement*, 65 J. ECON. LIT. 595, 614 (2007).

[152] For examples of other intermediaries, see *id.*

[153] *See* Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. L. & ECON. 67, 68–69 (1973) ("Credence qualities are those which, although worthwhile, cannot be evaluated in normal use. Instead the assessment of their value requires additional costly information. An example would be the claimed advantages of the removal of an appendix, which will be correct or not according to whether the organ is diseased. The purchaser will have no different experience after the operation whether or not the organ was diseased. A similar example would apply to replacement of a television tube, certain automobile repairs, and the like. The line between experience and credence qualities of a good may not always be sharp, particularly if the quality will be discerned in use, but only after the lapse of a considerable period of time.").

claim that their dark chocolate reduces one's chance of cardiovascular problems. As this example indicates, for many credence goods and services, expert providers often know more about the quality of good than does the consumer. Because of this extreme form of information asymmetry, it is possible for disreputable providers to charge the consumer for goods or services never provided, or provide the wrong quantity or type of goods or services to the consumer (under- or over-providing).[154] Credence goods are like experience goods for which the consumers' experience provides no information to the consumer about the quality of the good or service or the truth of the seller's statements about her needs, unless first analyzed and interpreted by a third party expert. Indeed, because the consumer can be perfectly satisfied with the observed outcome and yet have received the wrong good or service, or have been misled as to the good or service, direct consumer sanctions—such as failing to buy again from or bad-mouthing a particular seller —are inherently limited in the case of credence goods.[155]

For this reason, it is perhaps unsurprising that the market alone suffices to discipline credence good suppliers if, and only if, a number of very restrictive conditions are met.[156] While it is in general more difficult for third parties to evaluate and provide information to consumers about the quality of credence goods and services than to evaluate and provide information about experience goods and services, it is not impossible. In the medical service area, for example, a number of states have recently begun to provide so-called "medical report cards" that give consumers accessible information about crucial medical outcomes (such as mortality rates) at different hospitals. While it is unclear whether such report cards have the intended impact on

[154] *See* Uwe Dulleck & Rudolf Kerschbamer, *On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods*, 44 J. ECON. LIT. 5, 5–6 (2006).

[155] *See id.* at 11.

[156] These conditions include observability and verifiability, neither of which is likely to hold in the typical credence goods situation. *See id.* at 12–15.

patients—who choose to stay away from hospitals with bad report cards—or hospitals—who either terminate poor-performing physicians or encourage them to alter their practice patterns—there is evidence that such reports have significantly improved outcomes at the low-quality hospitals in particular.[157]

In concluding this discussion of experience and credence goods, it is important to emphasize the very real welfare consequences of consumer deception. The weaker the ability of consumers to verify quality through experience or outside certifiers, and the less informative the seller's reputation, the greater the probability that a consumer will buy a poor or deceptively low quality good. Prices will send the wrong signals for the allocation of productive effort and capital, and because they will sometimes pay more than a product is worth to them, consumers will be hesitant to buy at all. While not as extreme as the lemons market non-existence result, the practical consequence of consumer deception is to shrink the market in a socially undesirable way.[158]

[157] *See* David M. Cutler et al., *The Role Of Information In Medical Markets: An Analysis Of Publicly Reported Outcomes In Cardiac Surgery*, 94 AM. ECON. REV. 342, 344–45 (2004) for a study of the impact of the oldest medical report card system in the U.S., the Cardiac Surgery Reporting System (CSRS) in New York State. Using data on the distribution of risk-adjusted mortality rates across hospitals over the period 1991–1999, the authors found evidence indicating that the system especially improved the performance of low-quality hospitals. Hospitals labeled as high mortality initially decreased bypass surgery volume by about ten-percent (for an average-sized hospital), with the decrease almost entirely among the healthiest patients (who presumably did not need the surgery at all in many cases).

[158] For an excellent survey of the various ways consumers may become informed and the consequences of imperfect information, see Joseph Stiglitz, *The Causes and Consequences of the Dependence of Quality on Price*, 25 J. ECON. LIT. 1 (1987).

4. State CPA Laws as Currently Construed Hinder Rather than Support Market Forces that Discipline Seller Deceptive Practices

The primary mechanism underlying market forces for consumer protection is accurate and verifiable information. Whether consumers obtain information through search, product use, or third party evaluators, it is such information that allows consumers to discipline sellers who engage in deceptive practices by taking their business elsewhere and rewarding sellers who establish a reputation for honesty and quality with their continuing business. In terms of its effectiveness in supporting these positive market forces, the key question about the current CPA regime is whether the signal sent by CPA liability adds to the amount of useful information possessed by market participants or detracts from it. Our earlier analysis of both the CPA process and the substantive standard for CPA liability strongly suggests that the current CPA regime may significantly blur the information that consumers have about producers, thus hindering rather than supporting market forces.

The primary defect of the CPA regime as currently configured is that it creates incentives for class action attorneys to bring suits in order to obtain settlements from defendants whose conduct was almost surely neither deceptive nor misleading in any meaningful way. Announcements of settlements of claims that are actually meritless may convey false information to consumers. More importantly, for sellers who are selling precisely the goods that they claim to be—honest sellers—the prospect of being sued and paying potentially large class action settlements lowers the return from such honest behavior relative to the return from opportunistic behavior. To be blunt, if a seller is going to be sued under a state CPA and made to pay roughly the same amount regardless of whether she has tried to increase her sales and profits by deceiving consumers, then why would she rationally give up the extra profits obtainable through deception? By both confusing consumers and confronting honest sellers with a risk of CPA liability, the current CPA significantly interferes with market mechanisms for consumer protection.

B. The Common Law and its Limitations as a Supplement to Market Forces for Consumer Protection

As we have seen, market sanctions against low quality or deceptive sellers are not perfect. They are dependent upon the speed and accuracy with which consumers observe actual product quality and with which product quality information is transmitted to market participants. However, by enforcing promises to provide goods of a particular quality—warranties—and by penalizing false and misleading seller communications about product quality as fraudulent, the common law of contracts itself may significantly enhance market incentives for consumer protection.

1. The Power of Contractual Commitment

Through the simple but powerful device of making contractual promises of quality legally enforceable, the common law can greatly strengthen market forces for consumer protection. To see this, consider the case of an experience good where buyers and sellers are not repeat players. As explained earlier, in this case, voluntary disclosure of product quality will not occur when consumers cannot perfectly and costlessly verify the truth of the disclosure. However, because the good is, by assumption, an experience good, consumers do learn the quality of the product through use. Provided that warranties of quality—promises of quality, that is—are legally enforceable, high quality, high cost sellers can distinguish themselves to consumers by making such warranties. Here, legally enforceable means that quality failures are not only observable by consumers, but also verifiable to courts. When quality is both ex post observable and ex post verifiable, then it can be shown that under both monopolistic and competitive product markets, sellers of high-quality goods perfectly distinguish themselves by offering complete or full warranties.[159]

Warranties are by no means the only contractual mechanism by which high-quality sellers attempt to distinguish themselves from low-quality sellers. Liberal product return policies, such as promises to take products back and then repair or replace defective products at no cost to the consumer, are generally costlier to low-quality sellers than to high-quality sellers. Hence such return policies can also allow high-quality sellers to distinguish themselves from low-quality sellers.[160]

2. Common Law Fraud and Information Disclosure

An equally important common law doctrine protecting consumers is fraud. Economic models that predict full voluntary disclosure of product quality hinge on the assumption that false statements about product quality are not made because of certain detection and high penalties for such statements.[161] Another way to put the "unraveling result" is that if false seller statements are precluded either by perfect consumer knowledge or by effective penalties, then sellers will not only disclose truthful product quality information, but will also be induced by market competition to fully and precisely disclose product quality.

In practical terms, the way in which such market disclosure works is elegantly simple. By asking sellers to describe the various attributes of the good for sale, consumers elicit either vague answers—at the extreme, the

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[159] *See* Grossman, *supra* note 136, at 470–77.

[160] *See* Wernerfelt, *supra* note 143, at 302–03.

[161] *See, e.g.*, Grossman, *supra* note 136, at 462; Paul H. Rubin, *The Economics of Regulating Deception*, 10 CATO J. 667, 679 (1991) ("There is much support in the recent literature for the proposition that, as long as deception is not allowed, there are incentives for sellers to disclose even the negative attributes of their products. This is because consumers will rationally assume that any advertisement which omits a critical piece of information (say, the durability of a product) will imply that the value of that attribute for that product is at the lowest level.").

answer of "we don't know, it could be anything"—or precise answers. A perfect fraud rule confronts sellers with certain large penalties if they make a false precise statement. With such a fraud rule in place, sellers either make an accurate precise statement about product quality, or a vague statement. But this is precisely the set of options that generates the unraveling result: high-quality sellers precisely reveal product quality, and consumers rationally infer the lowest quality consistent with a vague seller disclosure, causing all sellers to precisely reveal product quality. Thus, if consumers know that the common law fraud doctrine prevents sellers from lying to them about product quality, consumers themselves can elicit full disclosure even about multi-attribute items by asking sellers to describe the various attributes of the goods for sale.

3. Limitations to Common Law, Market-Based Consumer Protection

Inasmuch as the effectiveness of market incentives for consumer protection depends upon the common law enforcement of warranties and the prohibition of fraud, weaknesses and imperfections in the common law weaken market incentives for consumer protection. If promises were perfectly and costlessly interpreted and enforced by courts, then a seller would incur liability for breaching a warranty of quality whenever, but only when, it actually breached the warranty. But courts are not perfect. Sometimes a seller might be held liable for breach of warranty even though the product fully lived up to its promised quality. Sometimes a warranty might be breached, and yet the consumer would either be unable to discern the breach or find the cost of suit too high to merit filing a lawsuit. Even if a consumer sues, courts may mistakenly find no breach of warranty despite the provision of lower quality than promised.

The various costs and errors of common law litigation mean that legally enforceable promises can be exploited by opportunistic sellers and consumers. An opportunistic seller can provide a warranty without any intention of honoring the warranty should the product fail. To the extent that some buyers will rely on the warranty, those consumers are harmed. Moreover, such a phantom warranty can cause a competitive imbalance by giving an advantage (perhaps only temporary) to the dishonest sellers. In the extreme, a lemons market can develop.[162] Conversely, opportunistic consumers might well take advantage of liberal and legally enforceable return policies to use and then return non-defective durable goods, essentially obtaining a free rental. Similarly, opportunistic consumers might claim breach of warranty for quality defects due not to anything that the seller did, but to the consumer's own mis- or overuse of the product. Such consumer opportunism causes sellers to limit the range of legally enforceable promises that they make to consumers, making it more difficult for high-quality, reputable sellers to signal their type to consumers, and ultimately hurting honest but imperfectly informed consumers.[163]

The primary "consumer law" provisions of the common law—actions for fraudulent misrepresentation or negligent misrepresentation—are similarly far from the ideal market support mechanisms.[164] A common law action for fraudulent misrepresentation generally required the plaintiff to show that the defendant intentionally and knowingly deceived the plaintiff regarding a material fact and that the plaintiff justifiably relied on the misstatement which caused the plaintiff's financial loss.[165] It was difficult for consumers to prove these elements. Even when a plaintiff could prove all

[162] Of course, legitimate sellers also have an interest in removing honest sellers from the market. They often achieve this through enactment of special interest legislation limiting entry into the market.

[163] The equilibrium result is the sellers' use of standard-form consumer contracts that give sellers the discretion, but do not legally obligate them, to provide additional product and service quality benefits to consumers. *See* Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation between Businesses and Consumers*, 104 MICH. L. REV. 857, 877 (2006); Lucian A. Bebchuck & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827, 827–28 (2006).

[164] GREENFIELD, *supra* note 5, at 173.

[165] RESTATEMENT (SECOND) OF TORTS § 525 (1977).

of the elements, common law actions were viable only when the plaintiff's damages were large enough to justify the cost of suing, something that was not often the case in typical consumer fraud actions.[166]

The common law of fraudulent misrepresentation was gradually supplemented by negligent misrepresentation which allowed recourse even when the defendant did not knowingly misrepresent a material fact, but did so because of lack of reasonable care in ascertaining the truth.[167] Specifically, a plaintiff had to show that the defendant made a false statement due to a lack of reasonable care in determining the facts or in the manner of expression, or an absence of skill or competence expected in a given industry or profession.[168] The plaintiff also had to show that it was reasonable to rely on the defendant's statement and that the statement caused the plaintiff's injury.[169] These last few requirements gave plaintiffs the same problems that abounded with fraudulent misrepresentation, mainly that the common law had no form of recourse to punish the defendant before the plaintiff went through with the transaction, and that the cost of bringing the suit far outweighed the actual damages. Contract law was equally unhelpful because businesses were often able to make false claims in their advertising materials without actually entering into a contract.[170]

[166] Schwartz & Silverman, *supra* note 6, at 7; *see also* Jonathan A. Mark, *Dispensing with the Public Interest Requirement in Private Causes of Action Under the Washington Consumer Protection Act*, 29 SEATTLE U. L. REV. 205, 207-10 (2005) (discussing the history of the FTC and its limitations in protecting consumers); Donna S. Shapiro, *The Georgia Fair Business Practices Act: Business as Usual*, 9 GA. ST. U. L. REV. 453, 483 (1993) (distinguishing the Georgia Fair Business Practices Act as a statute that courts construe to provide less protection for consumers and business enterprises than unfair or deceptive business practices).

[167] RESTATEMENT (SECOND) OF TORTS § 552 (1977).

[168] *Id.*

[169] *Id.*

[170] RESTATEMENT (SECOND) OF CONTRACTS § 26 (1981).

4. The Common Law's Shortcomings: A Role for Federal and State Consumer Protection

Thus, as a general matter, the effectiveness of the common law as a mechanism enabling market incentives for quality is limited by two factors:

> i) Imperfect Determination of Liability: the general imperfection of the common law process in determining whether warranties and similar promises have been breached and in determining whether a false statement had been knowingly or negligently made;
>
> ii) Disproportionate Costs of Liability Determination: the tendency for individual costs of bringing suit to be greater than the loss from seller deception about product quality.

These analytical conclusions tell us what a consumer protection regulatory system (whether federal or state) would look like if, as its proponents originally intended, it were truly designed to supplement the shortcomings in the consumer protections provided by a market system subject only to the common law.[171] Such a system would indeed need to locate a procedural device for overcoming the lack of viability of individual suits. The class action is such a device. But it would not need to supplement the class action with statutory, enhanced, or punitive damages. And most importantly, it would need to send a signal that is very clear ex ante as to precisely what kinds of seller conduct and seller communications run afoul of the statutory standard. As we have argued, the current CPA regime of private enforcement does not do this.

[171] *See* Muris, *supra* note 20, at 14 ("Consumer protection policy also has a vital role in supporting markets. It helps ensure that consumers can make well-informed decisions about their choices and that sellers will fulfill their promises and not increase sales by lying about their products. Thus, prevention of deception helps consumers in two ways: first, most obviously, by deterring deceptive sellers; and second by making it easier for honest sellers to make credible claims about their products.").

C. Regulation: Market Monitoring and Intervention by the Federal Trade Commission

As described earlier, in supplementing market and common law forces for consumer protection, CPAs do not stand alone, but against the background provided by FTC regulation. Such regulation is indeed the traditional (and sometimes economically recommended) response to a perceived inadequacy of markets and the common law.[172] On the view that the purpose of state CPAs are to supplement the gaps in deterrence already achieved by the market and the common law, as well as federal enforcement, the logical question to ask is whether and how the FTC regulatory regime needs to be supplemented at all.

1. Key Aspects of the FTC Enforcement Regime

Perhaps the most direct, market-oriented regulatory strategy to protect consumers from exploitation due to incomplete, asymmetric information is for the government to

[172] In addition to state and federal consumer protection law, the federal antitrust laws, embodied in the Sherman Act and Clayton Act, provide another constraint on business activities. While consumer protection law is aimed at protecting consumers directly, antitrust law governs the interaction between competitors in the marketplace. Specifically, antitrust law controls the supply side of the market by proscribing collusive and exclusionary tactics among competitors or unilateral action by a firm aimed at curbing competition. Consumer protection, on the other hand, regulates the market on the demand side, ensuring that consumers make well-informed decisions and that sellers provide accurate and reliable information. Nonetheless, consumer protection and federal antitrust law complement one another by serving the common purpose of improving consumer welfare. There is also an overlap between these two means of market regulation. Whereas consumer protection law directly governs transactions between buyers and sellers, it indirectly governs competition between sellers. For example, when a seller uses deceptive methods to generate sales, those sales come at the expense of lost sales to honest sellers. Furthermore, unfair and deceptive business practices of one or a handful of sellers may spread ill will throughout an entire industry, impacting all competitors in the industry by reducing the primary demand in general for a certain product or service.

simply require sellers to disclose certain information to consumers. This has been the predominant approach of federal securities regulation since its inception in 1933, and other federal agencies have adopted a similar strategy for at least part of their regulatory function, such as the Consumer Product Safety Commission, Food and Drug Administration, and Occupational Health and Safety Administration. Another regulatory strategy is for government regulators to promote competition through antitrust policy on the belief that "robust competition in a strong market is the primary bulwark of consumer protection."[173]

Congress expanded and clarified the FTC's consumer protection function in 1938 when it amended the FTC Act to grant the Commission the power to regulate all "unfair or deceptive acts or practices in commerce"[174] regardless of whether the act affected competition between businesses[175] or merely the communication between a business and consumer.[176] The Wheeler-Lea Act of 1938 left the task of determining what constituted "unfair or deceptive" to the Commission. It has been suggested that the difficulty in

[173] Muris, *supra* note 20, at 3.

[174] Wheeler-Lea Act of 1938, Pub. L. No. 75-447, § 3, 52 Stat. 111, 111 (1938) (codified as amended at 15 U.S.C. § 45(a) (2006)).

[175] The Federal Trade Commission was originally created to prevent monopolistic activity within the business community. *See* Federal Trade Commission Act, Pub. L. No. 62-203, 38 Stat. 717 (1914) (codified as amended at 15 U.S.C. §§ 41-58 (2000)) (establishing the FTC). Specifically, Congress charged the FTC with preventing "[u]nfair methods of competition." *Id.* § 5. Later, when the FTC attempted to regulate product advertising, the Supreme Court held that Congress only granted the FTC authority to regulate anti-competitive activity and therefore the agency could not regulate things such as deceptive advertising aimed at consumers. *See* FTC v. Raladam Co., 283 U.S. 643, 654 (1931) (holding that the FTC had no authority to regulate an advertisement promoting a supposedly ineffective weight loss product where only consumers were harmed).

[176] Unfair consumer practices are clearly a subset of unfair competition as a business engaged in unfair consumer practices is trying to attract customers away from a competitor. *See generally* Neil W. Averitt, *The Meaning of "Unfair Acts or Practices" in Section 5 of the Federal Trade Commission Act*, 70 GEO. L.J. 225 (1981).

pinning down a definition of "unfair or deceptive" and the evolving nature of the terms explains why Congress delegated that duty to a bi-partisan expert commission and empowered it with the tools to stop unfair and deceptive trade practices.[177] Those definitions continue to develop through agency guides, FTC rulemaking, and administrative adjudication and case law.[178]

The current FTC definition of an unfair act is one that "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or competition."[179] As applied, the definition of unfairness is determined by a comparison of benefits and costs of the action.[180] The definition of a deceptive act currently involves the examination of a series of factors: "First, there must be a representation, omission or practice that is likely to mislead the consumer. . . . Second, we examine the practice from the perspective of a consumer acting reasonably in the circumstances. . . . Third, the representation, omission, or practice must be a 'material' one."[181] Under contemporary regulatory practice, the FTC decides whether an advertisement is false or misleading by looking at the "percentage of consumers who interpret the ad as making a given claim, often relying on empirical tests. . .that involve showing the disputed ad to a representative sample of consumers."[182] As explained by Richard Craswell, framing

[177] *See* Schwartz & Silverman, *supra* note 6, at 11.

[178] The law authorizes the FTC to circulate general rules, as well as rules declaring certain practices to be "unfair or deceptive" when it thinks they have become prevalent. 15 U.S.C. § 57a (2000). The FTC also issues informal guides but they do not have the same weight as official Commission rules.

[179] *See* Federal Trade Commission Act Amendments of 2006, Pub. L. No. 109-455, § 3, 120 Stat. 3372 (codified at 15 U.S.C. § 45(n)).

[180] *See* Beales, The FTC's Use of Unfairness Authority, *supra* note 17.

[181] Letter from James C. Miller III, Chairman, to Rep. John D. Dingell, Chairman of House Comm'n on Energy & Commerce, FTC Policy Statement on Deception (Oct. 14, 1983), *available at* http://www.ftc.gov/bcp/policystmt/ad-decept.htm.

[182] Craswell, *supra* note 89, at 596.

the question this way has allowed the FTC (and federal courts) to look and apply a "sliding scale, in which the number of consumers affected and the seriousness of their potential losses are both taken into account."[183] Under this approach, the greater the importance of the product attribute advertised—and the injury that would therefore be done if consumers were misled about it—the smaller the threshold proportion of consumers that are misled about it for the FTC to deem the ad misleading.[184]

As further observed by Professor Craswell, even though the FTC has not often explicitly recognized that its decisions about whether or not a seller communication is deceptive are based on such a cost-benefit calculus, "a good deal" of cost-benefit analysis in fact underlies such decisions.[185] Thus, even though the FTC does not need to show that the defendant intended to deceive, that anyone was injured, or that the defendant even made a false statement,[186] its practice has increasingly been guided by a consumer welfare standard. The agency eschews bringing actions where technical or inconsequential violations have not resulted in meaningful harm to consumers.

Another feature of the FTC enforcement regime that distinguishes it from the state CPA regime is the enforcement process and remedy. Very often, the FTC issues an administrative complaint, and such complaints have over the years generated hundreds of decisions by FTC administrative law judges and thousands of consent agreements.[187] In addition to the administrative law process, the FTC now "frequently" uses the additional enforcement authority given to it in 1975 to go directly into federal court,

[183] *Id.* at 597.

[184] *Id.* at 596.

[185] *Id.* at 601.

[186] Jon Mize, *Fencing Off the Path of Least Resistance: Re-examining the Role of Little FTC Actions in the Law of False Advertising*, 72 TENN. L. REV. 653, 657–58 (2005).

[187] CAROLYN A. CARTER & JONATHAN SHELDON, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 184–85 (National Consumer Law Center ed., 7th ed. 2008).

where the remedy is usually a cease and desist order, injunction, or settlement.[188]

2. State CPAs Fail to Optimally Compliment FTC Enforcement

The economically justified role for state CPAs in complimenting FTC enforcement depends upon why it is that one believes that FTC enforcement is insufficient. One possibility is that the FTC is doing precisely what it should be doing, on economic grounds, but is subject to inevitable enforcement shortfalls due to its limited budget. The other possibility is that the FTC enforcement is inadequate because the FTC is subject to political influences.

Suppose first that the FTC is doing precisely what it should be doing on economic grounds. We call this the faithful agent model. This is not a fanciful case: in our view, the FTC's cost-benefit approach to determining whether a selling practice or advertisement is false or misleading is based on sound economic principles. In other words, on the faithful agent view, the FTC is doing what it says it tries to do—focus its law enforcement resources on practices that cause the greatest consumer harm—and so has the economically correct enforcement target. Like every regulatory agency, however, the FTC's budget is limited and it must therefore prioritize cases on its enforcement agenda. Undoubtedly, some false or deceptive consumer practices escape FTC enforcement simply because of the agency's budget constraint. There is no way to know for sure how often truly deceptive practices escape FTC enforcement, but we can be sure that the probability that the FTC detects and takes remedial action against any given deceptive practice is in general less than one. If the FTC is behaving as a faithful agent, then it also seems plausible that the more widespread and serious the harm from a deceptive practice, the more likely it is that the FTC will take action to stop it, and the sooner that such action will be taken. Companies that are marketing and selling well known products and services on

[188] *Id.* at 185.

the national market would, we expect, be squarely and continuously on the radar screen of the FTC as a faithful agent. On the other hand, firms that sell in more limited markets, for shorter time periods, may escape FTC detection and enforcement.

On this faithful agent story, the basic problem with FTC enforcement against false and deceptive consumer practices is that the expected sanction in a system that relies solely on FTC enforcement is likely to be too low to optimally deter such practices. The expected sanction from FTC enforcement is too low because: (1) the remedy sought by the agency can never exceed, and is generally less than, the harm caused by any such practice; and (2) the probability of detection and sanction is never larger than one. Due to these two facts, the expected sanction facing a firm subject only to FTC enforcement (equal to the probability of detection and sanction multiplied by the sanction) is always less than the actual harm caused by the practice. As firms internalize only the expected sanction, they internalize too little of the harm that their false and deceptive practices may cause. Moreover, the longer it takes the FTC to detect and get a cease and desist order against a firm, the larger is the harm done by the false or deceptive practice (and the greater the gain to the firm from engaging in the practice). Still, even if the FTC recovered all the profits earned from every firm against which it enforced the law, the less-than-one probability of detection and enforcement means that the expected sanction is too low to optimally deter false and deceptive practices. In many instances, potential FTC sanctions are supplemented by adverse reputational effects so that the inadequacy of FTC sanctions alone is corrected. Reputational effects can combine with FTC sanctions to move closer to optimal deterrence only when the potential wrongdoer has a reputation worth protecting.

The problem of the inadequacy of FTC sanctions alone is likely to be most severe for firms that are smaller and operate on limited geographic markets (or, more generally, smaller markets) and which therefore are less likely to be on the FTC's enforcement radar screen. If the point of state

CPA laws is to offset the inadequacy of FTC sanctions alone, then state CPA enforcement should be targeted against these and any other identifiable category of firms that are unlikely to be targeted by the FTC.

The dual public-private enforcement of state CPAs creates substantial challenges for CPAs to accurately and adequately address the inadequacy of FTC sanctions. There is no reason to think that either state attorneys general or private class action attorneys will have an incentive to restrict their enforcement activity to firms and/or practices that would escape FTC enforcement. In recent years, state AGs have been criticized for their aggressive pursuit of high profile cases against large multi-national companies—including numerous actions joined by dozens of AGs.[189] These are precisely the companies that are likely to be adequately policed by the FTC. AGs can easily justify the pursuit of such extraterritorial actions as an out-of-state revenue source for the AG's state treasury—but that justification does not mean that the AGs' actions enhance either consumer or taxpayer welfare. Our analysis of private actions carries over to unwarranted actions by AGs (that is, actions that do not satisfy a consumer welfare standard and infringe on the FTC's turf) and suggests that such AG prosecutions do cost in-state consumers in the form of higher prices—an invisible tax imposed by the AG. Of course, a faithful agent AG may buck the political incentives and not bring actions solely on revenue-generating or headline-generating capacity. The consumer welfare standard provides a guide to which consumer protection actions are properly pursued by AGs.

The incentive of class action attorneys filing actions under CPAs is, in general, to bring actions against those firms and practices that they believe will settle quickly and on relatively generous terms. As argued earlier, ideal targets for private lawsuits may include a mix of both small,

[189] *See, e.g.*, Michael S. Greve, *Government by Indictment: Attorneys General and Their False Federalism* (American Enterprise Institute, Working Paper No. 110, 2005), *available at* http://www.aei.org/publications/pubID.22565/pub_detail.asp.

risk-averse firms and large publicly traded corporations subject to potential stock market impacts. While some small firms may indeed be likely to escape FTC enforcement—and therefore ought on economic grounds to be targeted by state CPA enforcement—private class action attorneys may have an even stronger incentive to pursue large multinational companies that are especially likely to be under more or less continuous scrutiny by the FTC. Unlike the faithful agent FTC, moreover, private class action attorneys have every incentive to persuade courts to expansively interpret the substantive "false" or "deceptive" liability standard to encompass selling practices which the FTC would not find to be violative of its own cost-benefit understanding of that standard. Hence, as currently configured, state CPA liability certainly supplements FTC enforcement, but it goes far beyond what would be justified on optimal deterrence grounds.

It may be argued that it is much too sanguine to assume that the FTC is a faithful agent. Instead, it may be said, the FTC is subject to a variety of political influences that lead it to selectively enforce the FTC Act, shying away from politically costly enforcement actions and choosing instead to bring only those enforcement actions that promise political benefits or at least risk minimal political costs. The general model of agency behavior presumed by this argument—that much agency behavior can be explained by the desire of regulatory agencies to maximize their perceived net political benefits—is we believe in general a quite accurate explanation of agency decision-making.[190] But to our knowledge, there is no evidence that the interests of the FTC in maximizing its perceived political net benefits has caused it to deviate from its stated mission by under-enforcing against false and deceptive practices. Instead, supporters of state CPA liability trumpet FTC enforcement practices as a

[190] *See, e.g.*, WESLEY A. MAGAT ET AL., RULES IN THE MAKING: A STATISTICAL ANALYSIS OF REGULATORY AGENCY BEHAVIOR (1986).

model.[191] This leads us to surmise that if anything, the FTC may be a bit too zealous at times, especially in its scrutiny of the largest and most visible firms. If this is so, then this further supports the argument that state CPAs may be used much too frequently against such firms.

3. National Markets and Federalism Concerns

State CPAs present a patchwork of consumer protection laws to larger consumer products and services companies with national markets. Although state CPAs use similar terms and rely on private enforcement, there can be dramatic differences across states in terms of the definition of crucial terms and enforcement. The only commonality appears to be that every state but one allows a private right of action under its CPA. Everything else—from whether the plaintiff needs to show reliance or actual injuries to the available remedies and everything in between—differs from one state to the next.

The differences between these statutes make large consumer protection class action cases ripe for forum shopping,[192] which can have a negative effect on the defendant. But the diversity of consumer protection approaches can also make multi-state class action lawsuits a bad deal for consumers. Additionally, the oft-cited criticism of class actions—that the relief provided to the unnamed

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[191] *See, e.g.*, Braucher, *supra* note 9, at 851 ("Concerning its deception power, the FTC has issued a particularly lucid, and conservative, statement of principles about why it will act.").

[192] Although Congress has attempted to curb class action forum shopping with the Class Action Fairness Act of 2005 (CAFA), it looks as though its effort will have little beneficial effect on consumer protection cases (from the business owner's point of view). CAFA only allows the defendant to remove the case to a federal court, thus avoiding prejudicial procedural rules and prejudiced juries and judges, but the state's substantive laws are still applicable. *See* Amelia L. Sweeny & Rudy A. Englund, *The Class Action Fairness Act's Impact on Consumer Protection*, 72 DEF. COUNS. J. 233, 239 (2005).

class members is usually pitiful—is even clearer in the context of a large consumer protection class action.[193]

State CPAs raise the same type of federalism challenges faced by many other areas of regulation in a federal system. State tort law, and its interaction with federal health and safety regulations, has been a particularly vexing problem in recent years.[194] Our civil justice system benefits from diffused economic and political power, but it surely comes with costs. The static inefficiency caused by CPAs must be balanced against the dynamic benefits of jurisdictional variety and the "laboratory" of the states. A challenge is to design institutions that maximize the net value of federalism in the face of pressure for centralized control. Although it is tempting to advocate federal domination of consumer protection because of the inefficiencies of the current system of CPAs, such centralization must be evaluated in terms of the reality that federal enforcement of consumer protection has gone through some rough times of its own.[195] Moreover, our analysis in the preceding subsection suggests an economically sensible demarcation of federal and state

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[193] A recent and typical multi-state consumer protection class action illustrates this point. In April 2006, owners of Teflon-coated pots and pans brought a suit against DuPont, alleging that the company concealed information from the government that indicated that Teflon-coated cooking utensils released harmful toxins when heated past a certain temperature. David Pitt, *Class-Action Status Sought in Teflon Suit*, WASH. POST, Apr. 20, 2006. The plaintiffs sought to certify a class that included potentially millions of Teflon-coated pan owners in a $5 billion dollar suit. The sheer logistics of identifying, locating, and contacting every owner of a non-stick pan in a single state would be impractical and, moreover, locating them in several states would be prohibitively expensive. While there are other legally acceptable forms of notice, they are nowhere near as effective. *See generally* Todd B. Hilsee, Shannon R. Wheatman, & Gina M. Intrepido, *Do You Really Want Me To Know My Rights? The Ethics Behind Due Process in Class Action Notice is More Than Just Plain Language: A Desire to Actually Inform*, 18 GEO. J. LEGAL ETHICS 1359 (2005).

[194] *See generally* RICHARD A. EPSTEIN & MICHAEL S. GREVE, EDS., FEDERAL PREEMPTION: STATES' POWERS, NATIONAL INTERESTS (2007).

[195] *See* Pamela C. Engle, *The FTC as National Nanny*, WASH. POST, Mar. 1, 1978, at A22.

consumer protection enforcement actions that allows for capturing the strength of both systems of enforcement—state CPA enforcement should be targeted against identifiable categories of firms that are unlikely to be effectively monitored by the FTC.

IV. POLICY IMPLICATIONS: REMOVE REDUNDANT "SOLUTIONS"

State CPAs are intended to complement the consumer protection policy of the FTC, and the FTC is intended to complement the consumer protection attributes of markets and the common law. Former FTC Chairman Timothy Muris has characterized the institutions of consumer protection policy—markets, common law, and regulation—as a three-legged stool. Muris cautions about the need to keep the legs of the stool balanced. Our analysis suggests that private actions under state CPAs have unbalancing negative consequences for all three legs of the consumer protection stool: Markets are distorted by the perverse incentives to either disclose too much or too little information, while news of extortionate settlement sends inaccurate signals to consumers. The common law has been distorted to the point that private CPA litigation is stacked in favor of plaintiffs as CPAs have been interpreted by courts to limit the common law protections that reflected a balance of seller and consumer interests. And, regulation at the state level is managed by a decentralized and uncoordinated decisionmaking process by private plaintiffs' attorneys who are not in any manner constrained by the traditional public interest requirements of government regulation.[196] Clearly, consumer protection policy is knocked out of balance by the current regime of state CPAs.

CPAs were designed to solve two simple economic problems: (1) individual consumers often do not have the incentive or means to pursue individual claims against mass

[196] For general comments on the development of such regulation through litigation, see W. KIP VISCUSI, ED., REGULATION THROUGH LITIGATION (2002).

marketers who engage in unfair and deceptive practices; and (2) because of the difficulty of establishing elements of either common law fraud or breach of promise, those actions alone are too weak an instrument to deter seller fraud and deception. The most striking lesson of our analysis is that the typical state CPA—with relaxed rules for establishing liability, statutory damages, damage multipliers, attorneys' fees and costs, and class actions—solves the basic economic problem that CPAs were intended to address several times over. The effect of this redundancy in solutions is that CPAs can deter the provision of valuable information to consumers and, thus, harm consumers. That is, as currently applied, state CPAs harm consumers. This need not be the case.

The primary culprit in our analysis is the private cause of action under state CPAs. Our analysis suggests that consumer welfare would be enhanced if states did away with private actions. We are mindful of the argument that private actions are necessary because state governments do not have the resources to adequately enforce state CPAs. We find this argument woefully lacking. First, it begs the question of why states are not willing to devote the resources to adequate consumer protection. "Protecting consumers" would seem to be a proper and popular service for a government to provide its citizens. Indeed, it would seem to be a government role that should be closely monitored by the chief law enforcement officer of the state—the Attorney General. Second, although private actions do not cost the state budget, our analysis indicates that private actions tax consumers in the form of higher prices—in effect, an excise tax to pay for "protection" that we argue is actually harmful to consumers. Such a tax (if it could be indentified to consumers for what it is) is particularly offensive to many consumers, policy analysts, and politicians because it is regressive. Since consumers are already forced to pay for the private enforcement of the state CPAs, it would be much more straightforward and transparent to dispense with the private actions and then let the taxpayers decide whether they are willing to pay for increased public enforcement with higher taxes.

Our proposal to do away with private enforcement is unlikely to generate significant political attraction. No doubt, many consumer protection groups would view it as an assault on consumer welfare. On the other hand, a crusading attorney general could make the argument that consumer protection is too important to be left to disorganized litigation. Regardless, we believe that a few more modest and politically palatable reforms would dramatically improve the impact of CPAs on consumer welfare.

A. Different Rules for Class Actions Versus Individual Actions

Our analysis clearly demonstrates that the consumer class action by itself solves one of the fundamental economic problems that CPAs were intended to correct: the economic infeasibility of private lawsuits in which the individual consumer suffers only small harm from seller deception but aggregate consumer harm is large. Once a putative class has been formed, all the other provisions of CPAs are unnecessary and, indeed, potentially harmful to consumers. This suggests that courts and legislatures should have one set of rules for individual consumer actions and another set of rules for consumer class actions under CPAs. Specifically, the traditional common law protections of requiring reasonable reliance, causation, and injury should be restored to consumer class actions. Statutory damages, damage multipliers, and punitive damages are not necessary for consumer class actions to solve the basic economic problem addressed by CPAs.

B. Class Actions Should Meet a Consumer Welfare Standard

The private attorney general rhetoric about attorneys' fee provisions of CPAs suggests that private attorneys should be held to a standard that assures that their actions are, in fact, in the public interest.[197] This point is relevant to both individual consumer actions and consumer class actions. For example, even a relatively inconsequential individual action under a CPA can send important signals to mass marketers that may result in behavior that does not benefit all consumers. A requirement that all actions under CPAs serve the public interest can be implemented through a consumer welfare standard.

An important and significant means to rationalize consumer class actions would be for state legislatures or state courts to require that consumer class action attorneys allege as part of the class certification process that certification of the class and recovery by the class would in fact promote consumer welfare. The court could hold pre-trial hearings on the consumer welfare standard and decide whether success by the class attorney is reasonably likely to help consumers. This would be a particularly important safeguard because the certification of a large class action often forces defendants to settle even when they believe that they would likely prevail at trial.

At a common sense level, it seems that CPAs should be interpreted to promote consumer welfare. The FTC's consumer protection mandate is now interpreted to be the promotion of consumer welfare. In some states, the CPAs explicitly instruct judges to consider and give weight to FTC precedent.[198] In fact, Florida, Hawaii, Idaho, and Tennessee, among others, require direct consistency with federal precedent.[199] And even without explicit mandate, many state courts will often defer to FTC precedent in construing the

[197] *See* Martin H. Redish, Private Contingent Fee Lawyers and Public Power: Constitutional and Political Implications (post-roundtable revision) (Apr. 7–8, 2008) (paper presented at Searle Center Research Roundtable on Expansion of Liability under Public Nuisance), *available at* http://www.law.northwestern.edu/searlecenter/uploads/Redish_revised.pdf.

[198] *See* Bauer, *supra* note 33, at 148 tbl.1.

[199] FLA. STAT. ANN. § 501.202 (West 2002); HAW. REV. STAT. ANN. § 480-3 (Lexis Nexis 1985); IDAHO CODE ANN. § 48-618 (2003); TENN. CODE ANN. § 47-18-115 (2001).

language of their CPA statutes.[200] Finally, some CPAs create private rights of action against violations of the separate antitrust laws in that state (sometimes referred to as "mini-Sherman" or "mini-Clayton" Acts), which can allow more direct adherence to the standard of promoting consumer welfare by prohibiting anti-competitive practices.[201] However, numerous judicial interpretations have opened the door to actions that may harm consumer welfare. The so-called "no loss" cases provide a perfect example of the type of action that would not be allowed under a consumer welfare standard. If a loss is so remote or so difficult to prove, perhaps it should not be actionable.

The current state of judicial interpretations may be a classic example of the law of unintended consequences. Judges may simply be carrying out what they perceive as the legislative intent. However, the multifaceted penalties in CPAs suggest that a better approach would be for the judges to be constrained by requiring the plaintiffs to make a credible story of how the action would promote the consumer welfare—beyond simply alleging that it is a violation of the public policy as reflected in the relevant CPA.[202]

C. State Court Reliance on FTC Interpretations of Unfair and Deceptive Practices

The FTC's expertise in consumer protection far exceeds what can be expected of state courts. As discussed above, the FTC's definitions of unfair and deceptive practices reflect a

[200] Bauer, *supra* note 33, at 146–47.

[201] *See* Practising Law Institute, *Procedural Aspects Of Private Antitrust Litigation*, 1526 PLI/CORP 631, 654 (2006).

[202] If actual damages are greater than statutory damages, it should be presumed that the concerns about a case not being worthwhile have been satisfied. CPAs have sufficiently increased plaintiffs' expected recovery and incentives to sue in order to help grant access to the courts, and certainly to provide increased deterrence. Thus, judges should not further expand access to the courts through liberal interpretations of other aspects of the case—such as intent and reliance. That is, if the deterrence has been increased by the statute, there is no need for judges to add to the statutory incentive structure.

consumer welfare standard and the balancing of costs and benefits of intervention that is simply not a part of the typical consumer action—individual or class—under state CPAs. It is logical and reasonable for state courts to rely on the expertise and experience of the FTC in consumer protection matters. First, the FTC actually played an active role in encouraging the adoption of the "Little FTC Acts." The FTC helped create this leviathan, so perhaps it should help solve the problem. Second, state courts initially deferred to FTC interpretations,[203] but recent applications under CPAs have strayed far from that original relationship. Indeed, it is clear that many actions under CPAs would not be entertained by the FTC. Third, the FTC has developed a great deal of expertise in consumer protection and brings thousands of consumer protection complaints every year. If a complaint would not be pursued by the FTC, then a similar complaint should not move forward in state court. Fourth, in general, neither state agencies nor state courts have developed the expertise to analyze consumer protection issues.

For all of these reasons, state legislatures and state courts should require the application of the FTC's definitions of unfair and deceptive practices in all cases alleging the existence of such practices. The currently ad hoc and highly uncertain state court interpretations of what constitutes "unfair" or "deceptive" seller communications almost surely deter some valuable and informative seller speech. Either by state legislation or judicial interpretation, a safe harbor from state CPA liability should be created for seller statements that comply with the FTC's considered regulatory definitions of "unfair" and "deceptive" practices.

[203] *See, e.g.*, Bauer, *supra* note 33, at 20 ("Even when a Little FTC Act makes no specific reference to the federal FTC Act itself, state courts will frequently look to federal law because of the similarity to the state language, and because the FTC Act is a 'rational source of authority' to the broad Little FTC Acts.") (citing Marshall A. Leaffer & Michael H. Lipson, *Consumer Actions Against Unfair or Deceptive Acts or Practices: The Private Uses of Federal Trade Commission Jurisprudence*, 48 GEO. WASH. L. REV. 521, 534 (1980)).

D. Proactive FTC Intervention in Consumer Class Actions Filed Under State CPAs

The FTC consumer protection function logically extends to attempting to influence private litigation that threatens to harm consumer welfare. A proactive role by the FTC would be for the Bureau of Consumer Protection to file amicus briefs with its staff's analysis of the likely impact of the case on consumer welfare. Another approach would be for the FTC, possibly at the suggestion of the judge hearing the case,[204] to file a simple statement that similar practices have been investigated by the FTC and deemed to not contradict the FTC standards for unfair and deceptive.

E. In Class Action CPA Litigation, Punitive Damages Should be a Rare Exception, Awarded Only When There Is a Low Probability of Detection and Liability

The availability of the class action procedural device overcomes the problem of inadequate individual incentives to seek relief for false or deceptive seller practices and also provides very strong incentives for plaintiffs' attorneys to discover and then pursue claims against sellers who have engaged in false or deceptive practices. The attorneys' fee incentive in pursuing class action litigation gives plaintiffs' attorneys a very strong incentive to monitor and investigate seller communications. For this reason, the class action device itself increases the probability that false and deceptive seller practices are detected and trigger liability. While the probability of detection and liability may rarely be equal to one, in class action CPA litigation, it will generally be sufficiently high that punitive damages are not necessary for optimal deterrence. When punitive damages are awarded, the multiplier should rarely exceed one.

[204] Judges may request the FTC's advice on the economics of various practices.

F. Regulatory Compliance Defense

A business's compliance with state regulatory mandates should be an absolute defense to private CPA actions under that state's law. Professor Alan Schwartz has argued that such compliance should exculpate compliant firms as a matter of law.[205] The "regulatory compliance defense"—which is also called the "regulatory standards defense"[206]—would allow manufacturers and service providers a reasonable degree of certainty in acts and practices. One implication of the regulatory compliance defense is that courts court put a quick end to cases such as *Avery v. State Farm Mutual Insurance Co.*, in which State Farm was hit with a billion dollar punitive damages judgment for using generic replacement parts when the state insurance regulations encouraged them to use such parts to save money for policyholders.[207] Moreover, it seems reasonable to insulate businesses from punitive damages awards when they comply with relevant regulations.

Adoption of these modest proposals would be a major step toward reducing the corrosive effect of private actions under state CPAs. Many of these steps are consistent with what Victor Schwartz and Cary Silverman call "common sense interpretation" of the statutes.[208]

V. CONCLUSION

Just as unintended consequences resulted from the states' desires to empower consumers, any reform of state CPAs will equally need to be cognizant of reaching beyond the policy objectives of restoring balance to this area of the law. The framework developed in this article demonstrates that a

[205] Alan Schwartz, *Statutory Interpretation, Capture, and Tort Law: The Regulatory Compliance Defense*, 2 AM LAW ECON REV. 1–57 (2000).

[206] *See, e.g.*, Victor E. Schwartz & Cary Silverman, *Punitive Damages and Compliance with Regulatory Standards: Should a Manufacturer or Service Provider Be Punished When It Follows the Law?* Washington Legal Foundation, Legal Backgrounder, Vol. 12, Number 1 (September 2005).

[207] *See* cases cited *supra* note 131.

[208] *See* Schwartz & Silverman, *supra* note 206.

relatively simple and straightforward set of policy reforms can make state CPAs a valuable tool for deterring socially harmful, false, and misleading seller practices, while preventing the threat of massive CPA liability from chilling the communication of socially valuable product information. These reforms recognize the deterrent power of class action lawsuits, but discipline such suits by looking to federal regulatory standards for the substantive regulatory standard and by eschewing procedural devices (such as attorneys' fees and damage multipliers) that the class action makes unnecessary. Properly reformed state CPAs can advance the interests of both consumers and sellers in providing information to and driving fraud from consumer markets.

VI. APPENDIX: THE ECONOMICS OF PRIVATE ACTIONS UNDER STATE CPAS

We are interested in how three crucial procedural institutions—the class action, attorneys' fees, and damage multipliers—interact to determine both the incentive for a plaintiff and plaintiff's attorney to file suit, and also the expected sanction. Our basic point is this: to overcome the lack of plaintiff incentives to sue under the common law, CPAs adopted attorneys'-fee shifting provisions and damage multipliers. But especially when combined with the class action mechanism, these innovations have created a very strong incentive for plaintiffs' attorneys to bring lawsuits. CPAs have generated such high expected damages faced by defendants that, unless CPA liability arises only when defendants engaged in clearly egregiously careless product design or marketing choices, CPAs will cause defendants to refrain from marketing socially desirable products and from under-advertising those products that they do market.

A. Clarifying the Economic Rationale for Attorneys'-Fee Shifting and Damage Multipliers: The Defendant's Incentives

We begin with the defendant's incentives. These are a function of: the sanction that the defendant expects to pay in the event that it is sued, which we call D; the cost to the defendant of taking actions that lower its risk of having to pay the sanction, which we denote by x (equal also to the level of precautions with normalized per unit cost of 1), and three probabilities: that harm occurs, which we denote by h; that it is sued given that harm occurs, which we denote by s; and the probability that it has to pay the sanction D if sued, which we denote by q.

Consider a simple case where the defendant is risk neutral, and either takes the action and reduces its probability of harm and suit to zero, or does not take the action. In this case, the defendant's choice is:

(1) $min \{hsqD, x\}$.

Now if the social goal is to have the defendant take the costly action if and only if the expected harm thereby averted is greater than the cost x, then what we would like the defendant to choose is:

(2) $min \{hH, x\}$, where H is the actual magnitude of harm.

Comparing (1) and (2), we can see that whenever the probability of suit and probability of being sanctioned when sued are less than one, or when damages are set equal to the actual harm ($D = H$) then the defendant perceives too low a benefit from taking the costly, preventive action. Under these assumptions, $hH > hsqH$.

But suppose that we set damages not equal to actual harm, but at whatever level is necessary to equate the defendant's expected benefit from the costly action—eliminating expected liability in the amount $hsqD$—to the expected social benefit from the costly action—eliminating the expected social harm hH. Equating these two means setting:

(3) $hsqD = hH$, or simplifying and solving for D, we have that: $D = H/sq$.

Equation (3) gives the basic economic rationale for punitive damages.[209] Whenever the probabilities of suit and

[209] *See* A. Mitchell Polinsky and Steven Shavell, *Punitive Damages: An Economic Analysis,* 111 HARV. L. REV. 869 (1998). Amicus briefs based on this economic model of deterrence have been filed by each side in both of the most recent Supreme Court cases on punitive damages. *See* Brief of A. Mitchell Polinsky, Steven Shavell, and the Citizens for a Sound Economy Foundation as Amici Curiae Supporting, State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408 (2003) (No. 01-1289); Brief of Keith N. Hylton as Amicus Curiae Supporting Respondents, State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408 (2003) (No. 01-1289); Brief of A. Mitchell Polinsky, Steven Shavell, and the Cato Institute as Amici Curiae Supporting Petitioner, Philip Morris USA v. Williams, 549 U.S. 346 (2007) (No. 05-1256); Brief of Professors Keith N. Hylton et al. as Amici Curiae Supporting Respondents, Philip Morris USA v. Williams, 549 U.S. 346 (2007) (No. 05-1256). A recent application of this model to punitive

sanction are less than one, a rational, cost minimizing defendant will have too weak an incentive to take costly harm-averting action. To equate the social and private benefit of taking care, the optimal sanction must be increased by a multiplier that equals the inverse of the probability of suit times the probability of liability. For example, if the probability of suit is .5, then even if the probability of paying damages D when sued is very high, say .9, damages must be set equal to $H/(.9)(.5)$ or roughly 2.2 times H in order to restore optimal incentives.

Of course, by the same token, if damages are set too high relative to the probability of suit and liability, then a potential defendant will behave as if the social harm from her activity is much greater than it actually is. If, for example, we presume as just before that the optimal multiplier is 2.2, but punitive damages are set equal to, say, 9 times actual harm, then the defendant will invest far more to lower the probability of liability than is socially optimal to reduce the probability of harm.

There is, however, an important qualification to equation (3), one that in fact explains why American law generally awards punitive damages against a defendant only if the plaintiff can show a very high degree of defendant fault. Equation (3) essentially assumes that q, the probability of sanction given suit, is less than one only because sometimes careless or faulty defendants somehow escape liability. But this is of course only part of the story. A defendant's behavior may be reasonably careful, and yet the defendant may face a positive risk of liability q even when it in fact did nothing wrong. If the law routinely awarded punitive damages according to the formula in (3), then punitive damages would be higher when the probability that the defendant will be found liable for such damages is lower. Assuming that the legal process is imperfect but nonetheless rational, a lower probability of liability for punitive damages means that the defendant's behavior was less, rather than

damages is Judge Richard Posner's opinion in Mathias v. Accor Economy Lodging Inc., 347 F.3d 672 (7th Cir. 2003).

more, culpable. Optimal incentives require that liability falls as culpability falls, not the opposite.

On the economic model of deterrence, it is indeed precisely because of the risk of such error that American law does not allow punitive damages to be assessed against a defendant unless the jury finds that the defendant was greatly at fault. For if a defendant is found to have been "grossly negligent" or to have acted with "reckless disregard," then ordinary liability (q above) is likely to have been extremely high, approaching 1, and we need have no fear that punitive liability is being incorrectly imposed. Hence in the cases in which punitive liability is actually imposed—those with a very high probability q of ordinary liability—the formula in (3) simplifies to:

(4) $D = H/s \equiv mH$, where we define $m \equiv 1/s$.

Equation (4) says that the optimal multiplier for punitive damages is equal to 1 divided by the probability of suit. The minor transgressions that often provide the basis for suit under CPAs are inherently a lower probability of detection and suit, but the de minimis nature of the damages suggests that the imposition of punitive damages should always require an analysis of the defendant's fault.

B. The Plaintiff's Side: Attorneys' Fees, Damage Multipliers and the Plaintiff's Incentive to Sue

The previous section assumed a particular probability of suit. But the plaintiff's incentive to bring suit is determined by three things, which together give us the plaintiff's expected payout from filing suit: the amount of money that the plaintiff expects to get, whether from a jury or by settlement, an amount we shall denote as above by $D > 0$; the attorneys' fees and other costs that the plaintiff must incur to get that payout, an amount that we shall denote by $c > 0$; and, finally, the probability (as perceived by the plaintiff) that she will in fact get the payout D, which we denote, as above, by q.

As our focus is not on issues relating to risk and uncertainty, we shall assume that consumers are risk neutral with respect to the decision whether or not to bring suit. We shall also assume away agency cost problems, and presume that the consumer controls the level of effort and hence cost of any lawsuit that she were to bring, so that costs are optimally chosen, given the probability of success in a particular type of claim and possible payout.[210] This means that consumers value their right to bring suit by its expected value, net of the cost of suit. Assuming that plaintiffs are economically motivated and rational in a very basic sense—in that they will undertake suit only if they perceive that suit has a positive net expected value—an injured consumer will bring suit if and only if her expected payout is bigger than her expected cost. Using the notation just defined, the consumer will bring suit if and only if:

(5) $qD \geq c$, or, $q \geq c/D = q^T$.

Inequality (5) defines a threshold probability of success in getting a payout from suing, q^T, below which the plaintiff expects a negative net expected return from suing and therefore will not sue. From (5), we can see that this threshold probability q^T is higher—and suit less likely to be in the plaintiff's interest—the higher are the plaintiff's costs c and the lower is the plaintiff's expected payout D. In the classic consumer deception case that CPAs were intended to address, any individual plaintiff suffers only very small, economic harm and therefore expects a small payout D, so small that such a plaintiff would not find a lawsuit to be worthwhile, even if c, her cost of suit, is small. In addition, as we discussed earlier, the traditional common law tort elements together worked to create a relatively low probability that the plaintiff would prevail at trial and hence also (for reasons we shall come to momentarily) a small

[210] As we focus in on types of claim, we presume that the probability of success and magnitude of payout is determined solely by the claim type, rather than by the effort level of the plaintiff's attorney. In a more complete model, the effort level would be chosen optimally so as to solve the problem $max_c\ [q(c)D(c)-c]$. The threshold probability we discuss in the text is then to be understood as the constraint that the solution to this problem generate a non-negative return.

probability q that the plaintiff would get a payout either from settlement or a trial award. With no one to bring suit, ex post legal sanctions have no deterrent effect, and we have precisely the under-deterrence problem that CPAs were designed to address.

With the help of Figure 2 below, we can make these points more precise and pave the way for analysis of the procedural changes introduced by CPAs. Figure 2 graphs a mass marketer's perceived probability of liability: its probability of being sued for unfair trade practices and having to pay the amount D in damages. This probability is given by g, and it is equal to the probability of being sued, which we will denote by s, multiplied by the probability of being found liable for damages in the amount D, which as above is given by q. What we have just shown is that for $q < q^T$, the probability of suit, s, and hence, the probability of liability (given by $g = qs$) is 0. Figure 1 depicts a simple case in which for $q \geq q^T$, we have $g = q$ (suit is always brought once it is economically viable, and so the probability of having to pay D is simply given by q).

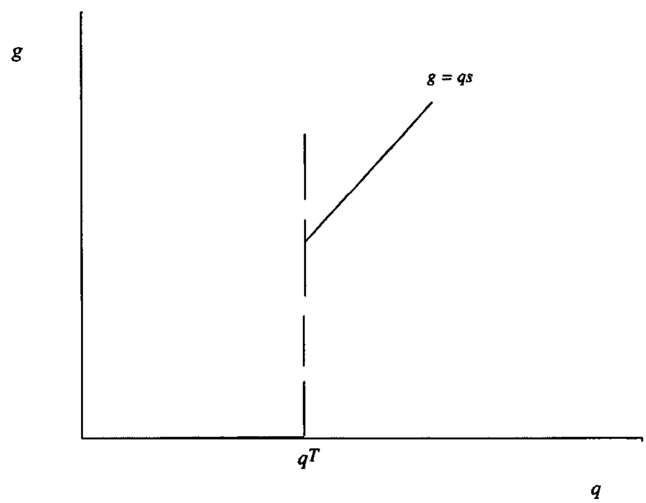

Figure 2

The procedural innovations made by CPAs—attorneys' fees and various damage enhancers—affect the incentives depicted in Figure 1 on both the cost side and the payout side. On the cost side, assuming that attorneys' fees that are paid when the plaintiff is successful in getting a payout (either in the form of settlement or a trial award) and fully cover the plaintiff's costs, the attorneys' fee provisions of CPAs lower the plaintiff's expected cost of bringing a lawsuit from c to $(1\text{-}q)c$. Punitive damages, with damages equal to a multiple m of compensatory damages D, a common feature of CPAs, would of course increase the plaintiff's payout from D to $m(m+1)D$. With these two changes, plaintiffs will now find suit worthwhile whenever:[211]

$$(6)\ q > c\ /\ ((m+1)D + c) \equiv q^{T}_{cpa.}$$

Comparing (5) and (6), we see that when a CPA allows for the recovery of attorneys' fee and treble damages, the threshold success probability for which plaintiffs will file suit falls by a factor of $1/(m+1+c/D)$ or—since the under-deterrence problem is most severe when $c > D$—by at least a factor of $1/(m+2)$. (Recall that $m > 1$). As depicted by Figure 3, the procedural innovations of attorneys'-fee shifting and treble damages greatly increase the range of claims that are individually rational for a plaintiff to bring.

[211] In the more complete model, with plaintiff effort affecting both the probability of success and the magnitude of the payout, the optimal effort level would change under a CPA. And, because the CPA both lowers the plaintiff's expected cost and increases the plaintiff's return, the plaintiff would generally choose a higher level of effort—that is, cost—under the CPA than under the common law. However, for any level of cost, the plaintiff gets a higher expected return under the CPA, and so the threshold probability would move in a model with cost endogenous as it does in our text and Figures.

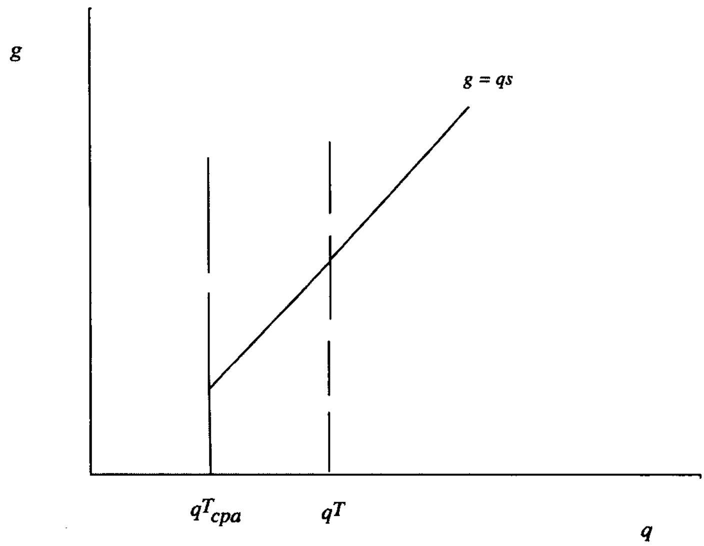

Figure 3

By looking back at inequality (6), we can see inherent limitations on the effect of attorneys' fees plus treble damages in a typical consumer action. The impact of these procedural innovations is limited by the relationship between the cost of suit and the actual damages D suffered by the plaintiff. If the damages are very slight relative to the cost of suit, then the threshold probability for suit to be viable will remain high even under a CPA that awards attorneys' fees and punitive damages.[212] With very small individual damages, even if successful plaintiffs are refunded their attorneys' fees and are rewarded treble damages, individual plaintiffs will have an incentive to bring suit only in cases that are virtually sure winners (that is, for $q \rightarrow 1$). Similarly, statutory damages of, say, \$2,500 per claim, may not solve the incentive problem.

Thus, in our model, the procedural innovations of CPAs—attorneys' fees, costs, and enhanced damages—by themselves

[212] To see this most clearly, consider the limiting case, when $D \rightarrow 0$. In this case, as can be seen from inequality (2), the threshold probability even under treble damages remains very close to 1.

fail to solve the economic problem of individual actions with small amounts at stake. On the other hand, the substantive changes brought about by CPAs—e.g., relaxation of traditional common law requirements of reliance, causation and injury—greatly increase the likelihood of success by plaintiffs. Arguably, this is precisely what CPAs were intended to accomplish: helping to solve the incentive problems of plaintiffs with relatively small claims. However, as shown in the following section, these salutary effects in the individual consumer cases of CPAs' procedural and substantive innovations have a perverse effect when combined with class actions. Indeed, the logic of extending the procedural and substantive innovations that were intended to help individual consumers achieve redress to large classes is flawed.

C. Adding the Class Action to the CPA Equation

1. Class Actions Versus Individual Common Law Actions

The class action procedural device allows the aggregation of small claims across the entire set of consumers who have purchased an allegedly deceptively marketed product. Under the class action, what matters are not the incentives of an individual consumer to bring suit, but rather the incentives of the attorney for the class. Under a CPA with class actions, the attorney's payout differs from the individual plaintiff we have considered thus far in that the attorney gets a payout which is generally an increasing function of the payout to the entire class that she represents. With n class identical class members, the class payout is given by nD, where D as before represents individual damages, of which we may assume that the attorney gets a judicially-determined share r. The attorneys' fee provision of CPAs also ensures that regardless of the size of the class or the class members' individual damages, the attorney gets at least her actual fees incurred when she succeeds in obtaining a payout (whether by settlement or trial award). Hence in the event of success, a CPA class action attorney's payout is *max {rnD, c}.* Hence a class action attorney's expected payout is given by:

(7) $max\ q\ [max(rnD,c)] - c$.

A quick look at (7) shows that if the most that a class action attorney could hope for in the event of success was to get back her fees, c, then she would have no incentive to pursue the action, no matter how likely, because her expected payout would be less than or equal to zero.[213]

In general, the attorney expects a payout that is a share of the class damages (that is, $max\ \{rnD,c\} = rnD$). In this case, the attorney pursues the class action if and only if:

(8) $qrnD - c > 0$, or if $q > c/rnD$.

Comparing (8) to (5), we see the threshold probability of success at which a class action lawsuit is viable for an individual attorney is lower than the threshold probability for an individual common law plaintiff whenever it is true that:

(9) $rnD > D$, or if $r > 1/n$.

What inequality (9) says is that the larger the number of plaintiffs in the class (on behalf of each of whom, the attorney recovers an amount D), the lower is the attorney's share of the payout sufficient to ensure that the class action will enhance the viability of suit relative to individual common law actions. For a very large class (n large), even for a relatively low share of the payout, class action attorneys will find it worthwhile to file a large range of low probability of success lawsuits that an individual plaintiff would not file.For example, even for a very small class action

[213] The only exception to this would be an attorney who would otherwise be unemployed. Such an attorney would perceive an opportunity cost less than her hourly fees—that is, she would get an hourly-based amount c if successful but her actual cost of pursuing the action would only be some fraction of her actual hourly rate (if she were certain to be otherwise unemployed, it would equal only the unemployment compensation amount, if any). Our exposition in the accompanying text is presumably the more general situation.

of only 10 plaintiffs, the attorney's payout from filing will be higher than the individual plaintiffs' whenever the attorney expects to get a share of the payout that is bigger than or equal to 10 percent. For a more typical large class of 10,000 plaintiffs, the attorney's expected payout will be bigger than that of the individual class members whenever that attorney expects to get more than .0001 share of the class payout. Hence, for any reasonably large class action, the attorney's expected payout will be higher than what the individual plaintiffs would have expected, and so significantly more lawsuits will be brought simply as a consequence of the class action procedural device.

2. Class Actions, CPAs, and Over-Deterrence

Under very general circumstances, the class action will make unnecessary the enhanced damage provisions of CPAs. The reason is that when both procedural devices exist—that is, CPA class actions—the threshold probability of success for suits to be brought will be even lower than with CPAs or class actions alone. Even more importantly, in terms of the deterrence effect, class actions and punitive damages are completely duplicative: they both essentially give the plaintiff's attorney the right to enforce against the defendant a large multiple of any individual plaintiff's damages. Therefore, punitive damage multiples that essentially assume that there is no class action will be higher than the level that is necessary to optimally deter defendants from socially harmful behavior.

The CPA class action with punitive damages is one in which the class action attorney gets her fees plus a share of the class payout when she is successful in obtaining such a payout, while bearing her own fees (her opportunity cost of bringing a CPA suit) when unsuccessful. Under such a regime, the threshold probability of suit becomes:

$$(10)\ q > c/(mrnD + c) \equiv q^T.$$

Comparing inequality (10) with inequalities (6) – (8), we can see how CPA class actions generate the lowest threshold success probability suits to be viable. This threshold probability falls, the bigger is the punitive damage multiplier m. Were we to place the threshold q^T in Figure 2, it would lie quite far to the left of q^T_{cpa}.

What class actions CPAs with punitive damages do is to effectively give the plaintiff's attorney the right to enforce the rights of mrn individual plaintiff (where, to recall, m is the punitive damage multiplier, n is the number of plaintiffs in the class, and r is the attorney's share of the award.) Especially for large class actions of say 10,000 or more, even if the plaintiff attorney gets only 25 percent of the recovery (r = .25), the class action alone gives the attorney a very large expected recovery. Multiplying this recovery by the punitive damage multiple m further enhances the attorney's expected payout. All of these devices together create such a large expected payout for attorneys that they have an incentive to sue even if the probability of receiving a recovery (which we denoted earlier by q) is low. Because of this large expected payout, the combined effect of class action representation with attorneys' fees and punitive damages—the CPA procedural package—is to drive the probability of suit (denoted as above by s) close to 1 even for suits with a low probability of success.

Now recall from our earlier discussion that on optimal deterrence grounds, the punitive damage multiplier m should equal $1/s$. If, as just argued, CPA class actions offer such a large reward to plaintiffs' attorneys that s approaches 1, then it might seem that there should be no punitive damage multiplier: that is, $s = 1$ implies that $m = 1$. But this is a bit too simple, because as we have just seen from (10), it is the interaction of m, the punitive damage multiplier; n, the size of the class, and r, the attorney's share of the class recovery, that determines a plaintiff attorney's expected reward, incentive to sue and hence s. The general lesson from (10) is more complex but also more important:

> *The larger is the size of the class in a CPA class action and the higher is attorney's share of the class recovery, the higher the probability of suit, and the less need there is for damage enhancements (statutory damages, double or*

treble damages, or punitive damages) in class action CPAs.