Striking a Balance: Basic Questions About Consumer Protection Law

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Chapman Law Review's annual symposium, this year entitled "Responsibility and Reform: Striking a Balance in the Marketplace," is focused on an important issue in today's legal landscape: how much and what kinds of protections should be provided to consumers? Central to this issue is how to balance the protection of consumers' persons and pocketbooks with the defense of their autonomy, how to keep consumers from entering into dangerous or disadvantageous transactions without stripping them of the freedom to choose for themselves which products, services, and deals will most benefit them. The panels of speakers for the symposium were focused on four separate but interrelated topics: Predatory Lending, Punitive Damages, Gun and Tobacco Liability, and California's Unfair Trade Practices Act (Business and Professions Code Section 17200).

This Introduction sets forth some of the most important questions raised in the course of the Symposium and describes some answers suggested in the articles that follow. Naturally, the authors often disagree with each other, but my goal is not to prove that one side or the other in any debate is correct but merely to lay out the questions in a methodical manner and direct the reader to the different authors' attempts to respond to these questions.

1. Which Transactions Benefit Consumers?

Normally, consumers are better judges of which transactions benefit them than any state regulator or legislator could be, as consumers have more direct and in depth knowledge of their own preferences. Professor Narveson, in "Consumer's Rights in the Laissez-Faire Economy: How Much Caveat for the Emptor?," states, "Did Consumer make a 'good buy?' That's for Consumer to decide."[1] However, this basic principle has important

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1 Jan Narveson, *Consumers' Rights in the Laissez-Faire Economy: How Much* Caveat *for the* Emptor*?*, 7 CHAP. L. REV. 181, 193 (2004).

limitations, since to be effective judges of whether a transaction will provide a net benefit to them, consumers must be informed and competent to make the decision at hand, and the transaction must be voluntary.

Most of the disagreement over whether and how much protection to provide consumers stems from conflicting opinions about when consumers' decisions are sufficiently informed, competent, and voluntary. Too little protection leaves consumers vulnerable to abuse. Too much protection leads to a paternalistic restriction of consumers' autonomy. Where exactly to draw the line between protection and paternalism is subject to great dispute. Proponents and opponents of consumer protection disagree on how much information consumers need to make decisions effectively, who is responsible for ensuring they have that information, what decisions consumers are competent to make without help, how often they lack the ability to make good decisions, and how voluntary their agreements are to the terms of various transactions. How these disputes are resolved is central to the design, role, and function of consumer protection law.

2. Should there be a Separate Law of Consumer Protection?

A basic question addressed in this symposium is whether there should be a separate law of consumer protection to begin with, or whether the common law systems of contracts and torts provide consumers with all the protection they need or deserve, or that it is efficient to provide them. In his article "Consumer Law, Class Actions, and the Common Law," Greve lays out (only to attempt to knock down) the normally stated rationales for consumer protection: that buyers have limited information gathering and processing abilities or even limited rationality in their decision-making process which leads them to make errors in their transactions. This information asymmetry and unequal bargaining power between seller and consumer allows merchants to take advantage of the ignorance and lack of bargaining prowess of the less sophisticated buyers.[2]

Greve argues, however, that each of these arguments proves either too much or too little, since information asymmetries and unequal bargaining powers exist in commercial as well as consumer transactions. Greve is even more concerned about the overlay of a consumer protection system on top of the common law; worried that a duplicative set of systems will decrease,

2 Michael S. Greve, *Consumer Law, Class Actions, and the Common Law*, 7 CHAP. L. REV. 155, 157 (2004).

rather than increase, the benefits of those laws to consumers. Professor Harrell, in his article "Basic Choices in the Law of Auto Finance: Contract Versus Regulation," also argues for the primacy of the common law over separate consumer protection law. He states that because contract and tort law depend on case-by-case decision-making by judges, rather than on across-the-board rule-making by a regulatory body, the common law system infringes less on the freedom to contract as it wields a more precise scalpel to cut out inappropriate transactions.[3] Harrell also asserts that this system of individual trials is better able to address the infinite variety of fraud, duress, and abuse than a "one size fits all" regulatory scheme. Unlike the common law, which Harrell sees as being based on the usage of market participants, consumer protection law is largely designed by legislators and regulators. Thus, Harrell views consumer protection law as the "top-down" imposition of their own interests and views by an elite few and fundamentally different from the common law, which bubbles up from everyone who participates in commerce.

In contrast, Michael L. Rustad, in his article "Punitive Damages in Cyberspace: Where in the World is the Consumer?," portrays a bleak fate for consumers who cannot depend on effective consumer protection law in the unregulated, unprotected environment of Internet commerce. In the wild west of cyberspace, consumers face scammers posing as legitimate businesses, "phishing" for credit card numbers and other credit information.[4] Rustad argues that ordinary damages in tort or contract actions would not provide consumers adequate protection, as the on-line evildoers are too unlikely to be caught. Even when they are caught, rarely can a judgment be collected from "phishers" and Internet scammers.

3. Should Consumer Protection Generally be Enforced by Governmental Agencies, Private Litigation, or Both?

If consumer protection law is to exist, we must still decide whether the dominant means to enforce that law should be governmental regulatory enforcement, either through agency litigation or otherwise, or private litigation. In his article focusing on the firearms industry, "Suing the Firearms Industry: A Case for Federal Reform?," Stephen P. Halbrook argues that

3 Alvin C. Harrell, *Basic Choices in the Law of Auto Finance: Contract Versus Regulation*, 7 CHAP. L. REV. 107, 110-11 (2004).

4 Michael L. Rustad, *Punitive Damages in Cyperspace: Where in the World is the Consumer?*, 7 CHAP. L. REV. 39, 40 (2004). "Phishing" is the act of posing as a legitimate business in order to obtain confidential information from another. *Id.* at 40-41.

where legislation has already struck a definite balance and a pervasive set of regulations govern a specific sector of consumer affairs, private litigation that is not authorized by that legislation and regulatory structure is inappropriate, even if it is based on traditional common law causes of action such as public nuisance or other torts.[5] Greve appears to agree, stating that an obvious means of preventing the underdeterrence of wrongdoing is to "entrust public agencies with the definition and enforcement of prohibitions and injunctions against unfair or fraudulent business practices," without forcing those agencies to prove the common law elements of any cause of action.[6] Greve laments that only rarely do federal and state regulations, as enforced by the appropriate agencies, have preclusive effect and preempt private litigation. He says that "[c]ompliance defenses rarely succeed in liability lawsuits over 'unsafe' pharmaceutical drugs or automobiles. The risk is not simply confusion or incoherence: it is massive over-deterrence."[7]

By comparison, and as previously noted, Harrell prefers the individualized decision process of common law trials to the system-wide rulemaking of regulation. Harrell also notes that "public enforcement has exceeded the volume of private litigation" in many areas of federal law.[8] Moreover, Harrell notes that a significant portion of consumer regulation is federal in nature, and that federal regulation, as opposed to state litigation, benefits large, national enterprises over smaller, local businesses that are less able to bear the burden of complex federal regulation.[9] Rustad observes that regulatory agencies attempt to track down and punish bad actors in cyberspace, but that these agencies are overwhelmed. "It is as if the FTC is trying to hold back a tidal wave of cyberfraud with a broom."[10]

4. Should Consumer Protection Law Primarily Be Enacted at the State or Federal Level?

A question closely related to the choice between regulatory action and private litigation is whether most consumer protection law should be enacted at the state or federal level. Harrell notes that regulatory action is more often federal, while most private litigation occurs in state courts. He argues this rough division is

5 Stephen P. Halbrook, *Suing the Firearms Industry: A Case for Federal Reform?*, 7 CHAP. L. REV. 11, 21-22 (2004).

6 Greve, *supra* note 2, at 159-60.

7 *Id.* at 171 (internal citation omitted).

8 Harrell, *supra* note 3 at, 121.

9 *Id*. at 121-22.

10 Rustad, *supra* note 4, at 80.

caused by the fact that most common law is state law and even statutory contract law is primarily state law, whereas most regulatory law, with significant exceptions, is federal law.[11] Harrell asserts that state-based common law is more flexible and better able to nourish the development of new and innovative industries, while broad-based federal regulation leads more often to the dominance of large, stable firms.[12]

In his article "Wrong from the Start? North Carolina's 'Predatory Lending' Law and the Practice v. Product Debate," Donald C. Lampe worries that, rather than nurturing new and innovative financial service companies, the state-based laws attempting to prevent predatory lending have created a "regulatory Tower of Babel for multi-state residential mortgage lenders."[13] Inconsistent state laws, in Lampe's view, fall too heavily on large, multi-state businesses. Halbrook is also concerned that state regulation will lead to an unreasonable burden on interstate commerce, in this case, the interstate sale of firearms.[14]

Playing an important role in deciding whether federal or state law will govern consumer issues is the doctrine of preemption, which allows federal laws and regulations to supercede their state counterparts. However, states have their own arsenal of weapons to combat the wholesale preemption of their systems of consumer protection. Lampe notes that states attempt to subvert, stealthily if need be, federal preemption. For example, North Carolina's predatory lending law focused on consumer protection rather than on interest rate limitations as a way to avoid the preemptive effect of the Alternative Mortgage Transaction Parity Act ("AMTPA"), which frees protected lenders from states' usury ceilings.[15] Lampe argues that, to the extent that state law discourages lenders protected by AMTPA from making high cost home loans, the state law can be seen as a "stealth override" of the federal preemption.[16]

By comparison, Harrell celebrates the surprising dominance of private state law litigation in the consumer protection arena and the fact that federal regulation has not occupied the field. This, Harrell states, "is surely a testament to the viability of the common law system and should provide a continuing lesson for

11 Harrell, *supra* note 3, at 121-22.

12 *Id.* at 122.

13 Donald C. Lampe, *Wrong From the Start? North Carolina's "Predatory Lending" Law and the Practice vs. Product Debate*, 7 CHAP. L. REV. 135, 148 (2004).

14 Halbrook, *supra* note 5, at 32.

15 Lampe, *supra* note 13, at 142.

16 *Id.* at 143.

policy makers and advocates on both sides of the consumer law policy debates."[17]

5. What Areas Of Commerce Involving Consumers Should Receive Their Own Sets of Special Rules?

An issue addressed by two of the symposium authors is whether any areas of commerce should be governed by their own sets of special rules. Halbrook argues that trade in firearms should be exempt from some forms of litigation, such as suits for public nuisance, negligence, "negligent design and marketing . . . , strict liability for defective . . . products, and ultra-hazardous activity."[18] Halbrook argues that the provisions of the Second Amendment to the U.S. Constitution, as well as similar provisions in various state constitutions, should foreclose such private litigation.

By comparison, Rustad argues that the unique characteristics of Internet commerce require special protections for consumers, since few consumers have the technical sophistication "to determine who is tracking their click-streams, unleashing viruses, or sending fraudulent offers."[19] Many website providers and other Internet businesses have no assets or physical, as opposed to virtual, presence in the United States.[20] Even tortfeasors inside the United States may be difficult to locate, as they can falsify the return addresses on their emails and so post defamatory or deceptive messages anonymously.[21] Rustad argues that these aspects of Internet commerce render ordinary damages an insufficient deterrent for wrongdoing.[22]

6. Does Consumer Protection Necessarily or Unduly Limit Consumers' Autonomy?

Professor Harrell sees an immutable, inevitable trade-off between the autonomy of consumers and their protection, concluding that the two alternatives are (a) party autonomy protected and achieved by the consumers' ability to freely to enter into contracts and (b) restricted autonomy, caused by regulations that limit the products or services or the terms of consumer transactions.[23] However, I have argued elsewhere that

17 Harrell, *supra* note 3, at 122.
18 Halbrook, *supra* note 5, at 11.
19 Rustad, *supra* note 4, at 69.
20 *Id.* at 69-70.
21 *Id.* at 64.
22 *Id.* at 93.
23 Harrell, *supra* note 3, at 132.

mere freedom of choice and lack of regulation does not necessarily maximize the autonomy of consumers.[24] A consumer unrestricted by consumer protection law may end up with less autonomy if he enters into transactions under the influence of a high-pressure sales agent and without the information or time he needs to decide what he really wants.[25] Worse yet, if unprotected by predatory lending regulation, a homeowner who loses her house because of a high cost loan could lose the critical personal autonomy that being a homeowner provides.[26] Paradoxically, specific limitations of autonomy, such as absolute freedom to contract, may result in the overall maximization of a consumer's autonomy.[27]

One specific limitation on consumers' freedom to contract is caused by merchants' use of form contracts of adhesion which consumers have no means of revising or renegotiating. Rustad notes that such contracts dominate Internet commerce, appearing not only as "shrink-wrap" contracts that a buyer purportedly agrees to by opening a product purchased over the Internet, but also as "web-wrap" contracts that spring into effect when one uses a web page.[28] Rustad argues that these form agreements force consumers, often unwittingly, not only to waive their rights to punitive damages and other tort remedies, but also to agree to choice of law and choice of forum terms that may severely limit their ability to sue.[29]

Harrell, on the other hand, asserts that form contracts of adhesion do not significantly limit consumer autonomy. Instead, consumers are not prevented from negotiating the significant terms of their transactions, such as price.[30] Furthermore, Harrell argues that at least in consumer credit transactions, consumer form contract terms are mandated by law or by the secondary market, and these standards are designed not only to be consistent but also fair.[31]

7. What Forms of Consumer Protections Should Be Used?

Informational remedies, including the requirement that merchants disclose some information regarding their products, are perhaps the easiest form of consumer protection to defend.

24 Kurt Eggert, *Lashed To The Mast And Crying For Help: How Self-Limitation Of Autonomy Can Protect Elders From Predatory Lending*, 36 LOY. L.A. L. REV. 693 (2002).

25 *Id*. at 732.

26 *Id*.

27 *Id*. at 736.

28 Rustad, *supra* note 4, at 88.

29 *Id*. at 87-90.

30 Harrell, *supra* note 3, at 111.

31 *Id*. at 127.

Even Greve, who refers to consumer law "in its modern, disembodied state" as a "bastard regime,"[32] agrees that mandatory disclosure requirements can be "efficient in some settings."[33] Narveson frames the question not so much as whether the merchant should be required to divulge information, but rather how much information is required, how precise that information must be, and how high a level of risk must be before that risk must be disclosed.[34] What punishment should the business face if it provides inaccurate information, intentionally or otherwise? The goal, to Narveson, is to ensure that the seller does not significantly increase the amount of risk that a consumer faces involuntarily.[35]

Restrictions on types or terms of agreements and banning certain abusive practices are less universally popular. Greve argues that merchants, when faced with limitations on some terms—such as the interest rate they can charge—will instead compete "on some other, less transparent margin."[36] Lampe criticizes the effort to restrict particular loan terms and products such as high cost loans, rather than merely attacking abusive sales practices and tightening the requirements to be a mortgage broker.[37]

Consumer protection can be provided not only by giving consumers causes of action not recognized by the common law, but also by increasing the penalties that consumers can seek, including punitive damages for bad behavior by businesses, or by providing remedies, such as disgorgement of profits in addition to or instead of traditional damages.[38] While Greve asserts that corporations universally oppose punitive damages,[39] Rustad notes that in Internet litigation, punitive damages are a sword typically wielded by large corporations against individuals, such as cybersquatters, spammers, and critics.[40] Also, Rustad argues that enhanced remedies such as punitive damages are necessary to encourage individual litigants to act as private attorneys general and so protect other consumers.[41]

Greve criticizes other tools of consumer protection, such as class actions and laws lessening the common law's standing

32 Greve, *supra* note 2, at 178.
33 *Id.* at 156.
34 Narveson, *supra* note 1, at 194-95.
35 *Id.* at 199.
36 Greve, *supra* note 2, at 161.
37 *See generally* Lampe, *supra* note 13.
38 Greve, *supra* note 2, at 160.
39 *Id.* at 177.
40 Rustad, *supra* note 4, at 57-58.
41 *Id.* at 100.

requirements. Greve asserts that the procedural protections and due process safeguards of class actions "are deadweight at best and an invitation to opportunism at worst"[42] and he raises the "specter that corporate defendants will cut themselves cheap, collusive settlements with a plaintiffs' lawyer of their choice."[43] Unfair competition law that does not involve a certified class suffers, Greve argues, from the lack of preclusive effect, thus leaving defendants who win, lose, or settle still subject to suit on the same or similar claims.[44]

Lampe, by comparison, criticizes consumer protection regulations that remove the intent requirement and impose strict liability, for example on loans that trip certain triggers imposing additional regulation on high cost loans.[45] Such strict liability is even more dangerous, Lampe asserts, when it is framed in "ambiguous, non-standard definitions" and the lender is given only a limited opportunity to cure any mistakes or missteps.[46]

Both Lampe and Harrell are troubled by laws seeking to protect consumers by forcing third parties, such as the assignees of loans, to be liable for the bad actions of the original seller or lender who dealt with the consumer. Lampe views such laws as a "market disruptive"[47] approach not to mention "esoteric and legally complicated."[48] Harrell is especially wary of class action attorneys seeking assignee liability in order to find a deep pocket or a windfall and warns that the resulting litigation costs as well as liability risks to assignees can harm consumers by driving up the cost of doing business.[49] I have argued, on the other hand, that assignee liability is a crucial weapon in the battle against predatory lending, as it forces secondary markets to police mortgage brokers.[50] By protecting borrowers from abusive loan practices, assignee liability should lower, rather than increase, the cost of credit.

Conclusion

Consumer protection law is a complex, vibrant body of doctrine and can be examined from many different viewpoints. Chapman's symposium shows the importance of the questions

42 Greve, *supra* note 2, at 166.
43 *Id.* at 167-68.
44 *Id.* at 168.
45 Lampe, *supra* note 13, at 143.
46 *Id.*
47 *Id.* at 149.
48 *Id.* at 151.
49 Harrell, *supra* note 3, at 130.
50 Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002).

that arise from this area of law, as well as how the individual authors have chosen to answer them. From the differing and conflicting views that follow should come a richer understanding of the balance that must be struck between protection and paternalism in the design and implementation of consumer protection laws.

Suing the Firearms Industry: A Case for Federal Reform

*Stephen P. Halbrook**

I. INTRODUCTION

A wave of lawsuits against the firearms industry for criminal acts of third parties crested and substantially evaporated during the 1980s. Primarily brought by individual plaintiffs, these suits alleged a variety of theories of negligence (including negligent design and marketing), strict liability for defective (actually nondefective) products, and ultra-hazardous activity. Since the firearms at issue worked properly and were made and distributed lawfully, these cases were by and large dismissed as failing to allege cognizable claims.[1]

While such individual actions continue to be brought and are usually dismissed,[2] in the late 1990s municipalities began to

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1 *E.g.*, Delahanty v. Hinckley, 564 A.2d 758, 759-60 (D.C. Cir. 1989) (holding that there is no duty where crime victims had no special relation with manufacturers); Bennet v. Cincinnati Checker Cab Co., 353 F. Supp. 1206 (E.D. Ky. 1973) (holding that there is no duty where no special relationship existed between gun manufacturer and person injured by misuse of gun); Riordan v. Int'l Armament Corp., 477 N.E.2d 1293, 1296 (Ill. App. Ct. 1985) (finding that a manufacturer of nondefective handgun had no duty to control distribution of product to general public). *But see* Kelley v. R.G. Indus., Inc., 497 A.2d 1143, 1159 (Md. 1985) (finding liability for "Saturday Night Special"), *superseded by* MD. CODE ANN., PUB. SAFETY § 5-402(b) (2003).

2 *E.g.*, Bloxham v. Glock Inc., 53 P.3d 196, 201 (Ariz. Ct. App. 2002) (noting that "other courts faced with similar issues have almost uniformly refused to impose any duty on businesses related to the legal use and distribution of firearms owed to those harmed by the misuse of those firearms."); First Commercial Trust Co. v. Lorcin Eng'g, Inc., 900 S.W.2d 202, 205 (Ark. 1995) (finding no special relation between manufacturer and handgun purchaser); Valentine v. On Target, Inc., 727 A.2d 947, 953 (Md. 1999) (finding that the inherent danger of guns creates no duty of dealers to persons who may be harmed); Resteiner v. Sturm, Ruger & Co., 566 N.W.2d 53, 54 (Mich. Ct. App. 1997) (finding appeal to be vexatious and awarding attorney's fees; suit involved stolen weapon used in murder). *See also* TIMOTHY A. BUMANN, THE COMPENDIUM OF REPORTED UNITED STATES FIREARMS PRODUCTS LIABILITY CASES: A SYNOPSIS OF CIVIL LITIGATION AGAINST MANUFACTURERS AND SELLERS (1995).

bring similar lawsuits against the firearms industry. The same theories continued to be alleged but a new one was added: public nuisance. Under this theory, it is alleged that the firearms industry intentionally supplies the criminal market by manufacturing more firearms than lawful demand would support. During 1998-2003, some thirty-three municipalities and counties filed suits against the firearms industry.[3]

The following briefly analyzes some representative cases of the current litigation against the firearms industry, including discussion of the public nuisance theory and the effect on the constitutionally-guaranteed right to keep and bear arms.[4] It then provides a detailed analysis of the Ninth Circuit's *Ileto v. Glock Inc.*[5] decision, which pushes the envelope by basing its claim of wrongdoing on the marketing of guns to police departments in States with less strict firearm laws. Lastly, this Article evaluates the provisions of the Protection of Lawful Commerce in Arms Act, which is pending in the United States Congress and would preempt these types of suits against the firearms industry.

II. IS THE RIGHT TO BEAR ARMS A PUBLIC NUISANCE?

Typical allegations made in the current wave of anti-industry lawsuits are summarized in *Camden County Board of Chosen Freeholders v. Beretta, U.S.A. Corp.*,[6] as follows:

> [T]he manufacturers release into the market substantially more handguns than they expect to sell to law-abiding purchasers; the manufacturers continue to use certain distribution channels, despite knowing (often from specific crime-gun trace reports produced by the federal Bureau of Alcohol, Tobacco, and Firearms) that those channels regularly yield criminal end-users . . . . The County makes no allegation that any manufacturer violated any federal or state statute or regulation governing the manufacture and distribution of firearms, and no direct link is alleged between any manufacturer and any specific criminal act.[7]

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3 *Litigation Against the Gun Industry*, Violence Policy Ctr., http://www.vpc.org/litigate.htm (last visited Mar. 8, 2004); *Taxpayer Funded Reckless Lawsuits Against The Firearms Industry*, Nat'l Rifle Assoc., http://www.nraila.org/Issues/FactSheets/Read.aspx?ID=147 (posted Aug. 19, 2003).

4 The Second Amendment of the U.S. Constitution provides, "A well regulated Militia, being necessary to the security of a free State, the right of the people to keep and bear Arms, shall not be infringed." For a current listing of State arms guarantees, *see* Eugene Volokh, *State Constitutional Right to Keep and Bear Arms Provisions*, http://www1.law.ucla.edu/~volokh/beararms/statecon.htm (last visited Apr. 15, 2004).

5 349 F.3d 1191 (9th Cir. 2003).

6 273 F.3d 536 (3d Cir. 2001).

7 *Id*. at 539.

Actually, manufacturers become aware of traces when the Bureau of Alcohol, Tobacco, and Firearms ("BATF") requests information, but a mere trace request does not imply that any of the links in a distribution channel committed any wrongdoing or even that a crime was committed with the firearm traced.[8] At any rate, the Third Circuit held that "no New Jersey court has ever allowed a public nuisance claim to proceed against manufacturers for lawful products that are lawfully placed in the stream of commerce."[9] It added, "To extend public nuisance law to embrace the manufacture of handguns would be unprecedented under New Jersey state law and unprecedented nationwide for an appellate court."[10]

In *Penelas v. Arms Technology, Inc.*,[11] Florida's Third District Court of Appeal affirmed the dismissal of all theories of liability in Miami-Dade County's suit against the firearms industry.[12] Noting that virtually all appellate decisions from other states precluded liability, the court relied on Florida precedent holding that liability does not exist where the firearm was not defective, its manufacture and distribution were consistent with state and federal law, and no duty was breached by the defendants.[13] *Penelas* observed:

> The County's request that the trial court use its injunctive powers to mandate the redesign of firearms and declare that the appellees' business methods create a public nuisance, is an attempt to regulate firearms and ammunition through the medium of the judiciary. Clearly this round-about attempt is being made because of the County's frustration at its inability to directly regulate firearms, an exercise proscribed by section 790.33, Florida Statutes (1999) which expressly preempts to

8 Traces frequently implicate nothing about the first retail purchaser, much less the licensee. According to the U.S. Solicitor General: "If the tracing process is successful, it will identify the first retail purchaser of the traced firearm; yet that person may have long since relinquished ownership of the weapon and may have no connection to the underlying crime." Brief for the Petitioner at 27, BATF v. City of Chicago, 537 U.S. 1229 (2003) (No. 02-322) (internal citations omitted). Indeed, "because the agency requesting the trace does not inform ATF of whether possessors and their associates are ever indicted or convicted of any offense, ATF has no way of knowing whether the law enforcement agency requesting the trace believes the possessor or associate to have had any role in the crime." *Id*. at 10 (internal citations and quotations omitted). Finally, "ATF has informed this Office that approximately 30% of all trace requests do not tie the weapon to any individual possessor." *Id*. at 41.

9 *Camden*, 273 F.3d at 540.

10 *Id*. at 540-41. *See also* City of Philadelphia v. Beretta U.S.A. Corp., 277 F.3d 415, 419 (3d Cir. 2002) (rejecting liability of firearm manufacturers under negligence, negligent entrustment, and public nuisance theories for costs incurred by city associated with the criminal use of handguns).

11 778 So. 2d 1042 (Fla. Dist. Ct. App. 2001).

12 *Id*. at 1044.

13 *Id*. (citing Trespalacios v. Valor Corp. of Fla., 486 So. 2d 649, 650 (Fla. Dist. Ct. App. 1986)) (finding no liability for shotgun).

> the state legislature the entire field of firearm and ammunition regulation. The County's frustration cannot be alleviated through litigation as the judiciary is not empowered to "enact" regulatory measures in the guise of injunctive relief.[14]

The court cited references for "additional discussions of the right to bear arms,"[15] but did not explicitly quote Florida's arms guarantee.[16] Of course, where clear statutory grounds exist for a decision, courts prefer not to raise constitutional issues. But in the final analysis, one wonders how the lawful manufacture and distribution of a constitutionally-guaranteed product could give rise to liability.[17]

Several states have statutes which explicitly preempt municipal regulation of firearms or specifically prohibit municipalities from bringing actions of the type discussed here.[18]

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14 *Id*. at 1045 (internal citations omitted).

15 *Id*. at 1045 n.6.

16 Article I, Section 8 of the Florida Constitution provides: "The right of the people to keep and bear arms in defense of themselves and of the lawful authority of the state shall not be infringed . . . ."

17 Long before the rise of suits against the manufacturers, suits seeking to impose liability on firearm owners for possessing or using firearms were held to be precluded by the existence of the right to bear arms. *See* McKellar v. Mason, 159 So. 2d 700, 701-02 (La. Ct. App. 1964) (holding that an elderly man's use of firearm in self-defense did not expose him to liability, and stating that, "The Constitutions of the United States and Louisiana give us the right to keep and bear arms. It follows, logically, that to keep and bear arms gives us the right to use the arms for the intended purpose for which they were manufactured."); Lopez v. Chewiwie, 186 P.2d 512, 513 (N.M. 1947) (holding that parent who kept loaded firearm in home with unattended child is not liable for tort committed by minor, relying in part on the state constitutional right to bear arms). Of course, a parent may be liable for negligence. *E.g.*, Kuhns v. Brugger, 135 A.2d 395, 404 (Pa. 1957) (holding that, "common prudence, in behalf of self-protection, justified the possession of the pistol for immediate use at night," but owner negligent to absent himself and leave it "in a place frequented by young children.").

18 As an example, Florida provides:

> (1) Preemption.– Except as expressly provided by general law, the Legislature hereby declares that it is occupying the whole field of regulation of firearms and ammunition, including the purchase, sale, transfer, taxation, manufacture, ownership, possession, and transportation thereof, to the exclusion of all existing and future county, city, town, or municipal ordinances or regulations relating thereto. Any such existing ordinances are hereby declared null and void . . . .
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> . . . .
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> (3) Policy and intent. – (a) It is the intent of this section to provide uniform firearms laws in the state; to declare all ordinances and regulations null and void which have been enacted by any jurisdictions other than state and federal, which regulate firearms, ammunition, or components thereof; to prohibit the enactment of any future ordinances or regulations relating to firearms, ammunition, or components thereof unless specifically authorized by this section or general law; and to require local jurisdictions to enforce state firearms laws.

FLA. STAT. ANN. § 790.33 (West 2000). An example of the more recently passed preemption provisions which explicitly prohibit municipal lawsuits against the firearms industry is found in Louisiana:

Municipal suits against the firearms industry have been dismissed under such statutes; courts have ruled that municipalities have no due process rights which would negate such statutes.[19] It has also been held that cities have no direct injury from criminal violence and, thus, have no standing to sue the firearms industry.[20]

In *Sturm, Ruger & Co. v. City of Atlanta*,[21] the Georgia Supreme Court held that all claims should be dismissed because the State preempted the field of gun regulation and also because a recent statute prohibited municipalities from bringing such suits.[22] The court traced the source of the legislature's authority directly to the state's arms guarantee:

> Art. I, Sec. I, Par. VIII of the Georgia Constitution of 1983 provides: "The right of the people to keep and bear arms shall not be infringed, but the General Assembly shall have power to prescribe the manner in which arms may be borne." The General Assembly has exercised this power given by the Constitution to create a regulatory scheme for the distribution and use of firearms.[23]

> A. The governing authority of any political subdivision or local or other governmental authority of the state is precluded and preempted from bringing suit to recover against any firearms or ammunition manufacturer, trade association, or dealer for damages for injury, death, or loss or to seek other injunctive relief resulting from or relating to the lawful design, manufacture, marketing, or sale of firearms or ammunition. The authority to bring such actions as may be authorized by law shall be reserved exclusively to the state.
>
> B. This Section shall not prohibit the governing authority of a political subdivision or local or other governing authority of the state from bringing an action against a firearms or ammunition manufacturer, trade association, or dealer for breach of contract as to firearms or ammunition purchased by the political subdivision or local authority of the state.

LA. REV. STAT. Ann. § 40:1799 (West 2001).

19 *E.g.*, Morial v. Smith & Wesson Corp., 785 So. 2d 1, 11 (La. 2001) (holding that the municipal suit was an indirect attempt to regulate lawful firearm manufacture, the state statute precluding such suits applied retroactively, and that municipalities have no due process rights under the Fourteenth Amendment); Mayor of Detroit v. Arms Tech., Inc., 669 N.W.2d 845, 856-58 (Mich. Ct. App. 2003) (holding that the municipality lacked standing to contest the state preemption statute on due process grounds, and the statute did not violate separation of powers).

20 *E.g.*, Ganim v. Smith & Wesson Corp., 780 A.2d 98, 118 (Conn. 2001).

21 560 S.E.2d 525 (Ga. Ct. App. 2002).

22 *Id*. at 527, 531-32.

23 *Id*. at 529 (citing Rhodes v. R. G. Indus., Inc., 325 S.E.2d 465, 466 (Ga. Ct. App. 1984)). *Rhodes* in turn explained:

> Appellant first contends that "the trial court erred in holding as a matter of law that handguns are exempt from Georgia's product liability law because the lack of safety connected with such weapons raises a political, nonjusticiable question." Her last contention is that the trial court erroneously held as a matter of law that the R.G. revolver is not unreasonably dangerous when marketed to the general public. We disagree on both points. The Second Amendment to the U.S. Constitution guarantees the right of the people to keep and bear arms, as does Art. I, Sec. I, Par. VIII of the Georgia Constitution

In several cases, courts have refused to grant motions to dismiss and the cases have proceeded to discovery. Most were thereafter dismissed when discovery yielded no evidence supporting the allegations that the firearms industry intentionally and purposely distributed firearms to criminals. For instance, the trial-level Superior Court of Massachusetts characterized Boston's public nuisance theory as "unique in the Commonwealth," but declined to dismiss the case on the pleadings.[24] However, after nearly three years of litigation, Boston agreed to a dismissal of its lawsuit against the industry and even acknowledged that the industry had made commitments to safety.[25] It would appear that Boston simply could not prove that the industry intentionally distributed firearms to criminals.

The path of Cincinnati's suit against the industry is intriguing. The Ohio Constitution provides that "[t]he people have the right to bear arms for their defense and security,"[26] and the Ohio Supreme Court has reiterated that "the right to bear arms is fundamental."[27] However, when it came to deciding that a public nuisance action existed against the firearms industry, that right was not so much as mentioned. In *City of Cincinnati v. Beretta U.S.A. Corp.*,[28] the Court upheld the cause of action, stating: "Even though there exists a comprehensive regulatory scheme involving the manufacturing, sales, and distribution of firearms, . . . the law does not regulate the distribution practices alleged in the complaint."[29]

Yet it was perhaps those allegations which would be the Achilles' heel of the plaintiffs' own case. The Court remarked, "While we do not predict the outcome of this case, we would be

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1983 . . . .

Rhodes, 325 S.E.2d at 466.

24 City of Boston v. Smith & Wesson Corp., No. 199902590, 2000 Mass. Super. LEXIS 352, at *63-64 (July 13, 2000).

25 In dismissing its case, Boston and the industry agreed to a joint statement which stated in part:

> The City acknowledges that the members of the Industry and firearms trade associations are genuinely concerned with and are committed to, the safe, legal and responsible sale and use of their products. . . . The Industry and the City believe that through cooperation and communication they can continue to reduce the number of firearm related accidents, can increase awareness of the issues related to the safe handling and storage of firearms, and can reduce the criminal acquisition of firearms.

Plaintiffs' Unopposed Motion to Dismiss, Ex. A at 3-4, City of Boston v. Smith & Wesson Corp., No. 99-02590-C (Mass. Super. Ct. Mar. 27, 2001).

26 OHIO CONST. art. I, § 4.

27 Klein v. Leis, 795 N.E.2d 633, 636 (Ohio 2003).

28 768 N.E.2d 1136 (Ohio 2002).

29 *Id*. at 1143.

remiss if we did not recognize the importance of allowing this type of litigation to go past the pleading stages."[30] After the case was remanded for trial and discovery was completed, the City of Cincinnati voluntarily dismissed its lawsuit.[31] Stanley Chesley, counsel for the City, advised that "he could not justify moving forward with the city's 4-year-old lawsuit against the gun industry, dealing a major disappointment to gun control advocates across the nation."[32] Lawrence Keane, counsel for the National Shooting Sports Foundation, stated: "'The city can't prove the allegations, because they're not true . . . . They're unbelievably offensive, outrageous and patently false."[33] Thus, Cincinnati's lawsuit went the way of Boston's—down the tubes.

The most active litigation against the firearms industry has undoubtedly proceeded before federal Judge Jack Weinstein of the Eastern District of New York. In these cases he frequently allows causes of action to go forward against the gun manufacturers on multiple theories, despite consistent reversal by the Second Circuit. In *Hamilton v. Accu-tek*,[34] an individual plaintiff suit against the industry, Judge Weinstein allowed claims of market share liability and negligence to go to the jury.[35] On appeal the Second Circuit certified questions to the New York Court of Appeals,[36] which held that handgun manufacturers have no special duty to crime victims regarding the marketing of their products.[37]

In *NAACP v. AcuSport, Inc.*,[38] a public nuisance suit brought by a private association rather than a municipality, Judge Weinstein tried the claims before an advisory jury in Spring 2003. Meanwhile, the New York Appellate Division affirmed the dismissal for failure to state a cause of action of a similar public nuisance case against the industry, brought by New York State Attorney General Eliot Spitzer.[39] Nonetheless, in *AcuSport*, Judge Weinstein proceeded to render an opinion finding that the industry's distribution practices created a public nuisance, but

30 *Id*. at 1150-51.

31 *Cincinnati's Council Decides to Drop Suit Against Gun Makers*, N.Y. TIMES, May 1, 2003, at A24.

32 Gregory Krote, *Drop Suit, City Advised*, CINCINNATI ENQUIRER, Apr. 30, 2003, *available at* http://www.enquirer.com/editions/2003/04/30/loc_guncase30.html.

33 *Id*.

34 62 F. Supp. 2d 802 (E.D.N.Y 1999), *vacated sub nom*., Hamilton v. Beretta U.S.A. Corp., 264 F.3d 21 (2d Cir. 2001).

35 *Hamilton*, 62 F. Supp. 2d at 835-36, 839.

36 Hamilton v. Beretta U.S.A. Corp., 222 F.3d 36, 39 (2d Cir. 2000).

37 750 N.E.2d 1055, 1059 (N.Y. 2001).

38 271 F. Supp. 2d 435 (E.D.N.Y. 2003).

39 People v. Sturm, Ruger & Co., 761 N.Y.S.2d 192, 194 (N.Y. App. Div. 2003), *appeal denied*, 801 N.E.2d 421 (N.Y. 2003).

that the private association plaintiff lacked standing because it did not suffer injury different in kind from that of the general public.[40] Reaching the merits and then dismissing for lack of standing reversed the normal order of proceeding—if no standing exists, no reason exists to address the merits.

Judge Weinstein's holding that the industry is at fault was based in large part on the false equation of *traced* guns with "crime guns." He relied particularly on plaintiff's expert testimony that guns in the trace database were crime guns.[41] Yet the court itself observed that "[a] trace does not mean that the FFL retailer or the first purchaser engaged in illegal or wrongful activity" and that "[p]laintiff's statistical experts . . . were unable to identify specific dealers who had committed wrongdoing."[42] However, those facts did not prevent the firearm prohibitionist lobby from using the same trace data to compile a list of what they called the ten worst "bad apple" gun dealers.[43] Calling such assertions "misleading," BATF responded:

> Many other factors – including high volume or sales; the type of inventory carried and whether the gun [dealer] is located in a high crime area – contribute to the percentages cited by the Brady campaign.
>
> . . . Gun traces, for example, indicate only that a gun has come to the attention of law enforcement. They do not automatically implicate a dealer or purchaser in any wrongdoing.
>
> Large volume gun dealers will by their very frequency of sales have more guns come to the attention of law enforcement than a dealer who sells relatively few firearms.[44]

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40 *AcuSport*, 271 F. Supp. 2d at 455.

41 *Id*. at 522.

42 *Id*. at 504.

43 Mark Bowes, *Gun Report's Worth at Issue: Misleading, ATF Says of Findings*, RICHMOND TIMES-DISPATCH, July 28, 2003, at B1. The media committed the same error. *E.g.*, Katie Cornell Smith & Marianne Garvey, *N.Y. Gun Shop Shoots to 3rd on Crime-Weapon List*, N.Y. POST, Apr. 18, 2003, at 17 (equating traced guns with "crime guns").

44 Press Release, ATF, *Statement on Brady Campaign Allegations Regarding Federally Licensed Firearms Dealers* (July 16, 2003) (on file with author). The same statistics from the AcuSport litigation were later used in a publication by an organization calling itself "Americans for Gun Safety" to support allegations such as "Chuck's Gun Shop ranked No. 1 in the nation among stores that sold firearms that turned up in criminals' hands from 1996 to 2000." Frank Main, *Gun-safety Group Names 4 Area Stores*, CHI. SUN-TIMES, Jan. 13, 2004, Special Ed., at 9, *available at* http://www.suntimes.com/output/news/cst-nws-gun13.html. However, as the article noted:

> The owner of Chuck's has never been charged with a crime. When the store applied for a new federal firearms license last year, the U.S. Bureau of Alcohol, Tobacco, Firearms and Explosives approved the request.
>
> "There was no evidence of any criminal wrongdoing that would prevent him from reapplying and getting a license," ATF spokesman Tom Ahern said of Chuck's owner John Riggio . . . .

The extent to which information in trace records is subject to disclosure has been controversial. Judge Weinstein ruled in the *AcuSport* litigation that BATF had to disclose trace records to plaintiff's experts but imposed a protective order ruling that the experts could make public only the number of traces and the identities of the licensees.[45] Moreover, the end result of anti-industry litigation by the City of Chicago is that such records are not subject to disclosure under the Freedom of Information Act.[46]

In dismissing *AcuSport*, Judge Weinstein briefly addressed the federal Second Amendment.[47] Given that making and distributing a constitutionally-protected product would presumably not be a public nuisance, one might assume the right to keep and bear arms to be pertinent in this case. Instead, the opinion suggests that the scope of the right is virtually meaningless and concludes that "whatever view is taken of the Second Amendment is immaterial in this case. . . . There is no justification in the federal Constitution for private persons failing to exercise reasonable care in meeting their legal responsibility to help ensure a safe society."[48]

Id.

45 NAACP v. AcuSport Corp., 210 F.R.D. 268, app. B at 430-32 (E.D.N.Y. 2002) (approving report and reserving discretion for court to modify stipulation on disclosure between plaintiff and BATF). After the court dismissed the action, plaintiff moved the court to allow the experts to disclose further information for use in academic publications and in other lawsuits. Memorandum in Support of Application for Modification of the Protective Order for the BATF Firearm Trace Database at 1, NAACP v. AcuSport Corp., 210 F.R.D. 268 (E.D.N.Y. 2002) (No. 99 Civ 3999, 99 Civ 7037). Judge Weinstein denied the motion, commenting that "no public interest overrides the government's interest" and that "this case is dead." Proceedings in open court, Oct. 27, 2003 (author's notes).

46 *See* Dep't of Justice, BATFE v. City of Chicago, 123 S.Ct. 1352 (2003) (mem.), *vacating & remanding* 287 F.3d 628 (7th Cir. 2002). The Supreme Court remanded the case to consider the effect of an appropriations rider prohibiting ATF from disclosing firearms trace records except as previously disclosed. *See* Consolidated Appropriations Resolution, 2003, Pub. L. No. 108-7, div. J, tit. 6, § 644, 117 Stat. 11, 473-74 (2003). Congress considered that disclosure of the law enforcement databases in question "would not only pose a risk to law enforcement and homeland security, but also to the privacy of innocent citizens." H.R. REP. NO. 107-575, at 20 (2002).

Before passage of the rider by Congress, the Solicitor General pointed to various provisions of the Gun Control Act which deny records to BATF itself or limit disclosure of records by law enforcement. Brief for the Petitioner at 24-25, Dep't of Justice, BATFE v. City of Chicago, 123 S.Ct. 1352 (2003) (No. 02-322) ("[18 U.S.C.] Section 923(g)(3)(B)'s strict prohibition on retention and release of multiple sales information by state and local authorities would be wholly pointless if any member of the public could obtain the same data from ATF pursuant to the FOIA [Freedom of Information Act]."). The Solicitor General also stated that "the GCA specifically precludes ATF from imposing any system for the registration of firearms, firearms owners, or firearms transactions or dispositions." *Id.* at 26 (citing 18 U.S.C. § 926(a)). *See also* 18 U.S.C. § 923(g)(1)(D) (1996) (providing that ATF may release licensee records only to a federal, state, or local law enforcement agency and only in regard to "persons prohibited from purchasing or receiving firearms").

47 271 F. Supp. 2d at 462-63.

48 *Id.* at 462.

Regardless of the meaning of the Second Amendment,[49] the state arms guarantees protect individual rights to obtain and possess firearms. It seems curious that such guarantees have been given such short shrift by some courts. Two decades ago, the guarantee of the right of private citizens to bear arms under the Illinois Constitution was cited in part as precluding an action against handgun manufacturers for ultra-hazardous activity giving rise to strict liability.[50] However, that same constitutional right did not merit mention in the recent decision of the Illinois Court of Appeals upholding Chicago's public nuisance suit against the industry.[51]

Another case in point is the decision of the Indiana Supreme Court in *City of Gary v. Smith & Wesson Corp*.[52] The Indiana Bill of Rights provides that "[t]he people shall have a right to bear arms, for the defense of themselves and the State."[53] In prior precedent which upheld a civil rights claim against the City of Gary for refusing to provide and process handgun carry permits, the Indiana Supreme Court stated:

> [This] right of Indiana citizens to bear arms for their own self-defense and for the defense of the state is an interest in both liberty and property which is protected by the Fourteenth Amendment to the Federal Constitution. . . . This interest is one of liberty to the extent that it enables law-abiding citizens to be free from the threat and danger of violent crime. There is also a property interest at stake, for example, in protecting one's valuables when transporting them, as in the case of a businessman who brings a sum of cash to deposit in his bank across town.[54]

In *Gary v. Smith & Wesson Corp.*, the Indiana Court of Appeals relied on the above in part in refusing to recognize a public nuisance claim for manufacture and distribution of

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49 *See infra* note 114 and accompanying text.

50 As the Seventh Circuit explained:

> We are also concerned that plaintiffs' argument would thwart Illinois' policy regarding possession of handguns. The right of private citizens in Illinois to bear arms is protected, at least against all restrictions except those imposed by the police power, by the Illinois Constitution. . . . The State of Illinois regulates, but does not ban, the possession of handguns by private citizens. . . . Imposing liability for the sale of handguns, which would in practice drive manufacturers out of business, would produce a handgun ban by judicial fiat in the face of the decision by Illinois to allow its citizens to possess handguns.

Martin v. Harrington & Richardson, Inc., 743 F.2d 1200, 1204 (7th Cir. 1984).

51 City of Chicago v. Beretta U.S.A. Corp., 785 N.E.2d 16 (Ill. App. Ct. 2002), *appeal granted*, 788 N.E.2d 727 (Ill. 2003). Oral argument before the Illinois Supreme Court has taken place and a decision on the appeal is pending. Christi Parsons, *Justices Take Up Firearms Control*, CHI. TRIB., Sept. 11, 2003, Metro, at 1.

52 776 N.E.2d 368 (Ind. Ct. App. 2002), *rev'd*, 801 N.E.2d 1222 (Ind. 2003).

53 IND. CONST. art. I, § 32.

54 Kellogg v. City of Gary, 562 N.E.2d 685, 694 (Ind. 1990).

handguns.[55] The court noted that the U.S. Congress and the Indiana General Assembly pervasively regulated the manufacture, distribution, sale, and use of handguns and, thus, had evaluated the benefits and evils thereof. These legislative bodies represented the people in the democratic process and "struck the appropriate balance between the societal costs of handguns and the historical right to bear arms."[56]

The Indiana Supreme Court disagreed. It held that the complaint stated a claim against the firearms industry based on allegedly wrongful sales practices, negligent designs, and deceptive advertising.[57] The court actually agreed with the manufacturers that "in every one of over 1,000 Indiana state court and 50 federal public nuisance decisions," public nuisance claims were recognized only where a statute was violated or the nuisance resulted from use of real property.[58] Nonetheless, the court concluded that a municipality has a viable claim for public nuisance based on "an unreasonable interference with a public right," even where the activity is lawful and does not involve land.[59]

The *Gary* court cited the provisions of law dealing with the sale of handguns and also fleetingly referred to Indiana's constitutional guarantee that the citizens have a right to bear arms.[60] Without any discussion of how exercise of a constitutional right could give rise to liability, the court concluded that lawful activity could be conducted unreasonably and give rise to nuisance.[61]

The court made no attempt to reconcile upholding the deceptive advertising component of the public nuisance claim and the constitutional right to bear arms (the most absolute element of which is the right to keep arms in the home).[62] The court stated about that claim:

> The City also asserts claims of misleading and deceptive advertising and marketing of guns. . . . Specifically, the City alleges that guns are presented as adding to a homeowner's safety when in fact the opposite is true. . . . For the same reasons applicable to the allegation of contributing to unlawful

55 776 N.E.2d at 387.

56 *Id*.

57 City of Gary v. Smith & Wesson, Corp., 801 N.E.2d 1222, 1227, 1247 (Ind. 2003).

58 *Id*. at 1231 (internal quotations omitted).

59 *Id*. at 1233.

60 *Id*. at 1234 (citing IND. CONST. art. I, § 32 (right to bear arms) and IND. CODE §§ 35-47-2.5-1 to -15 (1998) (sale of handguns)).

61 *Id*.

62 *See*, *e.g.*, State v. Hamdan, 665 N.W.2d 785, 805 (Wis. 2003) (discussing the unreasonableness of regulating "sensible conduct" on one's private property).

> sales practices, we agree that these claims, if proven, state a claim for injunctive relief based on an action for public nuisance and negligence theories.[63]

Indiana's constitutional right to bear arms should have resolved the fact that guns may add to a homeowner's safety. The court's holding questions the very legitimacy of this provision and implies that the right to bear arms for defense is a false value. Are we to accuse the framers and ratifiers of the Indiana Constitution of deceptive advertising? In reality, the question of homeowner safety and gun ownership is one that is best left to the political process. It should be beyond the purview of the courts to decide that the people of Indiana are incorrect in the factual assumptions that underlie the constitutional right they created.[64]

Despite the *Gary* court's holding that a claim was stated in the pleadings, whether the plaintiffs can prove their allegations is another matter. The court itself agreed that "legislative policy permitting lawful distribution of guns is relevant here."[65] Moreover, the court further recognized: "The conclusory allegations of the complaint leave much unanswered. For the reasons cited, there may be substantial barriers to recovery of any or all of these damages."[66] In other words, the plaintiffs' sweeping allegations that the members of the firearms industry are somehow conniving conspirators intent on supplying criminals with guns may be unprovable and false.

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63 801 N.E.2d at 1247.

64 *See, e.g.*, Printz v. United States, 521 U.S. 898, 921 n.11 (1997) (invalidating Brady Act amendment to Gun Control Act and noting of comparison of constitutional systems different from that of the United States, "such comparative analysis [is] inappropriate to the task of interpreting a constitution, though it was of course quite relevant to the task of writing one"); Valley Forge Christian Coll. v. Am. United for Separation of Church and State, Inc., 454 U.S. 464, 484 (1982) (stating that some constitutional rights are not "in some way less 'fundamental' than [others]. Each establishes a norm of conduct which the Federal Government is bound to honor—to no greater or lesser extent than any other inscribed in the Constitution."); Ullmann v. United States, 350 U.S. 422, 428-29 (1956) ("As no constitutional guarantee enjoys preference, so none should suffer subordination or deletion. . . . To view a particular provision of the Bill of Rights with disfavor inevitably results in a constricted application of it."); Arnold v. City of Cleveland, 616 N.E.2d 163, 169 (Ohio 1993) ("We are cognizant of the current controversy that exists in Ohio and across our nation over the right of an individual to possess firearms. . . . [I]t is our charge to determine and not to disturb the clear protections provided by the drafters of our Constitution."); State v. Kessler, 614 P.2d 94, 95 (Or. 1980) ("We are not unmindful that there is current controversy over the wisdom of a right to bear arms . . . . Our task, however, in construing a constitutional provision is to respect the principles given the status of constitutional guarantees and limitations by the drafters; it is not to abandon these principles when this fits the needs of the moment.").

65 801 N.E.2d at 1244.

66 *Id*.

III. "NEGLIGENT MARKETING" TO POLICE IN STATES WITH "LESS STRICT" GUN CONTROL: THE NINTH CIRCUIT'S *ILETO V. GLOCK INC.* DECISION

In 1999, Buford Furrow shot and wounded five persons at a local Jewish Community Center in California and then shot and killed Joseph Ileto, a postal worker, at a nearby locality.[67] He used a Glock pistol that had originally been sold to a police department in the State of Washington and was later unlawfully purchased by Furrow, who was ineligible to possess firearms.[68] While aware that Furrow may have been in unlawful possession, police failed to follow up. As a law enforcement officer noted after the tragedy, "We planned to [search Furrow's home]; we just hadn't gotten around to it yet."[69] The inevitable lawsuit was filed against several firearm manufacturers and distributors, and in *Ileto*, the Ninth Circuit—in a 2-1 opinion by Circuit Judge Richard Paez—held that the defendants who made or sold the firearms used by Furrow could be subject to liability under California tort law for negligence and public nuisance.[70]

The court held that sufficient factual issues over whether the industry owed a duty of care and breached that duty were raised by plaintiffs' allegations that "the defendants created an illegal secondary firearms market that was intentionally directed at supplying guns to prohibited gun purchasers like Furrow."[71] This is the mantra of the current onslaught of lawsuits against the firearms industry, which would be shocking if supported but seems more fantasy than reality. This is made clear in the more particularized allegations of the complaint, which the court summarizes as follows:

> Plaintiffs allege that Glock's marketing and distribution strategy includes the purposeful oversupply of guns to police departments and the provision of unnecessary upgrades and free exchange of guns with police departments to create a supply of post-police guns that can be sold through unlicensed dealers without background checks to illegal buyers at a profit. Glock allegedly targets states like Washington, where the gun laws are less strict than in California, in order to increase sales to all buyers, including illegal purchasers, who will take their guns into neighboring California. The ATF has provided Glock with the names of the distributors who are responsible for the sales of guns that end up in the hands of criminals, but Glock

67 Ileto v. Glock Inc., 349 F.3d 1191, 1194 (9th Cir. 2003).

68 *Id*. at 1197.

69 *Evening News with Dan Rather: Furrow Faces Death Penalty; Tragedy Revives Gun Debate* (CBS News television broadcast, Aug. 12, 1999).

70 *Ileto*, 349 F.3d at 1217 (9th Cir. 2003).

71 *Id*. at 1204.

> has ignored the information and continues to supply these same distributors.[72]

Upholding the claims under such allegations raises serious questions regarding the fundamental system of American federalism, under which the states are free to experiment with their own versions of republicanism. In the words of Justice Brandeis: "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[73]

First, contrary to *Ileto,* it is not Glock but the State of Washington that enacts "gun laws [that] are less strict than in California."[74] Indeed, almost all states in the United States have gun laws that are less strict than California.[75] While California's Constitution has no arms guarantee, the Washington Bill of Rights provides: "The right of the individual citizen to bear arms in defense of himself, or the state, shall not be impaired."[76] The Washington courts have held that this provision must be strictly followed.[77] Under plaintiffs' theory, would not the State of Washington be ultimately responsible because it has "less strict" gun laws?

Second, it is difficult to blame Glock for the policies of Washington police departments which result in, as alleged by *Ileto,* "the purposeful oversupply of guns to police departments and the provision of unnecessary upgrades and free exchange of guns with police departments."[78] The premise of the complaint is that police departments buy, upgrade, exchange, and sell too many guns. Again, under plaintiffs' theory, would not the Washington police departments be responsible because of their own purchase and exchange policies?

In the final analysis, the question is raised of whether California policymakers are entitled to play schoolmarm to the policymakers of Washington and almost all other states. It would make as much sense to allow victims of crime in

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72 *Id*. at 1204-05.

73 New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

74 *Ileto,* 349 F.3d at 1204-05.

75 *See* STEPHEN P. HALBROOK, FIREARMS LAW DESKBOOK, app. A (West 2003) (summarizing state firearms laws).

76 WASH. CONST. art. I, § 24.

77 *E.g.*, State v. Spiers, 79 P.3d 30, 31 (Wash. Ct. App. 2003) (holding that a statute "unconstitutionally infringes on the right to bear arms by criminalizing firearm ownership for persons merely charged with a 'serious offense,' regardless of whether they have relinquished possession").

78 *Ileto,* 349 F.3d at 1204.

Washington to blame California and its police departments for disarming law-abiding citizens and allowing armed criminals to run amok, thereby allowing such criminals to spill over the borders and commit crimes in Washington.[79]

Third, *Ileto* claims that "[t]he ATF has provided Glock with the names of the distributors who are responsible for the sales of guns that end up in the hands of criminals, but Glock has ignored the information."[80] This allegation is based on the unwarranted insinuation that, because ATF has requested that Glock trace certain firearms, the distributors to which Glock transferred such firearms are criminals or knowingly sell guns to criminals. Yet firearm traces mean little. Neither Washington law nor federal law provides that a manufacturer may not sell firearms to a distributor or dealer which has been the subject of BATF trace requests.

It is simply false to suggest that traced firearms necessarily have "end[ed] up in the hands of criminals."[81] Nothing in the law provides for revocation of firearms licenses based merely on the number of traces. The federal Gun Control Act mandates license revocation upon the willful violation of the law or regulations[82] and provides authority to trace firearms,[83] but nowhere implies that traces are evidence of criminality of federally licensed firearms manufacturers, importers, or dealers. Revocation of a license based on the number of traces would violate the Gun Control Act and basic due process.

Any number of reasons exist to explain why one dealer would have more traces than another. The first would be sales volume—a large dealer which sells thousands of guns per year, for instance, would obviously have more traces than a small retailer. An urban dealer could have more traces because it does business in a high crime area. The higher crime rate in such areas does not necessarily indicate wrongdoing by the dealers or their customers.[84] For instance, persons who lawfully purchase

79 Indeed, in a hypothetical suit plaintiffs could turn the *Ileto* claims upside down and allege that as a result of the adoption of the *Ileto* rule, the marketing and distribution policies of firearm manufacturers have resulted in the undersupply of guns to Washington police departments and law-abiding citizens, and it was foreseeable that plaintiff X would be unable to obtain a firearm and protect herself from the crime described herein.

80 *Ileto,* 349 F.3d at 1205.

81 *Id*. at 1205.

82 18 U.S.C. § 923(e) (2002).

83 *Id*. § 923(g)(7).

84 For instance, a federal court rejected a lawsuit against inexpensive handgun makers for criminal acts based in part on the following:

> [W]hile blighted areas may be some of the breeding places of crime, not all residents of [such areas] are so engaged, and indeed, most persons who live there are lawabiding but have no other choice of location. But they, like their

firearms from licensed dealers may themselves be crime victims by reason of having their firearms stolen. Stolen firearms which are recovered will be traced and, in many instances, returned to their owners.

Some dealers will always have a greater number or a higher proportion of firearm traces than others. Statistically, all dealers will never have an identical percentage of firearms traced. If the dealers with an "above average" number of traces were eliminated, then the remaining set of dealers would also have an "above average" subset. The further elimination of "above average" dealers would ultimately leave just one dealer in the universe. Yet, it is rather unremarkable that some dealers have more traces than others. A world in which all dealers have a "below average" number of traces is no more possible than one in which "all of the children are above average."[85]

The *Ileto* court upheld a cause of action for breach of duty based on the following more embellished allegations of the complaint:

> First, plaintiffs alleged that the ATF provided manufacturers detailed reports of the distributors, dealers, and gun shows that consistently supply the guns used in crimes. Plaintiffs further alleged that the defendant manufacturers and distributors failed to utilize distribution techniques that were commonly used by other businesses to avoid distribution to illegal end users. Furthermore, the plaintiffs alleged that Glock and other defendant manufacturers negotiate contracts with distributors . . . and dealers that do not include basic provisions to address the risk of acquisition of firearms by prohibited purchasers despite the fact that other forms of incentive provisions regularly were included in the contracts. According to plaintiffs, the defendants also fail to utilize basic training instruction that would help dealers and distributors recognize straw buyers or avoid distribution to illegal purchasers.[86]

As explained previously, ATF's requests for trace information constitute no reliable index for "guns used in crime."

> counterparts in other areas of the city, may seek to protect themselves, their families and their property against crime, and indeed, may feel an even greater need to do so since the crime rate in their community may be higher than in other areas of the city. . . . To remove cheap weapons from the community may very well remove a form of protection assuming that *all* citizens are entitled to possess guns for defense.

Delahanty v. Hinckley, 686 F. Supp. 920, 929 (D.D.C. 1986).

85 Note the registered trademark of Garrison Keillor: "Where the women are strong, the men are good looking, and all of the children are above average." http://www.prairiehome.org/content/trademarks.shtml (last visited Jan. 27, 2004).

86 *Ileto*, 349 F.3d at 1205.

A study by the Congressional Research Service explains:

> [A] law enforcement officer may initiate a trace request for any reason. No crime need be involved. No screening policy ensures or requires that only guns known or suspected to have been used in crimes are traced. . . . [T]he extent to which trace requests focus on guns not involved in crimes cannot be determined . . . .[87]

As to the industry's failure to prevent ineligible persons from ever obtaining firearms, all licensed firearm dealers are subject to the federal Brady Act requirement that a criminal background check must be conducted on transferees.[88] They are held criminally responsible for transferring a firearm to any person they know or have reasonable cause to believe is ineligible to receive a firearm.[89] They must also follow whatever requirements state law mandates. The plaintiffs allege essentially that federal and state law requirements are insufficient and that somehow the members of the industry must achieve a more perfect world in which no criminal ever obtains a firearm.

Federal and state legislators have not figured out the panacea for crime, yet the *Ileto* court insists that "the defendants have the knowledge and the means to distribute guns in a manner that would reduce the risk of access and use by prohibited persons."[90] The court applies the same reasoning in upholding the public nuisance claim. It seems, in the court's opinion, that the defendants "market, distribute, promote, and sell their products with reckless disregard for human life and for the peace, tranquility, and economic well being of the public."[91] The court adds:

> [T]he fact that the manufacture and sale of guns is legal does not prevent the plaintiffs from pursuing their nuisance claim.

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87 Congressional Research Service, *Report for Congress; "Assault Weapons": Military Style Semiautomatic Firearms Facts and Issues, 1992*, app. B, at 66. The report explained further:

> For example, a trace may be conducted on a firearm found at the residence of a suspect though the firearm itself is not associated with a criminal act. Traces may also be requested with respect to abandoned firearms, those found by chance, those seen by officers for sale at guns shows or pawn shops, or those used by suicide victims. In addition, traces may be requested with respect to firearms seized pursuant to an investigation not directly related with a violent criminal offense, such as tax evasion or a technical violation of the Gun Control Act provisions. It is not possible to identify how frequently firearms traces are requested for reasons other than those associated with violent crimes.

Id. at 70.

88 18 U.S.C. § 922(t)(1) (1996 & Supp. 2003).

89 *Id*. at § 922(d).

90 *Ileto*, 349 F.3d at 1206.

91 *Id*. at 1210.

> Here, the alleged nuisance is not premised on the legal manufacture and design of the guns or the sale of guns to individuals who are legally entitled to purchase them. On the contrary, the nuisance claim rests on the defendants' actions in creating an illegal secondary market for guns by purposefully over-saturating the legal gun market in order to take advantage of re-sales to distributors that they know or should know will in turn sell to illegal buyers.[92]

In short, an industry which abides by all federal and state requirements should nonetheless know that it sells too many products and must not "over-saturate" the market. One can imagine the application of this theory to the beer industry. Brewers over-saturate the market knowing full well that some customers under the age of twenty-one will buy beer. Unscrupulous groceries and convenience markets merely card buyers without developing sure-fire techniques of weeding out straw purchasers (those persons over twenty-one purchasing for those under twenty-one). Manufacturers are well aware of high-violation zones, such as college towns, yet still ship beer to dealers at such places. Thus, the brewers must be responsible for all alcohol related injuries and deaths.

In a dissenting opinion, Circuit Judge Cynthia Holcomb Hall wrote that the action was in reality a products liability action and, therefore, was barred by a California statute that provided, "[i]njuries or damages resulting from the discharge of a firearm or ammunition are not proximately caused by its potential to cause serious injury, damage, or death, but are proximately caused by the actual discharge of the product."[93] In *Merrill v. Navegar, Inc.*,[94] the California Supreme Court rejected a similar attempt to redefine a product liability action into a negligent marketing action, which would have avoided that statute.[95] Judge Hall wrote:

> In *Merrill,* the plaintiffs alleged that the defendant gun manufacturer was negligent in that it marketed its guns to the general public while knowing that the guns would find their

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92 *Id*. at 1214.

93 *Id*. at 1218-19 (internal quotations omitted) (Hall, J., dissenting) (quoting CAL. CIV. CODE § 1714.4(b)(2) (Deering 2002)).

94 28 P.3d 116 (Cal. 2001).

95 *Id*. at 130. The *Merrill* court wrote:

> [V]irtually every person suing for injuries from firearm use could offer evidence the manufacturer knew or should have known the risk of making its firearm available to the public outweighed the benefits of that conduct, and could therefore raise a triable issue of fact for the jury. In each of these cases, the jury would be asked to do precisely what section 1714.4 prohibits: weigh the risks and benefits of a particular firearm. The result would be to resurrect the very type of lawsuit the Legislature passed section 1714.4 to foreclose . . . .

> way to criminals. Here, appellants allege that the appellee gun manufacturers were negligent by marketing their guns to *law enforcement* while knowing that the guns will find their way to criminals. But appellants' allegation that the gun manufacturers purposefully "over-marketed" their product to law enforcement, which made the guns reach illegal markets faster, is not legally cognizable. . . . In general, a manufacturer of a legal product has no duty to refrain from attempting to sell as many products as possible.[96]

Judge Hall also would have rejected the public nuisance claim because such cases invariably related to the use of real property not products.[97] She concluded: "The debate over the extent to which gun manufacturers should be held liable to victims of gun violence belongs in the democratic process. The public debate benefits from able advocates on all sides—we need not enter it."[98]

On remand, should *Ileto* proceed through discovery and summary judgment, plaintiffs will have to offer evidence that firearm manufacturers and police departments are in cahoots to distribute firearms to a vast criminal network. And, should the case go to trial, they will have to convince a jury that by selling guns to police the industry thereby arms the underworld. *Ileto* well illustrates the extent to which the suits against the firearms industry keep getting, in the words of Alice in Wonderland, "curiouser and curiouser."[99]

IV. THE PROTECTION OF LAWFUL COMMERCE IN ARMS ACT

The Protection of Lawful Commerce in Arms Act, designated as H.R. 1036 and sponsored by Rep. Cliff Stearns (R-Fla.), passed the House of Representatives on April 9, 2003, with a 285 - 140 vote.[100] It is described as "[a] bill to prohibit civil liability actions from being brought or continued against manufacturers, distributors, dealers, or importers of firearms or ammunition for damages resulting from the misuse of their products by others."[101]

The original Senate bill, S. 659, introduced by Senators Larry Craig (R-Idaho) and Max Baucus (D-Mont.), contained

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Id.

96 *Ileto*, 349 F.3d at 1222 n.3 (Hall, J., dissenting).

97 *Id.* at 1224 (Hall, J., dissenting).

98 *Id.* (Hall, J., dissenting).

99 LEWIS CARROLL, ALICE IN WONDERLAND 11 (1974).

100 Protection of Lawful Commerce in Arms Act, H.R. 1036, 108th Cong. (2003). *See also* 149 CONG. REC. H2996-99 (daily ed. Apr. 9, 2003).

101 149 CONG REC. H2,863 (daily ed. Apr. 7, 2003).

identical language as H.R. 1036.[102] Senator Thomas Daschle (D.-S.D.), the Minority Leader, announced his support for the bill subject to clarifying amendments.[103] That led to the introduction of S. 1805, the Daschle-Craig-Baucus version of S. 659.[104] A threatened filibuster did not materialize, as S. 1805 was debated February 25-March 2, 2004.[105] President Bush, who has stated that he will sign the bill if it passes, urged the Senate to enact "a clean bill" without amendments which would interfere with its ultimate passage.[106]

However, the Senate voted to add to the bill controversial provisions renewing the federal "assault weapons" prohibition, which was scheduled to expire,[107] and requiring background checks at gun shows for transactions between unlicensed persons.[108] This led the proponents of S. 1805 to join its opponents in voting against final passage of the amended bill, which went down in flames by a vote of 8 to 90.[109]

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102 S. 659, 108th Cong. (2003).

103 Press Release, Tom Daschle, U.S. Senator, Daschle Announces Support for Legislation Limiting Liability for Gun Manufacturers (Sept. 25, 2003), http://daschle.senate.gov/~daschle/pressroom/releases/03/09/2003926416.html.

104 Senator Craig introduced S. 1805, which incorporates the Daschle amendments, and S. Res. 1806, which is an unamended version of S. 659. *See* 149 CONG. REC. S13,711 (daily ed. Oct. 31, 2003).

105 150 CONG. REC. S1897-98 (daily ed. Feb. 27, 2004).

106 Press Release, Institute for Legislative Action, National Rifle Association, Unions, Commerce and Conservation Organizations Urge Passage of S. 659, The "Protection Of Lawful Commerce In Arms Act" (Sep. 9, 2003), http://www.nraila.org/news/read/releases.aspx?ID=3029. A policy statement by the Bush Administration states:

> The Administration strongly supports Senate passage of S. 1805. The Administration urges the Senate to pass a clean bill, in order to ensure enactment of the legislation this year. Any amendment that would delay enactment of the bill beyond this year is unacceptable. The manufacturer or seller of a legal, non-defective product should not be held liable for the criminal or unlawful misuse of that product by others. The possibility of imposing liability on an entire industry for harm that is solely caused by others is an abuse of the legal system, erodes public confidence in our Nation's laws, threatens the diminution of a basic constitutional right and civil liberty, sets a poor precedent for other lawful industries, will cause a loss of jobs, and burdens interstate and foreign commerce. S. 1805 would help curb frivolous litigation against a lawful American industry and the thousands of workers it employs and would help prevent abuse of the legal system. At the same time, the legislation would carefully preserve the right of individuals to have their day in court with civil liability actions. These civil actions are enumerated in the bill and respect the traditional role of the States in our Federal system with regard to such actions.

Statement of Administration Policy, Executive Office of the President, Office of Management and Budget, S. 1805 - Protection of Lawful Commerce in Arms Act (Feb. 24, 2004), http://www.whitehouse.gov/omb/legislative/sap/108-2/s1805sap-s.pdf.

107 *See* 150 CONG. REC. S1971 (daily ed. Mar. 2, 2004).

108 *Id*. at S2,006-08.

109 *Id*. at S1,976.

The following analyzes H.R. 1036 and S. 1805 (referred to below as the Daschle version). While enactment of the substance of these bills is uncertain, the support thereof by majorities in both the House and Senate suggests that some version of the bills may be enacted at a future time.

H.R. 1036 begins with significant Findings and Purposes, none of which would be changed by the Daschle version.[110] The first Finding declares: "Citizens have a right, protected by the Second Amendment to the United States Constitution, to keep and bear arms."[111] While that claim is being hotly debated in the courts,[112] Congress has passed similar declarations on three previous occasions,[113] and much of the scholarship supports the individual rights interpretation.[114] The Finding has significance for two purposes. First, given that having arms is a constitutional right, it hardly makes sense to allow lawsuits against manufacturers for making constitutionally-protected products.[115] Second, this right would provide federal jurisdiction to preempt state law that may authorize lawsuits against the industry merely for supplying this constitutionally-protected product to "the people" whom the Second Amendment protects.[116]

110 Compare H.R. 1036, 108th Cong. (2003), with S. 1805, 108th Cong. (2003).

111 H.R. 1036, 108th Cong. § 2(a)(1) (2003).

112 *Compare* United States v. Emerson, 270 F.3d 203, 232 (5th Cir. 2001) (holding that the Second Amendment guarantees an individual right), *with* Silveira v. Lockyer, 312 F.3d 1052, 1063 (9th Cir. 2003) (holding that the Second Amendment guarantees only State militia power), *reh'g denied*, 328 F.3d 567 (9th Cir. 2003) (denying a rehearing en banc over dissenting opinions by Judges Pregerson, Kozinski, Kleinfeld, and Gould), *cert. denied*, 124 S. Ct. 803 (2003).

113 Freedmen's Bureau Act, ch. 200, § 14, 14 Stat. 173, 176-77 (1866) ("[T]he right . . . to have full and equal benefit of all laws and proceedings concerning personal liberty, personal security, . . . including the constitutional right to bear arms, shall be secured to and enjoyed by all the citizens . . . ."); Property Requisition Act, Pub. L. No. 274, 55 Stat. 742, 742 (1941) (prohibiting construction of law to allow requisition or registration of "firearms possessed by any individual for his personal protection or sport" or "to impair or infringe in any manner the right of any individual to keep and bear arms"); Firearms Owners' Protection Act, Pub. L. No. 99-308, §1(b)(1)(A), 100 Stat. 449, 449 (1986) (declaring "the rights of citizens . . . to keep and bear arms under the second amendment to the United States Constitution").

114 *But see* Printz v. United States, 521 U.S. 898, 938 n.2 (1997) (Thomas, J., concurring) (citing scholarship supporting *both* sides of the issue).

115 *See generally* Stephen P. Halbrook, *Tort Liability for the Manufacture, Sale, and Ownership of Handguns?*, 6 HAMLINE L. REV. 351, 364-72 (1983). That the existence of a constitutional right limits state tort law is illustrated in *New York Times Co. v. Sullivan*, 376 U.S. 254, 256 (1964) (addressing "the extent to which the constitutional protections for speech and press limit a State's power to award damages in a libel action brought by a public official against critics of his official conduct.").

116 This presupposes that the Fourteenth Amendment incorporates the Second Amendment (as it does most of the rest of the Bill of Rights) and that Congress is using its enforcement power under the Fourteenth Amendment to prevent State infringement on the right. *See* STEPHEN P. HALBROOK, FREEDMEN, THE FOURTEENTH AMENDMENT, AND THE RIGHT TO BEAR ARMS, 1866-1876 (1998). But, Congress could do this under its militia power as well. U.S. CONST. art. I, § 8, cls. 15 & 16. As the Supreme Court long ago noted:

Lawsuits have been commenced, the Findings continue, against the firearms industry for damages and other relief for the harm caused by criminals and other third parties who misuse firearms.[117] However, "[t]he manufacture, importation, possession, sale, and use of firearms and ammunition in the United States are heavily regulated by Federal, State, and local laws."[118] Indeed, the federal Gun Control Act was originally passed under the Commerce Clause,[119] which is another jurisdictional hook for the proposed bill. As the Findings recite, businesses "are engaged in interstate and foreign commerce through the lawful design, manufacture, marketing, distribution, importation, or sale to the public of firearms or ammunition that has been shipped or transported in interstate or foreign commerce," and they should not be liable for the harm caused by unlawful misuse of firearms that function as designed and intended.[120]

Such imposition of liability on an industry abuses the legal system, erodes public confidence in the law, "threatens the diminution of a basic constitutional right and civil liberty,"[121] destabilizes other industries in the free enterprise system of the United States, and—again, the clincher for federal jurisdiction—"constitutes an unreasonable burden on interstate and foreign commerce of the United States."[122]

> All citizens capable of bearing arms constitute the reserved military force or reserve militia of the United States as well as of the states, and, in view of this prerogative of the general government . . . the states cannot, even laying the constitutional provision in question [the Second Amendment] out of view, prohibit the people from keeping and bearing arms, so as to deprive the United States of their rightful resource for maintaining the public security, and disable the people from performing their duty to the general government.

Presser v. Illinois, 116 U.S. 252, 265 (1886).

117 H.R. 1036, 108th Cong. § 2(a)(2) (2003).

118 *Id*. § 2(a)(3).

119 *See* United States v. Lopez, 514 U.S. 549, 561 (1995). As is clear on its face, the Arms Export Control Act was passed under Congress' authority to regulate commerce with foreign nations. The National Firearms Act, by contrast, was passed under the tax power and is part of the Internal Revenue Code. *See* Sonzinsky v. United States, 300 U.S. 506, 511 (1937).

120 H.R. 1036, § 2(a)(4).

121 Statement of Administration Policy, *supra* note 106.

122 H.R. 1036, § 2(a)(5). Justification of the bill under the Commerce Clause seems to be clear given the Supreme Court's upholding of most legislation (including Gun Control Act provisions) even purporting to be passed under that clause, particularly laws that include findings that an activity affects interstate and foreign commerce and that include elements requiring such commercial nexus. *See Lopez*, 514 U.S. at 1630. Indeed, this bill seeks to override attempts by single states to suppress commerce with foreign countries and among other states. *See, e.g.*, Ileto v. Glock, 349 F.3d 1191 (9th Cir. 2003) (imposing liability on Austrian manufacturer and Georgia importer for sales to law enforcement in Washington).

Such liability actions, which have been commenced or contemplated by the United States, various States, municipalities, and private interest groups, are unprecedented and are not "a bona fide expansion of the common law."[123] The sustaining of these actions by a "maverick" judge or jury would expand liability in a manner never contemplated by the Constitution's Framers or by the federal or state legislatures.[124] And now for yet another jurisdictional hook: "Such an expansion of liability would constitute a deprivation of the rights, privileges, and immunities guaranteed to a citizen of the United States under the Fourteenth Amendment to the United States Constitution."[125] Those rights would presumably include the right to keep and bear arms and the right to due process of law.

The above constitutional aspects are further clarified in the Purposes clause to the bill. The immediate purpose, of course, is to prohibit causes of action against the firearms industry for harm caused by criminals and others who unlawfully misuse firearms.[126] The values of the Second Amendment are reflected further in the Purposes: "[t]o preserve a citizen's access to a supply of firearms and ammunition for all lawful purposes, including hunting, self-defense, collecting, and competitive or recreational shooting," and "[t]o guarantee a citizen's rights, privileges, and immunities, as applied to the States, under the Fourteenth Amendment to the United States Constitution, pursuant to section 5 of that Amendment."[127] Section 5 is, of course, the Enforcement Clause.

After repeating the purpose of preventing such lawsuits from imposing "unreasonable burdens on interstate and foreign commerce,"[128] a new purpose is interjected—that of protecting the First Amendment rights of members of the firearms industry, including their trade associations, "to speak freely, to assemble peaceably, and to petition the Government for a redress of their grievances."[129] These rights were undoubtedly included because some of the suits alleged a conspiracy to defraud the public into believing that firearms are useful for self-defense, that associating and speaking together amounted to a plot to oversupply police and the public with firearms so that the criminal element could get them, and that petitioning Congress against passage of various firearms prohibitions helped criminals

123 H.R. 1036, § 2(a)(6).
124 *Id*.
125 *Id*.
126 *Id*. § 2(b)(1).
127 *Id*. § 2(b)(2), (3).
128 *Id*. § 2(b)(4).
129 *Id*. § 2(b)(5).

to obtain firearms.[130]

The meat of the bill is contained in a single sentence: "A qualified civil liability action may not be brought in any Federal or State court." Further, any such pending action "shall be dismissed immediately."[131] The remainder of the bill contains various definitions which clarify the nature of the prohibited civil actions in contrast with the types of traditional actions that are unaffected.

The term "qualified product" means a firearm, antique firearm, ammunition, or a component part thereof "that has been shipped or transported in interstate or foreign commerce."[132] The term "qualified civil liability action" is defined as "a civil action brought by any person against a manufacturer or seller of a qualified product, or a trade association, for damages or injunctive relief resulting from the criminal or unlawful misuse of a qualified product by the person or a third party."[133] In short, no action at law or in equity may be filed against a gun maker or seller where a criminal or other person unlawfully misused a firearm. (The Daschle version would add the definition of "unlawful misuse" as "conduct that violates a statute, ordinance or regulation as it relates to the use of a qualified product."[134] That would nip in the bud an action alleging an unlawful "use" rather than "misuse.")

The term "person" includes an individual, corporation, other specified groups, "or any other entity, including any governmental entity."[135] Thus, persons who could not file suit include private as well as governmental entities, such as municipalities, state attorneys general, and federal agencies—all of which have brought such suits in the past. Entities shielded from such lawsuits are federal firearms licensees, including a

130 Among the defendants named in *City of Boston v. Smith & Wesson Corp.*, No. 199902590, 2000 Mass. Super. LEXIS 352, at *1 (July 13, 2000), were the American Shooting Sports Council, Inc., National Shooting Sports Foundation, Inc., and the Sporting Arms & Ammunition Manufacturers Institute, Inc.

131 H.R. 1036, § 3.

132 *Id*. § 4(4). As the bill specifies, the definition of "firearm" is limited to the two "firearm" definitions in 18 U.S.C. § 921(a)(3)(A) and (B), which include a weapon which expels a projectile by the action of an explosive (or is designed or may be readily converted to do so), and the frame or receiver of such weapon. That excludes the definitions of firearm in (C) and (D) respectively as a firearm muffler or silencer, and as a destructive device, which includes explosive devices and certain non-sporting firearms with barrels over .50 caliber. The bill's definition of "firearm" also includes an antique firearm, which § 921(a)(16) defines to include firearms made before 1898 and certain replicas. The definition of "ammunition" may be found in § 921(a)(17), and includes both ammunition and components.

133 H.R. 1036, § 4(5)(A).

134 S. 1805, 108th Cong. § 4(9) (2003).

135 H.R. 1036, § 4(3).

"manufacturer" (a person engaged in the business of manufacturing a qualified product in interstate or foreign commerce)[136] and a "seller" (which includes a firearm importer or dealer or a person engaged in the business of selling ammunition).[137] The term "engaged in the business" refers to a person who devotes time, attention, and labor to the activity in question as a regular course of trade or business with the principal objective of livelihood and profit through the sale or distribution of the product.[138]

Also exempted is a "trade association," which is any non-profit association or business, regardless of whether incorporated, of which at least two members are manufacturers or sellers of a qualified product.[139] The Daschle version would add the further meaning that the association "is involved in promoting the business interests of its members, including organizing, advising, or representing its members with respect to their business, legislative or legal activities in relation to the manufacture, importation or sale of a qualified product."[140] This would further clarify the legitimate nature of such organizations and their First Amendment right to freedom of association.

As noted above, a qualified civil liability action may not be brought in any court. However, five types of causes of action are excluded from the definition of "qualified civil liability action," and may continue to be brought.[141] They include the following:

"*(i) an action brought against a transferor convicted under section 924(h) of title 18, United States Code, or a comparable or identical State felony law, by a party directly harmed by the conduct of which the transferee is so convicted*"[142] The referenced section punishes "[w]hoever knowingly transfers a firearm, knowing that such firearm will be used to commit a crime of violence . . . or drug trafficking crime."[143] As noted, the transferor must be convicted of this or a comparable state offense, and the crime of violence or drug trafficking crime of which the transferee is convicted must directly harm the party who would bring an action.

136 *Id*. § 4(2).

137 *Id*. § 4(6) (referring to 18 U.S.C. § 921(a)(9), which defines "importer," § 921(a)(11), which defines "dealer," and § 921(a)(17), which defines "ammunition").

138 *Id*. at § 4(1) (referring to 18 U.S.C. § 921(a)(21), which defines "engaged in the business").

139 *Id*. at § 4(8).

140 S. 1805, § 4(8)(C).

141 H.R. 1036, § 4(5)(A).

142 Id. § 4(5)(A)(i) (emphasis added).

143 18 U.S.C. § 924(h) (1996) (defining crime of violence as in § 924(c)(3) (felonies involving use or threat of force against person or property) and drug trafficking crime as in § 924(c)(2) (federal drug felonies)).

"*(ii) an action brought against a seller for negligent entrustment or negligence per se*"[144] The term "negligent entrustment" means:

> the supplying of a qualified product by a seller for use by another person when the seller knows or should know the person to whom the product is supplied is likely to use the product, and in fact does use the product, in a manner involving unreasonable risk of physical injury to the person and others.[145]

(The Daschle version would say "*or* others".)[146] That might mean supplying a firearm to an irresponsible youth or to a person known to be mentally ill. An action involving "negligence per se" might include, for instance, the sale of a firearm to a known violent felon.

"*(iii) an action in which a manufacturer or seller of a qualified product knowingly and willfully violated a State or Federal statute applicable to the sale or marketing of the product, and the violation was a proximate cause of the harm for which relief is sought*"[147] The Daschle version would strike "knowingly and willfully," reflecting the fact that the federal Gun Control Act requires proof that specific offenses be proven as either knowing or willful.[148] However, some state firearm statutes have been interpreted to impose a "knew or reasonably should have known" standard akin to civil cases,[149] or even to impose strict liability.[150] In such states, depending on how broadly a court interpreted proximate cause, this portion of the Daschle amendment may not

144 H.R. 1036, § 4(5)(A)(ii) (emphasis added).

145 *Id*. § 4(5)(B).

146 S. 1805, § 4(5)(B).

147 H.R. 1036, § 4(5)(A)(iii) (emphasis added). *Compare* Robinson v. Howard Bros. of Jackson, Inc., 372 So. 2d 1074 (Miss. 1979) (holding that the sale of a pistol to a person who certified that he was over twenty-one years of age—but whose driver's license indicated that he was actually twenty years old—violated the Gun Control Act but was not the proximate cause of the unforeseeable murder), *and* Hulsman v. Hemmeter Dev. Corp., 647 P.2d 713 (Haw. 1982) (holding that a gun seller was entitled to summary judgment because "federal statutes regulating firearm sale did not create a duty on a seller in a negligence action nor did it create a private right of action for damages"), *with* Decker v. Gibson Prods. Co., 679 F.2d 212 (11th Cir. 1982) (holding that whether sale of a firearm to a felon whose civil rights were restored and whose purchase was approved by sheriff could be reasonably foreseen to result in murder was a question for the jury).

148 S. 1805, § 4(5)(A)(iii).

149 *In re* Jorge M., 4 P.3d 297, 299, 312 (Cal. 2000) (holding that defendant knew or should have known that rifle was an "assault weapon").

150 *See* State v. Pelleteri, 683 A.2d 555, 557-58 (N.J. Super. Ct. App. Div. 1996) (holding that no scienter element is required regarding assault weapon ban, in that "knowledge of the character of the weapon is not an element of the offense"). By contrast, federal law requires proof of knowledge of "the characteristics that brought [the weapon] within the statutory definition." Staples v. United States, 511 U.S. 600, 602 (1994). "[T]here is a long tradition of widespread lawful gun ownership by private individuals in this country." *Id*. at 610.

preclude the types of lawsuits sought to be prohibited.

The Daschle version would also add to the above language clauses explicitly including cases in which a manufacturer or seller "knowingly made any false entry in, or failed to make appropriate entry in, any record required to be kept under Federal or State law;"[151] or aided, abetted, or conspired with any person either in making a false statement regarding a fact material to the lawfulness of the sale of a qualified product,[152] or to sell such product, "knowing or having reasonable cause to believe that the actual buyer" was prohibited from receipt of a firearm under federal law.[153] These are crimes which typically would involve sales directly to prohibited persons or "straw sales" in which a prohibited person obtains a firearm using a proxy to conduct the transaction. Once again, the proximate cause requirement would exist for civil liability.

"*(iv) an action for breach of contract or warranty in connection with the purchase of the product*"[154] Actions for breach of contract or warranty arise in diverse circumstances—for instance, a firearm was not delivered when due or did not work properly where needed[155]—but in this context such conduct is exempted from causes of action related to "the criminal or unlawful misuse of a qualified product by the person or a third party."[156] While it is unclear what causes of action might arise in that context, the exemption for those arising under contract and warranty is probably listed just to show that those actions generally are unaffected by the bill.

"*(v) an action for physical injuries or property damage resulting directly from a defect in design or manufacture of the product, when used as intended*"[157] This is the classic strict product liability case, and the bill clearly exempts such traditional actions. The Daschle version would add, "or [when used] in a manner that is reasonably foreseeable," provided that "'reasonably foreseeable' use does not include any criminal or unlawful misuse of a qualified product, other than possessory offenses."[158] The exclusion of unlawful misuse is consistent with

151 S. 1805, § 4(5)(A)(iii)(I) (this is an offense under 18 U.S.C. § 922(m)).

152 *Id*. § 4(5)(A)(iii)(II) (such a false statement is an offense under 18 U.S.C. § 922(a)(6)).

153 *Id*. § 4(5)(A)(iii)(III) (such a transfer is an offense under 18 U.S.C. § 922(d)).

154 H.R. 1036, 108th Cong. § 4(5)(A)(iv) (2003) (emphasis added).

155 *E.g.*, Thomas v. Olin Mathieson Chem. Corp., 63 Cal. Rptr. 454 (Cal. Ct. App. 1967) (involving situation where a rifle allegedly failed to discharge while the plaintiff was hunting big game).

156 H.R. 1036, § 4(5)(A).

157 Id. § 4(5)(A)(v) (emphasis added).

158 S. 1805 §§ 4(5)(A)(v), 4(5)(C).

traditional legal norms.[159] However, it is unclear what effect on the lawsuits at issue will stem from the condition that unlawful possession may be reasonably foreseeable.

The Daschle version would add a rule of construction that the above exceptions "shall be construed so as not to be in conflict and no provision of this Act shall be construed to create a Federal private cause of action or remedy."[160] This is a statement about the perils of legal linguistics and how lawyers have the ability to twist imperfectly worded rules. Under this clause, one exception would not trump another. Further, nothing in the enactment would create a new basis for actions against the firearms industry.

As noted, the above legislation has a good chance of passage. If it does, it will be challenged as beyond Congress' power, violative of federalism, and inconsistent with due process. One can be sure that novel theories will be devised to attack the firearms industry.

V. CONCLUSION

The current nationally-orchestrated efforts to suppress the firearms industry through litigation is premised on the theory that federal and state firearms laws do not go far enough and that the industry is to blame for not creating a more perfect world than the Congress or the state legislatures have devised. Indeed, the right of the people to keep and bear arms, as guaranteed by the Second Amendment and most state constitutions, and the manufacture and distribution of firearms, which are necessary to the exercise of that constitutional right, are depicted as being a public nuisance.

It is hardly a secret that this onslaught of litigation is primarily promoted by special interest lobbies that have failed to prohibit firearms ownership through the legislative process and have turned to the courts to obtain judicial legislation. While most courts have rejected this end run around the democratic process, some have embraced an activist role. Congress would be fully warranted in passing preemption legislation to end this disruption of a legitimate form of commerce, which is itself a penumbra of a basic constitutional right.

159 Restatement (Third) of Torts: Product Liability § 2 cmt. p (1997).

160 S. 1805, §4(5)(D).

Punitive Damages in Cyberspace: Where in the World is the Consumer?

Michael L. Rustad[*]

I. INTRODUCTION[**]

The Internet offers American consumers a global marketplace open 24 hours a day, 365 days a year. By 2004, online commerce is projected to account for nearly seven trillion dollars.[1] Currently, there are 262.3 million English-speaking Internet users with 280 million projected for 2004.[2] The worldwide online population is projected to be between 709 and 945 million.[3] In the United States there are 182.1 million people online, accounting for 65% of that population.[4] "With the ability to reach millions of Internet users simply by establishing a website, tens of thousands of companies are expected to take advantage of electronic commerce, 'redefining and restructuring the distribution of goods and services.'"[5]

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[**] The research for this article included examining several cases only available in jury verdict databases and jury verdict reporting publications. These cases were obtained from LEXIS, Verdict Library, Allver File; and WESTLAW, LRP-JV database (Jury Verdict and Settlement Summaries). Citations to these jury verdict databases are made to the LEXIS or WESTLAW database.

1 *Forrester Projects $6.8 Trillion for 2004 ($ B)*, Global Reach, *at* http://glreach.com/eng/ed/art/2004.ecommerce.php3 (last revised Nov. 23, 2001).

2 *Global Internet Statistics (by Language)*, Global Reach, *at* http://www.glreach.com/globstats/ (last revised Sept. 30, 2003).

3 CyberAtlas staff, *Population Explosion!*, ClickZ Network, *at* http://www.clickz.com/stats/big_picture/geographics/print.php/5911_151151 (Sept. 22, 2003).

4 *Id*.

5 Brian K. Epps, Maritz, Inc. v. CyberGold, Inc.*: The Expansion of Personal Jurisdiction in the Modern Age of Internet Advertising*, 32 GA. L. REV. 237, 239 (1997) (quoting Louise Kehoe, *Surge of Business Interest*, FIN. TIMES (London), Mar. 1, 1995, at XVIII).

The risks to consumers in this global marketplace are many. Consumers are flooded with virus-infected e-mail, spam, and a variety of fraudulent online scams. Online criminals use the technique of "phishing" to trick consumers into giving their credit card numbers by sending fraudulent e-mails posing as banks, financial service providers, or Internet Service Providers ("ISP").[6] The e-mails often have direct hyperlinks to unaffiliated web sites that mirror the sites of trusted institutions.[7]

The Internet makes it effortless for impostors to assume false identities, and therefore, it is a seamless haven for identity theft. The seamy side of the Internet is rapidly becoming a global Petri dish for new torts and crimes perpetrated against consumers. Consumers face a multitude of potential risks as the result of unsavory practices by Internet retailers. The following three horror stories illustrate the systematic ways wrongdoers are preying upon consumers in cyberspace:

The Naked Internet Consumer—In June of 2001, Eli Lilly and Co. inadvertently released the e-mail addresses of 669 medical patients who had registered at its web site[8] to receive messages regarding health-related matters, such as reminders to take certain medications.[9] Eli Lilly settled with the states, but no individual obtained a damages award in this significant compromising of consumer privacy.[10]

Consumers as "Phish" Food in Online Auctions—The majority of consumer frauds arise out of online auction sales.[11] This is due in large part to online fraudsters who use a technique called "phishing" to defraud consumers who use eBay.[12] When phishing, a con artist sends a consumer what appears to be an "'official' e-mail message directing the person to a counterfeit site where they are encouraged to 'update their account.'"[13] The

6 Cade Metz, *Can E-Mail Survive?*, PC MAG., Feb. 17, 2004, at 65, 66.

7 Troy Wolverton, *Wells Fargo Latest Target in Scams*, CNET News.com, *at* http://news.com.com/2100-1017-857177.html (last modified Mar. 11, 2002).

8 *Eli Lilly Strikes Deal Ending E-Mail Privacy Suit by Eight States*, 4 E-BUS. L. BULL. 14, 14 (2002) [hereinafter *Eli Lilly*].

9 Julekha Dash, *ACLU Knocks Eli Lilly for Divulging E-Mail Addresses*, Computerworld, http://www.computerworld.com/managementtopics/ebusiness/story/0,10801,62050,00.html (July 9, 2001).

10 The settlement of the e-mail privacy lawsuit was with the states of California, Connecticut, Idaho, Iowa, Massachusetts, New Jersey, New York, and Vermont. *Eli Lilly*, *supra* note 8, at 14.

11 *Internet Fraud Statistics*, National Fraud Information Center, *at* http://www.fraud.org/2002intstats.htm (last visited Jan. 29, 2004) [hereinafter *Internet Fraud Statistics*].

12 *eBay Email Hoax and Web Page*, *at* http://www.millersmiles.co.uk/identitytheft/101303ebay1.htm (Oct. 13, 2003) (noting that since October 2003 there has been a hoax web page to capture consumer information).

13 Kyle Stock, *Auction Site Can Turn Crime Scene for Unwary*, POST & COURIER

criminal uses the information provided by the consumer to hijack his or her credit card and identity.[14] A survey of Internet fraud found that online auctions accounted for 90% of consumer losses in 2002.[15] The government's Internet Fraud Complaint Center reports that online auction fraud has comprised 46% of complaint referrals since 2000.[16]

Stalking Children in the Internet's Red Light District—Con artists frequently target children online. In one instance, a notorious "typosquatter" registered domain names that employed misspellings of other popular Internet domain names for children-oriented websites, such as Teletubbies and Disneyland, in order to attract children to adult entertainment sites.[17] When children accidentally misspelled the domain names for the children's sites, they were redirected to adult entertainment sites where fees were automatically charged for each child's click stream.[18]

As demonstrated by the above examples, many of the online injuries suffered by consumers are the product of truly reprehensible wrongdoing deserving of punitive damages. This Article presents the results of the first empirical study of the role that punitive damages have played in redressing consumer injuries during the first decade of Internet-related litigation. It provides definitive data on the number, size, post-verdict history, and factual circumstances underlying punitive damages in cyberspace. Currently, punitive damages play no meaningful role in protecting consumers in cyberspace despite the epidemic of wrongdoing that goes undetected and unpunished by public authorities.

Tort law has always evolved to address new forms of misbehavior. In the latter half of the twentieth century punitive damages were awarded against product manufacturers who

(Charleston, S.C.), Dec. 26, 2003, at 1A, 11A, *available at* http://www.charleston.net/stories/122603/loc_26ebay.shtml.

14 *Id*.

15 *Internet Fraud Statistics*, *supra* note 11.

16 NAT'L WHITE COLLAR CRIME CTR. & FED. BUREAU OF INVESTIGATION, IFCC 2002 INTERNET FRAUD REPORT 3 (2003), *available at* http://www.ifccfbi.gov/strategy/statistics.asp (last visited Feb. 22, 2003) [hereinafter IFCC 2002 INTERNET FRAUD REPORT].

17 *US Authorities Redirect 'Most Wanted' Cybersquatter to Jail*, INTERNET MAG. 011 (Nov. 2003) ("John Zuccarini registered common misspellings of the names of popular children's websites . . . and earned up to $1 million (£600,000) per year in affiliate commissions by redirecting people to pornographic websites. Visitors to the sites were often trapped by pop up ads, forcing them to reboot their computers."), http://web2.infotrac-custom.com/pdfserve/get_item/1/s4waebw3_2/sb635_02.pdf [hereinafter *US Authorities*].

18 *Feds Nab Alleged Porn Piper*, *at* http://www.cbsnews.com/stories/2003/09/04/tech/printable571499.shtml (Sep. 4, 2003).

knowingly marketed their products with excessive, preventable danger.[19] Tort remedies have the potential of filling the gap left by ineffective criminal sanctions against cyberwrongs such as online stalking.[20] Public enforcement needs to be augmented by consumers operating as "private attorneys general"[21] who pursue punitive justice against corporate wrongdoers. "The primary function of punitive damages is to punish, to deter private actors from making particularly egregious decisions harmful to society."[22]

Part II examines the case characteristics of Internet lawsuits where plaintiffs initiated causes of action in state and federal courts in the United States between 1992 and 2002.[23] The analysis of plaintiffs' victories in Internet cases has a domestic focus, employing a database that includes virtually all U.S. plaintiff victories in Internet cases. This database permits the first comprehensive examination of: (1) the frequency of punitive damages in Internet cases; (2) the specific causes of action on which the remedy was based; (3) plaintiff and defendant characteristics; and (4) the role punitive damages plays in the cyber-litigation system. A content analysis of all Internet-related cases reveals that no consumer obtained punitive damages during a decade of cyberlaw litigation.[24]

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19 *See* Michael Rustad, *In Defense of Punitive Damages in Products Liability: Testing Tort Anecdotes with Empirical Data*, 78 IOWA L. REV. 1, 16, 18 nn.87-88 (1992) (noting that punitive damages in products liability cases evolved as a remedy beginning in the mid-1960s).

20 Lisa A. Karczewski, Comment, *Stalking in Cyberspace: The Expansion of California's Current Anti-Stalking Laws in the Age of the Internet*, 30 MCGEORGE L. REV. 517, 518 (1999) (arguing that the legal system has yet to develop effective remedies against online stalking).

21 Judge Jerome Frank of the Second Circuit Court of Appeals coined the term "private Attorney Generals [sic]" to refer to "any person, official or not," who brought a proceeding "even if the sole purpose is to vindicate the public interest." Associated Indus. of N.Y. State, Inc. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943), *vacated*, 320 U.S. 707 (1943). *See generally* Michael L. Rustad, *Smoke Signals from Private Attorneys General in Mega Social Policy Cases*, 51 DEPAUL L. REV. 511, 518 (2001) (arguing that "[t]he rubric under which all the definitions for the private attorneys general fall is the emphasis on private action for the public interest. It is only the possibility of private attorneys general receiving a contingency fee that permits lawsuits to be brought to vindicate the public interest").

22 *In re* Simon II Litig., 211 F.R.D. 86, 159 (E.D.N.Y. 2002).

23 The only foreign cases included in the research universe were lawsuits filed against non-U.S. defendants in state or federal courts.

24 The definition of a consumer for purposes used in this study is used by many state and federal statutes. A consumer transaction in cyberspace includes commercial transactions in which an individual is purchasing goods or services online for personal, family or household use. The definition of consumer is widely accepted and incorporated in such consumer statutes as the Truth in Lending Act ("TILA"). TILA's scope is limited to "consumer" credit transactions, which are defined as transactions in which "the money, property, or services which are the subject of the transaction are primarily for personal, family, or household purposes." 15 U.S.C. § 1602(h) (1998).

At present, punitive damages serve as a form of corporate self-help to assist corporations in protecting rights and consolidating market share in cyberspace. Part III explores the reasons why punitive damages have not yet developed as a consumer protection remedy in cyberspace. This Article will demonstrate that punitive damages are a necessary deterrent against Internet wrongdoers where the probability of discovery is low and the harm to consumers is generally undetected and unpunished by public authorities.

II. EMPIRICAL STUDY OF PUNITIVE DAMAGES IN CYBERSPACE

A. Research Methods

To obtain a more complete understanding of the roles that judges and juries play in the rapidly evolving arena of cyberspace litigation, all Internet-related cases in which a plaintiff received a punitive damages award were surveyed. This database of punitive damages awards in cyberspace was drawn from a variety of published and unpublished court opinions from the decade of 1992 to 2002. The appendix to this article describes the research methods and sources consulted to assemble the database on punitive damages in cyberspace. The research universe for this study is all Internet-related cases decided in state and federal courts during the first decade of Internet litigation.[25] Each of the reported findings is drawn from a larger universe of 484 cases in which plaintiffs received legal or equitable relief in an Internet-related case in a U.S. state or federal court between 1992-2002. The research findings reported below focus upon the cases in which prevailing cybertort plaintiffs received a punitive damages award.

25 For each Internet case, background information and data was compiled on the characteristics of plaintiffs, defendants, size of awards, and post-trial adjustments.

B. Research Findings

1. Punitive Damages in Cyberspace Are Increasing and Being Awarded at a Higher Rate than in Traditional Tort Caseloads

Table One

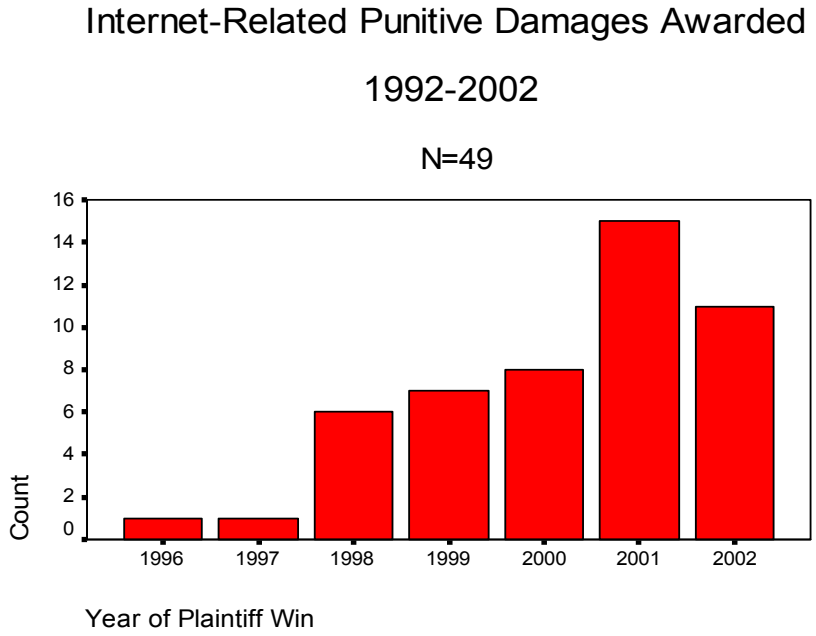

Table One depicts the forty-nine Internet related cases in which a plaintiff received a punitive damages award in all state and federal courts for the decade ranging from 1992 to 2002. The overall rate of punitive damages was roughly 10% of all Internet cases (49 of 484) in which either equitable or legal remedies were granted. Punitive damages are far more likely to be awarded in cybertort cases in which at least some monetary award was made. In the 187 cyberspace cases where money damages were awarded, punitive damages were also assessed in 49 cases (26%).

Table One suggests that the overall rate of punitive damages is greater in the Internet realm than in the real space world. All of the empirical studies of punitive damages agree that the rate of punitive damages is less than one in ten in cases where the

plaintiff prevailed.[26] The most comprehensive study of punitive damages in state courts was completed by researchers at the Bureau of Justice Statistics ("BJS").[27] The BJS study of civil courts of seventy-five of the largest American counties found that "[o]f the 12,026 verdicts in the sample, plaintiffs won a total of 364 punitive damages awards," which was less than 6% of the cases.[28] All prior empirical studies of the rate of punitive damages confirm that the overall rate is substantially lower than in cyberspace cases.[29] The higher overall rate of punitive damages may be explained by the fact that every case involved a defendant whose conduct was intentional. Another explanation would be that many of the cases involved repeat offenders such as spammers, pornographers, or wrongdoers who fled the jurisdiction.

Still, there were less than fifty punitive damages awards in a decade in all state and federal courts. The high-water mark for punitive damages in Internet cases occurred in 2001 with a total of only fifteen awards in all state and federal courts. As these numbers demonstrate, punitive damages are still a thimble-full of cases in the ocean of litigation.

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26 As one scholar reports:

> Studies conducted by researchers at the RAND Corporation found that punitive damages are only awarded in 1-8% of civil cases. Other studies have found punitive damages to be awarded at similar rates. In the sample of cases examined by Daniels and Martin, punitive damages were awarded in only 4.9% of civil cases and in 8.8% of cases in which the plaintiff prevailed.

Jennifer K. Robbennolt, *Determining Punitive Damages: Empirical Insights and Implications for Reform*, 50 BUFF. L. REV. 103, 161 (2002) (internal citations omitted).

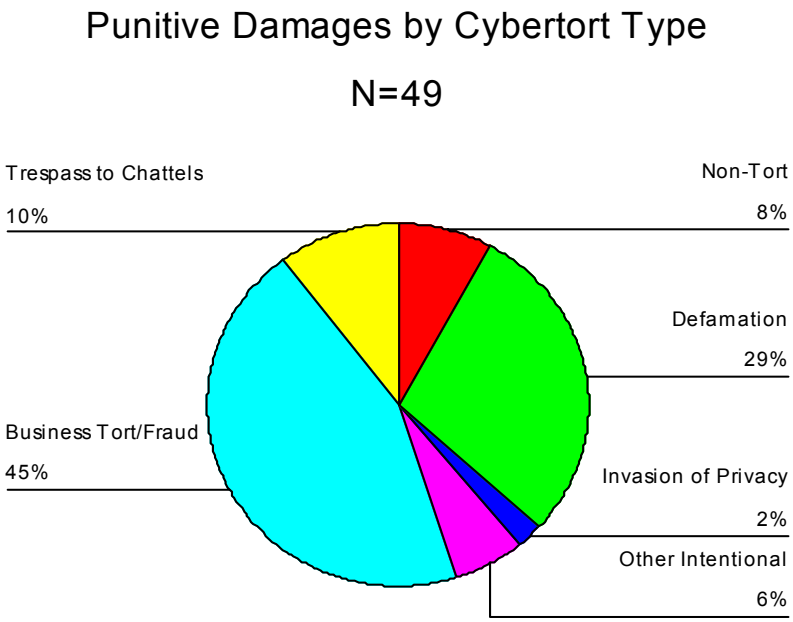
27 Bureau of Justice Statistics, U.S. Dep't of Justice, *Civil Justice Statistics*, *at* http://www.ojp.usdoj.gov/bjs/civil.htm (last revised Oct. 1, 2001).

28 Marc Galanter, *Real World Torts: An Antidote to Anecdote*, 55 MD. L. REV. 1093, 1127 (1996).

29 Michael L. Rustad, *Unraveling Punitive Damages: Current Data and Further Inquiry*, 1998 WIS. L. REV. 15, 17-33 (1998) (reporting the results of nine empirical studies of punitive damages and concluding that the rate of punitive damages is low).

2. Show Me the Money: Punitive Damages Are Mostly Found in Intentional Tort Cases Filed By Businesses To Recoup Economic Loss

Table Two



The first decade of punitive damages in cyberspace shares common ground with eighteenth-century English law where the elite used the legal system to achieve greater power.[30] Forty-five of the forty-nine punitive damages awards arose out of predominately cybertort cases, but every tort cause of action in the cyberlaw punitive damages sample arose out of an intentional tort. Most punitive awards arose in business tort cases filed by online or bricks-and-mortar[31] businesses. Cybertort punitive damages were predominately awarded in

30 Michael L. Rustad & Thomas H. Koenig, *Taming the Tort Monster: The American Civil Justice System as a Battleground of Social Theory*, 68 BROOK. L. REV. 1, 11 (2002) (describing Blackstone's Commentaries on English Law as reflecting the values of property owners and wealthy elites) [hereinafter Rustad & Koenig, *Taming the Tort Monster*].

31 A bricks-and-mortar business is an established company with a physical headquarters in the real space world as opposed to a purely online business with only a virtual presence.

economic loss cases rather than personal injury cases, which are the province of traditional tort law. Punitive damages in Internet-related cases have not yet developed in cases based upon negligence or strict liability.

The few cases where individuals obtained punitive damages often were in cases involving reputation or privacy injuries.[32] In fact, online defamation cases alone accounted for 29% of all punitive damages awarded in cyberspace cases during the ten-year period of the study.[33] For example, a doctor defamed by an Internet posting charging him with taking kickbacks led to a punitive damages award.[34] In another case, a University of North Dakota physics professor won a large punitive damages award against a former graduate student who accused him in online postings "of being a pedophile and having odd sexual habits."[35] In a Florida case awarding punitive damages, an Internet web page contained numerous defamatory postings pertaining to the plaintiff and his children.[36]

The most interesting aspect of Table Two is the cases that were not developed. No consumer was awarded punitive damages in a products liability action for bad software, the transmittal of a virus, or a faulty Internet security product. No consumer prevailed in a medical malpractice case arising out of telemedicine.[37] Moreover, not a single punitive damages award was handed out in any substantive area of the law predicated upon either negligence or strict liability.

Surprisingly, there were no personal injury lawsuits arising out of a decade of Internet sales or services. Punitive damages in cyberspace cases were predicated upon intentional tort causes of action, generally in business disputes. The business tort cases,

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32 *See infra* Appendix A. *See also* Varian Med. Sys., Inc. v. Delfino, No. 780187, 2001 WL 1904203 (Cal. Super. Ct. Dec. 17, 2001) (assessing $350,000 in punitive damages for "more than 14,000 defamatory and sometimes vulgar messages on more than 100 Internet message boards" accusing company executives of having illicit sexual relations and other bad acts).

33 *See, e.g.*, Matos v. Am. Fed'n of State, County & Mun. Employees, No. CV980578747, 2001 WL 1044632, at *1 (Conn. Super. Ct. Aug. 13, 2001) (reporting defamation claim by corrections department employee against union).

34 Graham v. Oppenheimer, JVR No. 382280, 2000 WL 33232110 (E.D. Va. Oct. 2000) (awarding $350,000 in punitive damages).

35 Scott Carlson, *North Dakota Professor Sues Former Student and a Web Site Over Allegations in an Article*, CHRON. HIGHER EDUC., Jan. 19, 2001, at A33.

36 Bagwell v. Phillips, No. 97-13631, 1998 WL 1656174 (Fla. Cir. Ct. Nov. 23, 1998) (awarding $15,000 in punitive damages).

37 "The Institute of Medicine has defined telemedicine to encompass telephone, video and electronic transmission of medical information using telephone or digital technology." Alissa R. Spielberg, *Online Without a Net: Physician-Patient Communication by Electronic Mail*, 25 AM. J.L. & MED. 267, 287-88 (1999) (citing COMM. ON EVALUATING CLINICAL APPLICATIONS OF TELEMEDICINE, INST. OF MED., TELEMEDICINE: A GUIDE TO ASSESSING TELECOMMUNICATIONS IN HEALTHCARE 16-17 (1996)).

which accounted for nearly half of the punitive damages awards (45%), included actions for the intentional interference with contract, unfair and deceptive trade practices, intentional interference with economic opportunities, intentional interference with noncommercial opportunities, unfair competition, fraudulent misrepresentation, and the misappropriation of trade secrets. However, most of the Internet-related business tort cases involved large companies suing rivals or other companies interfering with their businesses.[38]

A typical business tort case where punitive damages were awarded occurred when one dot-com company sued another dot-com over a generic domain name.[39] Punitive damages were also awarded in a wrongful discharge case against a former dot-com company.[40] Bitter internecine business disputes between online companies and employees accounted for another large segment of cases.[41]

The legally protected interest in the vast majority of cybertort awards was to protect intellectual property interests such as trademarks, domain names, or trade secrets. A court levied a $65 million judgment against an online pornographer for pirating the sex.com domain name.[42] The court's award included $25 million in punitive damages to punish the defendant's fraudulent scheme perpetrated by a forged letter to a domain name registrar.[43]

In *Brookfield Communications, Inc. v. West Coast Entertainment Corp.*,[44] the Ninth Circuit reversed the district

38 *See, e.g.*, eBay, Inc. v. Bidder's Edge, Inc., 56 U.S.P.Q. 2d (BNA) 1856 (N.D. Cal. 2000) (involving rival Internet companies suing over alleged anticompetitive conduct, such as tortious interference with an advertising contract).

39 Xuan-Thao N. Nguyen, *Shifting the Paradigm in E-Commerce: Move Over Inherently Distinctive Trademarks – The E-Brand, I-Brand and Generic Domain Names Ascending to Power?*, 50 AM. U. L. REV. 937, 977 (2001) (describing a case where E-cards.com was awarded $1 million in punitive damages in its unfair competition action against Ecards.com).

40 Moreau v. Direct Express, No. BC 222666, 2001 WL 761748, at *1 (Cal. Super. Ct. Mar. 21, 2001).

41 *See, e.g.*, *Home Interactive Corporation Wins $11 Million Verdict*, *at* http://www.marketwire.com/mw/release_html_b1?release_id=36285 (Dec. 21, 2001) (reporting that a jury ordered the former president of a software company to pay punitive damages for stealing company property, disabling the plaintiff's web site, emptying the company's bank account, and generally interfering with the plaintiff's business after he resigned).

42 Laurie J. Flynn, *Cybersquatting Draws Heavy Penalty*, N.Y. TIMES, Apr. 6, 2001, at C4.

43 Robyn Weisman, *Sex.com Plaintiff to Get US $65 Million*, *at* http://www.newsfactor.com/perl/story/8699.html (Apr. 4, 2001). *See* Kremen v. Cohen, 325 F.3d 1035 (9th Cir. 2003) (certifying question to the California Supreme Court).

44 174 F.3d 1036 (9th Cir. 1999).

court's denial of an injunction prohibiting a competitor's use of its rival's trademark in a domain name as well as in metatags on its web site.[45] The dispute grew out of the defendant's use of metatags with its rival's trademark to increase the traffic to another web site. The court compared the misuse of metatags and the diversion of web traffic from the rightful trademark owner's site to "posting a sign with another's trademark in front of one's store."[46] On remand, the District Court denied summary judgment for punitive damages, holding that there was a triable fact as to whether West Coast was aware of Brookfield's rights at the time.[47]

The dataset demonstrates that punitive damages have not yet evolved as a sanction to punish and deter unfair or deceptive practices against consumers in cyberspace. Few plaintiffs found any legal remedy for violations of Internet security, data mining, or the invasion of privacy, although hardly a day passes when there is not a media account of some egregious breach of Internet privacy.

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45 *Id*. at 1066-67.

> Metatags are HTML code intended to describe the contents of the web site. There are different types of metatags, but those of principal concern to us are the "description" and "keyword" metatags. The description metatags are intended to describe the web site; the keyword metatags, at least in theory, contain keywords relating to the contents of the web site.

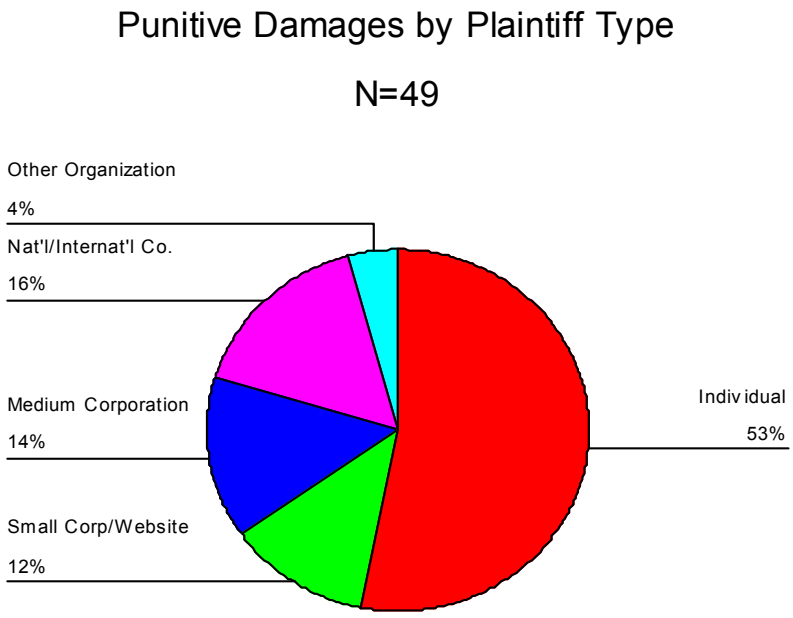
Id. at 1045.

46 *Id*. at 1064.

47 Brookfield Communications, Inc. v. W. Coast Entm't Corp., No. CV 98-9074, 1999 U.S. Dist. LEXIS 23251, at *25-26, 28 (C.D. Cal. June 10, 1999).

3. Punitive Damages Do Not Arise Out of Consumer Transactions

Table Three



Many individual plaintiffs obtained punitive damages for aggravated misconduct growing out of the employment relationship. Although individuals were the largest prevailing plaintiff category, these cases did not arise out of business-to-consumer transactions. For example, no consumer won an award against an Internet seller or renderer of services in a decade of cyberlaw cases.[48] Rather, 100% of the punitive damages awarded to individuals in cyberlaw cases were non-consumer in nature. It is remarkable that for a ten year period, in all U.S. federal and state courts, not a single consumer prevailed in a cyberlaw case in which punitive damages were awarded.

Individuals were the plaintiffs in one of every two punitive damages verdicts in Internet tort cases. However, punitive damages in cyberlaw cases played no meaningful role as a means of consumer protection for individuals. In a decade of punitive

[48] The plaintiff and defendant characteristic as well as the aggravating circumstances for each of the forty-nine cyberlaw cases were systematically coded. *See infra* Appendix A.

damages awards, no case arose out of an online sale or service which could be classified as a consumer transaction.[49] Punitive damages, for example, were not awarded for the failure of online merchants to deliver goods or defective software. Furthermore, no consumer received punitive damages for non-consented transfers of their personal information.

Punitive damages awarded in favor of individuals arose out of non-consumer contexts such as the employment relationship or in disputes between individuals. When punitive damages were awarded to individuals, it was often in the context of ugly disputes arising out of incendiary exchanges on listservs, web sites, or e-mails. Nasty neighborhood disputes sometimes morphed into full-scale punitive damages warfare. The category of cases awarding punitive damages to individuals involved online stalkers,[50] vengeful neighbors,[51] and sexual harassers.[52] For example, when a neighbor published derogatory statements on an Internet web page about a family, the target obtained punitive damages in a Florida court.[53] In that case, the defendant also published photographs of the plaintiff's minor child as well as the child's name, address, and telephone number on the web site.[54] The plaintiff's punitive damages award was based on the common law torts of trespass, slander, nuisance, and intentional infliction of emotional distress.[55]

Many of these non-consumer cases involved business torts where an individual filed suit against a company. In one highly publicized case, two former research scientists employed by a high tech company published over 14,000 defamatory and vulgar messages on their web site and on over 100 Internet message boards.[56] The postings targeted two current corporate executives,

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49 The Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, for example, defines consumer products as meaning "any tangible personal property which is distributed in commerce and which is normally used for personal, family, or household purposes." 15 U.S.C. § 2301(1) (1998). Consumers are defined in the online context as a plaintiff filing an action against a seller or provider of services for actions such as the invasion of privacy, release of defective software, failure to deliver merchandise or similar actions.

50 Tim Doulin, *Jurors Order Stalker to Pay Victims for Internet Harassment*, COLUMBUS DISPATCH (Ohio), Feb. 21, 2002, at C12 (awarding $105,000 to two female musicians who were stalked over the Internet).

51 Bagwell v. Phillips, No. 97-13631, 1998 WL 1656174 (Fla. Cir. Ct. Nov. 23, 1998).

52 *See, e.g.*, Butler v. Krebs, No. 96-1204096, 1998 WL 2023763 (Tex. Dist. Ct. June 8, 1998) (awarding punitive damages against a Continental Express pilot for superimposing plaintiff's photograph onto other female bodies and transmitting the images over the Internet).

53 *Bagwell*, 1998 WL 1656174.

54 *Id.*

55 *Id.*

56 Varian Med. Sys., Inc. v. Delfino, No. 780187, 2001 WL 1904203 (Cal. Super. Ct. Dec. 17, 2001) (noting that plaintiffs alleged libel, invasion of privacy, breach of contract,

accusing them of "having extramarital affairs, videotaping office bathrooms, chronically lying and hallucinating."[57] In another case, a urologist obtained punitive damages against a defendant pathologist and his affiliated medical corporation for anonymous postings on the Internet.[58] Punitive damages were based upon the false accusation that the plaintiff was accepting kickbacks from a bidding company.[59]

Many individual plaintiffs obtained punitive damages for aggravated wrongdoings growing out of the employment relationship. In one bizarre case, a female employee received punitive damages when another employee and his son used the Internet to harrass her by exposing her to web sites devoted to sexual perversion.[60] In another instance, Internet America and its executives were assessed $100,000 in punitive damages, with a total verdict of more than $6 million, in an Internet-related lawsuit for defrauding their former financial officer.[61] The former Internet America executive's contention was that the president of the company defrauded her by convincing her to sell off her stock at a mere $0.80 per share just prior to a successful Initial Public Offering ("IPO").[62]

The second largest plaintiff category is national or international corporations (16%) followed by medium (14%) and small (12%) companies. Court decisions have aided large stakeholders in expanding their identity and intellectual property rights in the new economy. The typical business plaintiff is a "repeat player" or a large corporation with substantial legal and financial resources, such as Playboy Enterprises and America Online ("AOL").[63] According to the survey of cases, the largest stakeholders of the Internet economy

and unfair business practices, and sought compensatory and punitive damages).

57 *Id*. "A Santa Clara County jury awarded $775,000 in compensatory and punitive damages to a business and two of its employees after finding two former employees had libeled the plaintiffs with defamatory and vulgar statements posted on the Internet." *Id*.

58 Graham v. Oppenheimer, No. 00-CV-57, 2000 WL 33381418, at *1 (E.D. Va. Dec. 15, 2000).

59 *Id*. *See also* Graham v. Oppenheimer, JVR No. 382280, 2000 WL 33232110 (E.D. Va. Oct. 2000).

60 Kelly v. Whitley County, No. 00-CV-388, 2002 WL 31932414 (E.D. Ky. Sept. 18, 2002) (awarding $230,000 damages against jailor and county in case involving retaliatory discharge).

61 Carradine v. Internet Am. Inc., No. 05-01-01577-CV, 2001 WL 1825528 (Tex. Dist. Ct. Mar. 26, 2001), *vacated*, 106 S.W.3d 906 (Tex. App. 2003) (vacating due to settlement).

62 *Id*.

63 *See, e.g.*, Am. Online, Inc. v. Nat'l Health Care Disc., Inc., 174 F. Supp. 2d 890 (N.D. Iowa 2001) (awarding $100,000 punitive damages for willful and wanton actions); Am. Online, Inc. v. IMS, No. 98-0011-A, 1998 U.S. Dist. LEXIS 20448 (E.D. Va. Nov. 20, 1998) (magistrate's report recommending award of punitive damages for bad faith actions), aff'd No. 98-0011-A, 1998 U.S. Dist. LEXIS 20645 (E.D. Va. Dec. 30, 1998). *See also* cases cited *infra* notes 156, 157, 164.

were using punitive damages as a tool for consolidating their market share in the Internet economy. Therefore, most cyberlaw cases in the business context feature large Internet companies suing newly-established companies or individuals.

Cybersquatters[64] were frequently sued by powerful Internet industry stakeholders for trademark infringement.[65] John Zuccarini, a notorious cybersquatter, earned millions by registering domain names based upon the common misspellings of trademarks, a practice called "typosquatting."[66] For example, in one case, Zuccarini was ordered to pay damages and attorney fees based upon a finding that the defendant's use of domain names was "confusingly similar," thereby constituting a violation of the federal Anti-Cybersquatting Consumer Protection Act,[67] and an infringement of a famous trademark[68] The court ordered greater damages because the defendant was a recidivist who had been enjoined from registering misspelled names in suits brought by other companies.[69] In another case, America Online sought injunctive relief, compensatory damages, and punitive damages against AT&T, a competing ISP, in a trademark infringement action because AT&T was using the terms "Buddy List," "You have Mail!," and "IM Here."[70]

While large corporations are often plaintiffs in these cases, they rarely find themselves on the defense side of cyberlaw lawsuits. In cases where large corporations were named defendants, punitive damages were rarely awarded.[71] Likewise, the government was a defendant in fewer than 2% of cyberlaw cases—primarily Internet speech cases. Again, punitive damages

64 Cybersquatting is "the practice of registering 'well-known brand names as Internet domain names' in order to force the rightful owners of the marks 'to pay for the right to engage in electronic commerce under their own brand name.'" Virtual Works, Inc. v. Volkswagen of Am., Inc., 238 F.3d 264, 267 (4th Cir. 2001) (quoting S. REP. NO. 106-140, at 5 (1999)).

65 *See, e.g.*, Shields v. Zuccarini, 254 F.3d 476, 479-81, 487 (3d Cir. 2001); Elecs. Boutique Holdings Corp. v. Zuccarini, 56 U.S.P.Q. 2d (BNA) 1705 (E.D. Pa. 2000).

66 *US Authorities*, *supra* note 17.

67 15 U.S.C. § 1125(d) (1998 & Supp. 2003); 113 Stat. 1501, 1537 (1999). Congress enacted the Anti-Cybersquatting Consumer Protection Act to deter the increasing practice of cybersquatting. *Virtual Works, Inc.*, 238 F.3d at 267.

68 *Elecs. Boutique Holdings Corp.*, 56 U.S.P.Q. 2d (BNA) at 1710-11.

69 *Id*. at 1713.

70 Am. Online, Inc. v. AT & T Corp., 243 F.3d 812, 814, 823 (4th Cir. 2001).

71 *See, e.g.*, Amazon.com, Inc. v. Barnesandnoble.com, Inc., 239 F.3d 1343 (Fed. Cir. 2001) (holding that Amazon.com was not entitled to injunctive relief because barnesandnoble.com had raised a substantial challenge to the validity of their "1-click" patent); GoTo.com, Inc. v. Walt Disney Co., 202 F.3d 1199 (9th Cir. 2000) (reinstating preliminary injunction prohibiting Disney from using confusingly similar logo); PlayMedia Sys., Inc. v. Am. Online, Inc., 171 F. Supp. 2d 1094 (C.D. Cal. 2001) (enjoining America Online because its use of software exceeded the license agreement).

were rarely assessed.[72] Rather, defendants such as spammers and online pornographers accounted for most of the punitive damages awards in business tort cases.[73] In cyberspace, the "repeat players" such as America Online and other large Fortune 500 companies have the economic and legal resources needed to successfully litigate punitive damages lawsuits.[74]

No straightforward enforcement mechanism exists for enforcing tort judgments against web site providers who have no physical presence within the United States. Cyberspace judgments are only enforceable if the defendant has assets subject to legal process in the plaintiff's forum state. American courts require the plaintiff to prove minimum contacts sufficient to satisfy due process over a nonresident defendant.[75] Courts have declined jurisdiction in many Internet-related cases, ruling that a passive web site alone is an insufficient basis for jurisdiction.[76] For a court to exercise jurisdiction, the defendant

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72 *See, e.g.*, PSINet, Inc. v. Chapman, 108 F. Supp. 2d 611 (W.D. Va. 2000); Mainstream Loudoun v. Bd. of Trs. of Loudoun County Library, 24 F. Supp. 2d 552 (E.D. Va. 1998).

73 *See, e.g.*, Am. Online, Inc. v. Nat'l Health Care Disc., Inc., 174 F. Supp. 2d 890 (N.D. Iowa 2001) (imposing punitive damages for sending spam e-mail on dental and optical plans); Mattel Inc. v. Internet Dimensions Inc., 55 U.S.P.Q. 2d (BNA) 1620 (S.D.N.Y. 2000) (enjoining pornographer's use of the phrase "Barbie's play pen" on its adult entertainment web site on the grounds that it diluted Mattel's trademark "Barbie" for dolls); Hollywood Entm't Corp. v. Hollywood Entm't, Inc., No. C 98-3670, 1999 U.S. Dist. LEXIS 6466 (N.D. Cal. May 4, 1999) (entering default judgment in favor of family video rental store against pornographic video rental store using identical trademark); Archdiocese of St. Louis v. Internet Entm't Group, Inc., 34 F. Supp. 2d 1145 (E.D. Mo. 1999) (enjoining use of PapalVisit.com domain name by adult entertainment web site because it tarnished the Catholic Church's trademark); Hotmail Corp. v. Van$ Money Pie Inc., 47 U.S.P.Q. 2d (BNA) 1020 (N.D. Cal. 1998) (enjoining defendants from using its trade name and service marks in spam e-mail); Hasbro Inc. v. Internet Entm't Group, Inc., 40 U.S.P.Q. 2d (BNA) 1479 (W.D. Wash. 1996) (enjoining pornographer's misuse of CANDYLAND trademark in domain name).

74 Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 97-114 (1974).

75 A threshold issue in many Internet cases is whether an out of state defendant may be subject to process in the forum. The inquiry frequently focuses on whether the defendant's web site activities are interactive or passive:

> The great majority of these cases have adopted the analytical framework of Zippo Manufacturing Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119, 1124 (W.D. Pa. 1997). In *Zippo* – also a case of specific jurisdiction – the court examined the few cases that had previously addressed the issue of whether a Web site could provide sufficient contacts for specific personal jurisdiction. It applied the results of these cases to the traditional personal jurisdiction analytical framework, noting that "the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of the commercial activity that an entity conducts over the Internet."

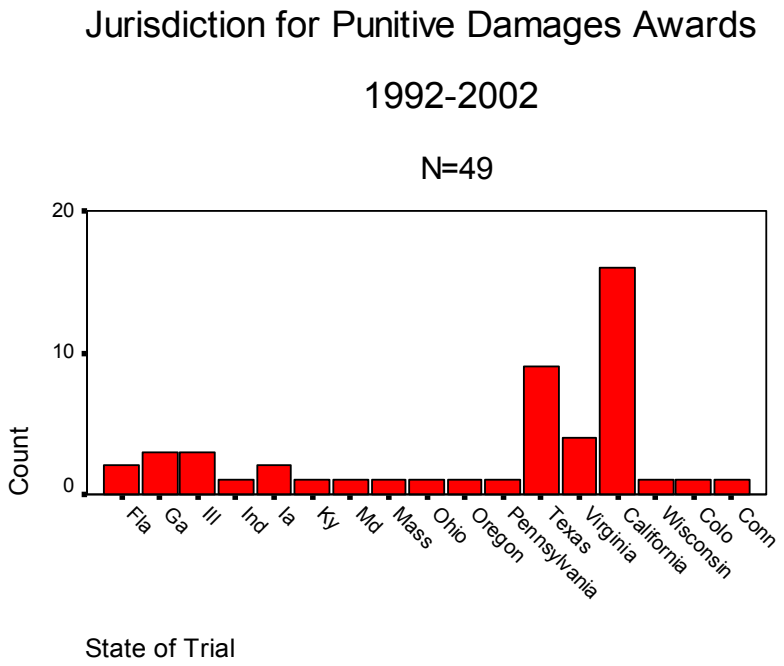
Lakin v. Prudential Secs., Inc., 348 F.3d 704, 710 (8th Cir. 2003) (affirming the district court's finding that the plaintiff had not proven minimum contacts to satisfy due process, but reversing on the issue of general jurisdiction ordering additional discovery).

76 *See generally* MICHAEL RUSTAD & CYRUS DAFTARY, E-BUSINESS LEGAL HANDBOOK § 7.03 (2003 ed.).

must have sufficient "minimum contacts" such that they have "purposefully availed" themselves of the privilege of doing business in the forum.[77] The issue of purposeful availment turns on factual circumstances such as whether the web site targeted residents in the plaintiff's jurisdiction.[78]

4. Punitive Damages Are Awarded In Internet Economy Strongholds

Table Four



Punitive damages in cyberspace between 1992-2002 were handed down in only a handful of states. The state of California accounted for approximately one in three punitive damages awards (N=16, 33%). Texas ranked second with 9 of the 49

77 *See, e.g.*, Bridgeport Music, Inc. v. Still N the Water Publ'g, 327 F.3d 472, 480-84 (6th Cir. 2003) (reversing district court's purposeful availment determination as to record company), cert. denied, 124 S. Ct. 399 (2003); Neogen Corp. v. Neo Gen Screening, Inc., 282 F.3d 883, 890 (6th Cir. 2002) (holding that the purposeful availment requirement is satisfied "if the website is interactive to a degree that reveals [that the defendant] specifically intended interaction with residents of the state"); Biometics, LLC v. New Womyn, 112 F. Supp. 2d 869, 872-73 (E.D. Mo. 2000) (selling products on web site to state residents constituted purposeful availment).

78 The leading case in this area is *Zippo Manufacturing Co. v. Zippo Dot Com, Inc.*, which developed a continuum where the middle ground is the borderline between passive and active web sites. 952 F. Supp. 1119, 1124 (W.D. Pa. 1997).

punitive damages awards (18%) followed by Virginia with four (8%) and Georgia and Illinois with three each. These five states were the only jurisdictions that handed down three or more punitive damages awards in Internet-related cases during that ten-year period.[79] Seventy-one percent of punitive damages in cyberspace cases were awarded in these five jurisdictions (N=35). Only twelve other states had one or more punitive damages awards during a decade of Internet-related litigation in all federal and state courts.[80]

Table Four documents that punitive damages coalesced in the epicenters of the Internet economy and were correlated with the location of key Internet companies. Table Four also confirms that the cyber-jurisdictional hot spots roughly correspond to centers of the Internet economy. A disproportionate number of punitive damages awards were made in states with powerful computer-based, entertainment or software industries. Two information-age leaders, California and Texas, accounted for greater than half of the punitive damages awards handed down in the decade 1992-2002. In many of these cases the plaintiff was a Texas or California corporation seeking redress against domain name entrepreneurs, cyberpirates, or online business competitors.

The greater incidence of punitive damages may be partially explained by the prominence of these states in the information economy. California's robust pattern of litigation is due to the dominance of the entertainment, high technology, and software industries. Similarly, Texas is rapidly becoming an epicenter of the computer software industry. Another notable mention is the Northern District of Virginia, where a flurry of anti-spam cases filed by America Online accounts for almost all of Virginia's punitive damages caseload in the decade studied. As we shall see, the empirical evidence suggests that punitive damages served primarily as a corporate means of legal control to protect the information industries in these states from spammers, cyberpirates, infringers, and other Internet wrongdoers.

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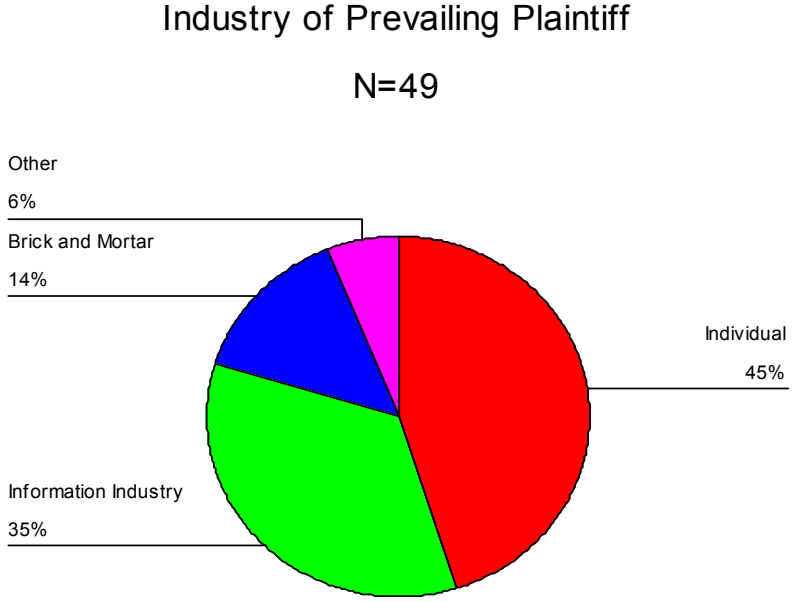
79 In the larger study of torts in cyberspace, seventy percent of the cybertorts were decided in only five states: California (33%, N=38), Illinois (4%, N=5), New York (6%, N=7), Texas (13%, N=15) and Virginia (13%, N=15). *See infra* Appendix A.

80 Professor Saks, University of Iowa, concludes that no reliable data exists on plaintiff wins or even the size of awards over time in traditional tort litigation. Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System – And Why Not?*, 140 U. PA. L. REV. 1147, 1154 (1992).

5. Punitive Damages Act as a Form of Corporate Self-Help

Table Five



a. Corporate Dominance in Cyberspace

Forty-nine percent of the cyberlaw punitive damages awards were assessed in favor of companies classifiable as either predominately a brick-and-mortar company or one in the information industry.[81] A content analysis of the cases in these industries confirms that corporate America is a major beneficiary of the punitive damages sword. Companies in all industries outnumber individual plaintiffs and many of the disputes involve powerful Internet stakeholders vindicating their rights in

81 The largest component of the "information industry" is made up of ISPs, online service providers, and telecommunication providers, which together account for 15% of all cases. Computer software companies, such as Microsoft, Adobe, Intel, and the larger ISPs were the big winners in cyberspace. Internet-based companies with a bricks-and-mortar presence constituted the single largest plaintiff class among the non-individual plaintiffs. ISPs accounted for the next largest plaintiff category industry, followed by other online sales and services. Miscellaneous organizations accounted for only two punitive damages awards. The information industry plaintiffs included companies that predominately involved the transfer of intangible products such as software, entertainment content, and other intangibles. ISPs such as America Online and Earthlink constituted one of the largest sectors of the information industry in the sample. Other organizations included non-profits. The research universe did not include governmental organizations as prevailing plaintiffs.

cyberspace.[82] The individual plaintiffs depicted in Table Five prevailed in cases arising out of non-consumer claims.[83] Stockholders, investors, or employees received punitive damages in only three of the forty-nine (6%) Internet-related cases involving securities fraud or the failure to pay stock options.[84] The residual "other" category included a few nonprofit organizations.[85] The next subsection examines the functions of punitive damages for corporate plaintiffs in business-to-business transactions.

b. Corporate Self-Help Remedy in Cyberspace

i. Protecting Trade Secrets in Cyberspace

In the Internet economy, the crown jewels of a company may be confidential information such as source code or methods of doing business online. Accordingly, companies have used punitive damages as a tool to redress the misappropriation of trade secrets. Trade secrets on the Internet may be lost at the

82 *See, e.g.*, EarthLink, Inc. v. Smith, 13 Internet L. & Reg. (P&F) 94, (N.D. Ga. July 9, 2002) (awarding punitive damages against spammer in favor of large ISP); Am. Online, Inc. v. Nat'l Health Care Disc., Inc., 174 F. Supp. 2d 890 (N.D. Iowa 2001) (awarding punitive damages to AOL); Schmerin v. CD Titles, Inc., No. SUCV95-07061, 1998 WL 1754045 (Mass. Super. Ct. Mar. 30, 1998) (awarding punitive damages to business against small web site). *See also* Nguyen, *supra* note 39, at 977 (noting the award of punitive damages in a business tort dispute over domain name between E-cards.com and ECards.com); *Neon Systems Says It Won $39 Million Verdict*, N.Y. TIMES, June 6, 2001, at C4 (punitive damages awarded in business torts case).

83 Non-consumer cases frequently arose out of the employment relationship. *See, e.g.*, Butler v. Krebs, No. 96-1204096, 1998 WL 2023763 (Tex. Dist. Ct. June 8, 1998) (awarding punitive damages against airline and co-workers for superimposing nude image of female pilot on web site and intranet among other acts of online harassment); Franza v. Hayes, No. 802402, 2001 WL 1137243 (Ga. Fulton County Ct. May, 2001) (awarding punitive damages to employee in workplace case).

84 There were a few Internet-related securities fraud cases in which punitive damages were awarded for new dot-com businesses that allegedly defrauded investors. In one case, investors were awarded $250,000 in punitive damages when directors of an educational web site misrepresented that its stock would be registered and that the investors would receive stock in another web site company. Chee v. PinkMonkey.com, Inc., No. 00-38766, 2002 WL 1919479 (Tex. Dist. Ct. June 11, 2002).

85 The research sample excludes actions by the Federal Trade Commission ("FTC"), Securities & Exchange Commission, and other government agencies prosecuting actions against cyberspace defendants. The sample includes cases where an individual or corporate entity files suits against a government agency as a wrongdoer. Civil penalties filed by the FTC in cyberspace cases are increasing rapidly. The cases in the FTC sample disproportionately included defendants advertising miracle health products, get rich business schemes, false credit repair schemes, deceptive investment opportunities, pyramid schemes, deceptive adult entertainment sites, spam e-mailers, and other marginal businesses. In recent years, FTC enforcers are expanding their enforcement sweeps to include mainstream companies. Gateway.net, for example, was fined for advertising free Internet services without the disclosure that long distance charges were not free. The FTC is also expected to expand its enforcement against web sites surreptitiously collecting consumer personal information. *Gateway Settles FTC Charges Over Free Internet Service Claims*, *at* http://www.ftc.gov/opa/2001/05/gateway.htm (May 15, 2001).

click of the mouse and must be protected by measures to guard the secrecy of information transmitted. Some of the first cyberlaw cases involved litigation to vindicate the misappropriation of trade secrets. The first online trade secrets cases arose out of the Church of Scientology's attempt to enjoin further distribution of church doctrine on web sites.[86] In one case, the Church of Scientology filed suit against the Washington Post for publishing portions of Scientology doctrine entitled "Advanced Technology," which were claimed as trade secrets.[87] The federal district court denied injunctive relief finding that the defendants' actions were protected by the fair use doctrine of federal copyright law and that the disputed documents were no longer a trade secret as they had already been posted on the Internet.[88]

Trade secrets in the online world deserve the same protections as in the bricks-and-mortar world. Internet trade secrets are particularly vulnerable because the interconnected system of computers makes it possible for hackers, ex-employees, and experts in corporate espionage to steal information without leaving physical evidence. The Internet economy is known for a rapid turnover in employees, and online companies face the constant danger that an ex-employee will misappropriate trade secrets for use in a competitor's business. For example, Monster.com recently settled a trade secret lawsuit against its former president and eighteen ex-employees who left the company to join a rival Internet company.[89]

The misappropriation of trade secrets is a popular cause of action to protect the intangible assets of companies connected to the Internet.[90] In *DoubleClick, Inc. v. Henderson*,[91] several employees of a prominent Internet advertising company planned to leave in order to form a dot-com startup.[92] DoubleClick

86 *See, e.g.*, Religious Tech. Ctr. v. Netcom On-Line Communication Servs., Inc., 907 F. Supp. 1361, 1365-66 (N.D. Cal. 1995) (refusing to enjoin bulletin board service which posted church documents); Religious Tech. Ctr. v. Lerma, 908 F. Supp. 1362, 1369 (E.D. Va. 1995) (granting defendant's motion for summary judgment because there was no trade secret misappropriation).

87 *Lerma*, 908 F. Supp. at 1364-65.

88 *Id*. at 1367-68. *See also* Religious Tech. Ctr. v. F.A.C.T.NET, Inc., 901 F. Supp. 1519 (D. Colo. 1995) (denying preliminary injunction where balance of harms weighed against the plaintiff in case involving Church doctrine allegedly protected as trade secrets).

89 *Monster.com Ends Suit on Ex-Workers*, N.Y. TIMES, May 1, 2001, at C7.

90 *See, e.g.*, SNA, Inc. v. Array, 51 F. Supp. 2d 554 (E.D. Pa. 1999) (enjoining use of plaintiff's domain name as trademark infringement and enjoining meta tagging of plaintiff's trademarks as unfair competition), *aff'd sub nom.*, Silva v. Karlson, 259 F.3d 717 (3d Cir. 2001).

91 No. 116914/97, 1997 WL 731413 (N.Y. Sup. Ct. Nov. 7, 1997).

92 *Id*. at *3.

confiscated one of the employee's laptops and found information on the hard drive, including e-mails and future business plans that provided evidence suggesting the misappropriation of trade secrets.[93]

Punitive damages are increasingly used as a corporate tool to punish and deter competitors that misappropriate trade secrets.[94] The Uniform Trade Secrets Act[95] ("UTSA") provides a wide array of remedies for trade secret misappropriation, including preliminary injunctive relief, monetary damages, lost profits, consequential damages, lost royalties, and attorneys' fees.[96] Section 3 of UTSA also gives the court the power to award "exemplary damages in an amount not exceeding twice any award."[97]

In October 2003, the Internet Truckstop, a web site devoted to improving efficiencies in freight services,[98] received a $120,000 punitive damages award against a competitor, Getloaded.com for the theft of trade secrets.[99] The judge imposed punitive damages after the jury found Getloaded.com liable for hacking into Internet Truckstop's computer system and misappropriating computer codes and other trade secrets.[100]

In yet another case, a California court imposed $2.25 million in punitive damages and $4.3 million in compensatory damages against a Seattle firm for misappropriating an Internet company's technology for pop-up ads.[101] The defendants, who were in the business of selling cameras, used the plaintiff's pop-up technology to feature "cameras trained on scantily clad women."[102] The plaintiffs charged the defendant with failing to pay online advertising revenues and with misappropriating client lists that were used to start the defendant's own company.[103]

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93 *Id*.

94 *See, e.g.*, Bob Mims, *Overstock.com Sues Two Former Employees*, SALT LAKE TRIB., Dec. 9, 2003, at E9 (reporting that an Internet closeout retailer filed a trade secret claim seeking punitive damages against former employees who allegedly sold customers' e-mail addresses to spammer).

95 THE NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS, UNIF. TRADE SECRETS ACT WITH 1985 AMENDMENTS §§ 3-4 (1985).

96 *Id*. at § 3.

97 *Id*.

98 The services offered by the Internet Truckstop included freight matching and its corporate goal is to "'[f]ill empty trailers.'" John D. Schulz, *Attacking Inefficiencies*, TRAFFIC WORLD, Sept. 18, 2000, at 33 (quoting Internet Truckstop executive, Scott Moscrip).

99 *Trucking Site Appeals $510K Verdict, $120K in Punitives in CFAA Case*, 16 SOFTWARE L. BULL. 3 (Oct. 2003).

100 *Id*.

101 Claire Luna, *Court Victory for Firm Run by 3 Brothers*, L.A. TIMES, Nov. 19, 2003 (Orange County ed.), at B3.

102 *Id*.

103 *Id*.

In general, large, established companies prevail in cybertort cases against smaller rivals, startups, or web sites. Punitive damages have been imposed in questionable business torts cases where the evidence of aggravated circumstances was weak or non-existent. The typical domain name dispute is a control struggle between an established trademark owner and an Internet entrepreneur who has registered a domain name containing the same trademark.

ii. Punitive Damages and Domain Name Warfare

Domain name disputes typically arise when the registrant, in an effort to attract Internet users, obtains the right to use a domain name that is substantially similar or identical to the trademarks or the name of a famous company or person. The impact on the trademark owner's business may be dramatic because of the confusion created by a misleading domain name address.

In *Kremen v. Cohen*,[104] ex-convict Stephen Cohen forged a letter to a domain name registrar, Network Solutions, claiming it was a letter he received from Online Classifieds.[105] The forged letter tricked the registrar into assigning Kremen's rights to the domain name, sex.com, to Cohen.[106] Cohen's letter "claimed the company had been 'forced to dismiss Mr. Kremen,' but 'never got around to changing our administrative contact with the internet registration [sic] and now our Board of directors has decided to *abandon* the domain name sex.com.'"[107] Judge Alex Kozinski observed:

> Despite the letter's transparent claim that a company called "*Online* Classifieds" had no Internet connection, Network Solutions made no effort to contact Kremen. Instead, it accepted the letter at face value and transferred the domain name to Cohen. When Kremen contacted Network Solutions some time later, he was told it was too late to undo the transfer. Cohen went on to turn sex.com into a lucrative online porn empire.[108]

Kremen filed a lawsuit against the perpetrator of the fraud as well as an action for conversion against the registrar for permitting the fraudulent transfer of sex.com.[109] The district court concluded that the letter had been forged, and accordingly,

104 337 F.3d 1024 (9th Cir. 2003).
105 *Id*. at 1039.
106 *Id*.
107 *Id*.
108 *Id*. at 1027.
109 337 F.3d at 1027-28.

directed the defendant to return the domain name to Kremen.[110] The court also invoked the constructive trust doctrine as well as California's unfair competition statute and ordered disgorgement of the defendant's profits.[111] The evidence was undisputed that Cohen had forged the letter, whereby the owner, Kremen, through his housemate, purportedly transferred the "sex.com" domain name.[112] The district court, however, ruled that the registrar was not liable since domain names could not be converted.[113] The Ninth Circuit reversed, holding that Network Solutions could be held liable for conversion in transferring Kremen's domain name to a con artist since California's law of conversion covers the theft of intangibles.[114] However, the defendant fled to Mexico, thumbing his nose at the court by secreting his assets in offshore locations beyond the reach of process.[115]

In *Simon Property Group, L.P. v. mySimon, Inc.*,[116] Simon Property Group ("SPG"), a bricks-and-mortar company that designed and managed shopping malls, brought suit against mySimon, a dot-com company that had launched a web site in October 1998.[117] Six months after mySimon's launch, SPG started "a corporate 'branding' campaign to inform consumers that it owned and managed certain shopping malls," although it had never considered such a campaign necessary in its 40 years of existence.[118] "SPG demanded that mySimon stop using the 'mySimon' name," but the dot-com refused.[119] SPG filed a trademark infringement lawsuit under the Lanham Act as well as business tort claims under Indiana state law.[120]

The gravamen of SPG's claim was that it had exclusive rights to the "Simon" name, and therefore, "that mySimon's name, Web address, and cartoon mascot named 'Simon' infringed on its rights."[121] The appeals court noted that SPG presented weak evidence that the "'Simon' name had attained secondary

110 *Id*. at 1027.

111 *Id*. The lower court "awarded $40 million in compensatory damages and another $25 million in punitive damages" under California's unfair competition statute. *Id.*

112 Kremen v. Cohen, No. C 98-20718, 2000 WL 1811403, at *1 (N.D. Cal. Nov. 27, 2000).

113 337 F.3d at 1036 (affirming dismissal of plaintiff's conversion claim against domain name registrar).

114 *Id*.

115 *Id*. at 1027 ("The district court froze Cohen's assets, but Cohen ignored the order and wired large sums of money to offshore accounts.").

116 282 F.3d 986 (7th Cir. 2002).

117 *Id*. at 987-88.

118 *Id*. at 988.

119 *Id*.

120 *Id*.

121 *Simon Prop. Group*, 282 F.3d at 988.

meaning or that consumers were likely to confuse SPG with mySimon."[122] MySimon presented a highly probative consumer survey "demonstrating that there was no likelihood of confusion between mySimon and SPG."[123] Despite this compelling defense to SPG's claim of trademark infringement, the jury handed down an $11.5 million compensatory damages award against mySimon, even though the record showed that mySimon had not yet earned profits.[124] The jury also awarded $5.3 million for corrective advertising and $10 million in punitive damages.[125] Finally, the court permanently enjoined mySimon from using or incorporating the terms "Simon" or "my Simon" in any Internet site and from using its "Simon" cartoon mascot on its web site.[126]

However, the trial judge "found that requiring mySimon to change its name provided sufficient relief," and therefore, reversed the $11.5 million damages award.[127] The judge also reduced the $10 million punitive damages award to $50,000 as required by Indiana's tort reform statute.[128] Finally, the judge "ordered a new trial on the corrective advertising issue, subject to SPG's acceptance of a *remittitur* to nominal damages of $10."[129] The Seventh Circuit dismissed SPG's appeal on the grounds that the company had "voluntarily abandoned its quest for a preliminary injunction after the district court denied its TRO motion," and because "[t]he potential threat to SPG's name [was] questionable."[130] In this case, the court apparently found that the corporate plaintiff was "pushing the envelope" in using punitive damages to protect its rights and defend its market position.

iii. Protecting Corporate Reputations in Cyberspace

Bitter disputes arise over the use of the Internet to impugn the reputation of companies by posting allegedly false information. In *Amway Corp. v. Procter & Gamble Co.*,[131] Amway brought suit against Procter & Gamble ("P & G") after a third party published on the Internet a complaint P&G had filed in another case. P & G's posted complaint contained allegedly defamatory statements about Amway, its officers, and its

122 *Id*. at 988, 991.
123 *Id*. at 989.
124 *Id*.
125 *Id.*
126 *Simon Prop. Group*, 282 F.3d at 989.
127 *Id*.
128 *Id*. at 989-90.
129 *Id*.
130 *Id*. at 990-91.
131 346 F.3d 180 (6th Cir. 2003).

business practices, asserting that Amway was operating as an illegal pyramid scheme.[132] The district court granted P & G's motion for summary judgment and found that Michigan's Reporting Privilege protected the accurate posting of the publicly available court documents.[133] The Sixth Circuit affirmed the dismissal, finding that even if the statements in the original document were defamatory, their publication on the Internet did not constitute an additional act of libel on P & G's part.[134] Disputes between business competitors over Internet activities may amount to legal warfare. The Sixth Circuit observed that the "hate-filled history between P & G and Amway would take a writing as long as both the Old and New Testaments and involve at least one of the Good Book's more prominent players."[135]

The Internet makes it easy to falsify return e-mail addresses, allowing web site posters to defame corporate actors anonymously.[136] The corporate plaintiffs are sometimes forced to subpoena ISPs in order to discover the identity of these John Doe defendants.[137] The use of John Doe subpoenas to unveil Internet corporate critics creates a conflict between tort law and the rights of free speech.

A California company and two of its executives filed a libel and invasion of privacy-based lawsuit against two ex-employees who posted a series of messages on an Internet bulletin board devoted to the company's publicly traded stock.[138] The offending "messages maligned the company's products and suggested that the two executives were incompetent and dishonest and that one of them, a woman, might have obtained her position by having sex with a supervisor."[139] A California jury found the ex-employees liable for invasion of privacy, libel, breach of contract, and conspiracy, and awarded $425,000 in general damages and

132 *Id*. at 181.

133 *Id*. at 187.

134 *Id*.

135 *Id*. at 182 (internal footnote omitted).

136 Trade libel is similar to an ordinary defamation case in that a defendant has published a false and derogatory statement about a company. Vondran v. McLinn, No. C 95-20296, 1995 U.S. Dist. LEXIS 21974, at *14 (N.D. Cal. July 5, 1995). The test for business defamation is "'whether, in the circumstances, the writing discredits the plaintiff in the minds of any considerable and respectable class of the community.'" Smith v. Suburban Rests., Inc., 373 N.E.2d 215, 217 (Mass. 1978) (quoting Muchnick v. Post Publ'g Co., 125 N.E.2d 137, 138 (Mass. 1955)).

137 *See* Am. Online, Inc. v. Anonymous Publicly Traded Co., 542 S.E.2d 377 (Va. 2001) (involving a corporation seeking to force America Online to reveal the identities of anonymous web posters).

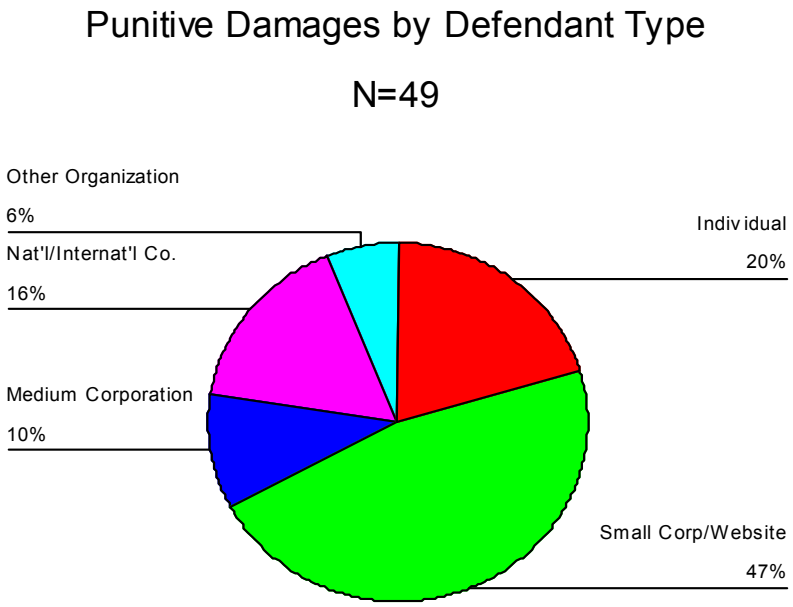
138 *Varian Wins $775,000 Jury Verdict in Internet Libel Case*, *at* http://www.orrick.com/news_events/releases.asp?action=article&articleID=56 (Dec. 18, 2001).

139 David Watson, *C.A.: Defamatory Internet Posting Libel, Not Slander*, METROPOLITAN NEWS-ENTERPRISE (Los Angeles), Nov. 14, 2003, at 1.

$350,000 in punitive damages.[140] The trial judge enjoined the defendants from posting additional defamatory information.[141] It is becoming clear that corporations are using punitive damages as a form of self-help to protect their intellectual property and intangible assets, and to punish trade libel.

6. Punitive Damages Are Assessed Against Corporate Mice Not Elephants

Table Six



a. Small Companies Comprise the Largest Category of Cybertort Defendants

Table Six suggests that small companies are more likely to be defendants in cyberspace tort cases than large or medium corporations.[142] A total of 47% (N=23) of the punitive damages

140 *Id.*

141 *Id.*

142 Punitive damages were rarely awarded in favor of small companies against large companies. Of the awards handed down against large corporate defendants, individuals won five of these cases. Two of three were won by a medium sized company and only one punitive damages award was in favor of a small company against a large company. In contrast, seven out of eight punitive damages awards won by large companies (defined as companies with a Fortune 500 presence or nationally known brand) were awarded against small corporate web sites or startup companies.

defendants were either small online companies or web sites. Medium-sized companies were defendants in only five cyberlaw cases in which punitive damages were awarded. Of the five cases, three awards were in favor of employees of that corporation. Of the remaining two awards assessed against medium-sized companies, one award was to another medium-sized company and the other to a national company. No small company prevailed against a medium-sized company in a decade of cyberlaw cases. The pattern suggests that small online companies are frequently targeted in punitive damages litigation. Still, the overall numbers of punitive damages awards are low. It is suprising that there would be less than fifty successful punitive damages claims in a decade of Internet boom. It is quite likely that there may be additional barriers to litigating in cyberspace. Even powerful corporate actors such as America Online or Microsoft may find it difficult to pursue elusive defendants in cyberspace. The cases that did not result in punitive damages or that were never even brought because of barriers to litigating in cyberspace are the really interesting aspects implied by Table Six.

The Internet allows anonymous communications that are virtually impossible to trace through Internet nodes. Cyber-tortfeasors frequently use false e-mail headers and anonymous remailers to make it difficult to retrace the steps of wrongdoing. Computer records are easy to alter and it is likely that spoliation of electronic evidence is widespread. Internet fraud is frequently launched from an offshore haven. For instance, the large numbers of Nigerian bank fraud schemes are hard to control because the perpetuators are located in West Africa.[143]

b. Punitive Justice Against Infringing Mice

The metaphor of Internet "elephants" and "mice" developed by Peter Swire is helpful in understanding the large number of cyberlaw wrongdoers who escape punitive justice.[144] Professor

143 Lagos and Lome-Togo, Nigeria are the places of origin for most Nigerian Letter Scams. *Nigerian Letter Scams*, Internet Fraud Complaint Center, *at* http://www.ifccfbi.gov/strategy/nls.asp (last visited Jan. 20, 2004). Congo-Zaire, Sadton, Cote d Ivoire, Accra Ghana, Eleme, Festac Town, Ivory Coast, and Sierra-Leone are other African cities where these scams have developed. *Id.* Interestingly, "Canada and the United Kingdom have [also] been identified as originating countries for this scam." *Id.* Given these diverse locations, it will be expensive to obtain redress for the loss of funds, even if the "dot conster" is identified.

144 Peter P. Swire, *Of Elephants, Mice, and Privacy: International Choice of Law and the Internet*, 32 INT'L LAW 991, 993, 1019-23 (1998) (arguing that large multi-national corporations are elephants easy to regulate on the Internet because they frequently have assets that can be attached, versus "mice," who are small, mobile actors that can easily elude enforcement because they have the capacity to disappear or hide in an off-shore haven).

Swire defines corporate "elephants" as "large organizations that have major operations in a country. Elephants are powerful and have a thick skin, but are impossible to hide. They are undoubtedly subject to a country's jurisdiction."[145] In other words, when a corporate elephant such as a national corporation commits wrongs in cyberspace, there will frequently be assets to attach and officers to receive process. For example, companies like AOL, Amazon.com, eBay, and Yahoo! are classified as "elephants" because they are subject to regulation everywhere. On the other hand, "mice" are the exact opposite.[146]

Even when a prevailing plaintiff wins a large punitive damages award, collecting it is a different matter. Collecting a punitive damages award is difficult because a number of wily Internet mice either fail to make an appearance, file bankruptcy, or simply disappear after the plaintiff obtains a judgment.[147] Default judgments outnumbered cases decided by juries in the larger cybertort dataset. The plaintiffs in cases against Internet mice have almost no chance of collecting their judgment.[148] In *John Does v. Franco Productions*,[149] forty-six young men were awarded $506 million against Franco Productions and Internet Distributors for compensatory and punitive damages in a case in which the defendants secretly filmed college athletes and sold the videotapes on the Internet.[150] The defendants secretly videotaped college athletes in locker rooms, restrooms, and showers.[151] The tapes carried names like "Straight Off the Mat" and "Voyeur Time," and depicted hundreds of young athletes who had unknowingly been photographed in various degrees of nudity.[152] However, since the primary defendant was likely offshore, and thus failed to make an appearance to defend the action, this multi-million dollar award is largely symbolic.

145 *Id*. at 993.

146 *Id*.

147 *See, e.g.*, Doe v. GTE Corp., 347 F.3d 655, 656 (7th Cir. 2003) (noting that online pornographer defaulted in a case filed by college athletes for secret filming and sale of videos online); Kremen v. Cohen, 337 F.3d 1024, 1027 (9th Cir. 2003) (reporting that primary defendant moved assets to an off-shore haven and defaulted); Caton v. Trudeau, 157 F.3d 1026, 1028 (5th Cir. 1998) (reporting that defendant filed bankruptcy after Internet libel judgment was rendered).

148 *See, e.g.*, *GTE Corp.*, 347 F.3d at 656-57 (observing that there was little chance in recovering $500 million award against defaulting primary defendant in decision dismissing claim against GTE for enabling sale of unauthorized tapes by defendant).

149 No. 99 C 7885, 2002 U.S. Dist. LEXIS 24032 (N.D. Ill. Nov. 25, 2002), *aff'd sub nom.*, Doe v. GTE Corp., 347 F.3d 655 (7th Cir. 2003).

150 *Id*. at *1; Does v. Franco Prods., No. 99 C 7885, 2000 U.S. Dist. LEXIS 9848, at *2 (N.D. Ill. July 12, 2000).

151 *Franco Prods.*, 2000 U.S. Dist. LEXIS at *2.

152 Jere Longman, *Videotaped Athletes Victorious in Court*, N.Y. TIMES, Dec. 5, 2002, at D8.

An Internet company "can reopen immediately after being kicked off of a server or can move offshore."[153] As Professor Swire notes, "Mice breed annoyingly quickly—new sites can open at any time."[154] When "harm over the Internet is caused by mice, hidden in crannies in the network, traditional legal enforcement is more difficult."[155] The large number of default judgments in cyberlaw reflects the reality that it is easy for web sites to disappear or assets to be transferred. The next subsection illustrates how large corporate actors ("elephants") are in a better position to litigate against elusive web site wrongdoers ("mice") than are consumers.

In the cyberlaw sample, corporate elephants were seldom defendants in punitive damages litigation. From the beginning of cyberlitigation, it has been the large corporate elephants that have prevailed in lawsuits against mice. In the field of intellectual property law, it is the owners of famous trademarks and trade names who frequently file lawsuits against small companies. Playboy Enterprises, for example, has the legal resources to file intellectual property lawsuits to protect its trademarks and copyrighted images in cyberspace.[156] Internet elephants frequently enjoy advantages as repeat players in cyberlitigation. In many cases, only the corporate elephants have the legal resources to vindicate their rights. Again, Playboy Enterprises is a good example of a major cyberlitigator who frequently files lawsuits to protect its corporate name and intellectual property rights. Frequently, the corporate elephant is litigating against smaller companies, some of which are located in foreign venues.[157]

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153 Swire, *supra* note 144, at 993.

154 *Id.*

155 *Id.*

156 *See, e.g.*, Playboy Enters., Inc. v. Netscape Communications Corp., 55 F. Supp. 2d 1070 (C.D. Cal. 1999) (denying Playboy's motion for a preliminary injunction against Netscape for using Playboy's Internet-related trademarks in keywords of search engine), *aff'd*, 202 F.3d 278 (9th Cir. 1999); Playboy Enters., Inc. v. Universal Tel-A-Talk, Inc., 48 U.S.P.Q. 2d (BNA) 1779 (E.D. Pa. 1998) (holding that plaintiff failed to allege necessary facts for a trademark counterfeiting claim).

157 *See, e.g.*, Playboy Enters., Inc. v. Welles, 279 F.3d 796 (9th Cir. 2002) (rejecting Playboy's arguments that former playmate who used the phrase "Playmate of the Year" on her web site and in metatags violated trademark law); Playboy Enters., Inc. v. Sanfilippo, 46 U.S.P.Q. 2d (BNA) 1350 (S.D. Cal. 1998) (awarding damages to Playboy based upon the web site's unauthorized copying of Playboy's copyrighted images); Playboy Enters., Inc. v. AsiaFocus Int'l, Inc., No. 97-734-A, 1998 U.S. Dist. LEXIS 10359 (E.D. Va. Feb. 2, 1998) (reporting copyright infringement action versus small foreign company); Playboy Enters., Inc. v. Webbworld, Inc., 991 F. Supp. 543 (N.D. Tex. 1997) (awarding damages to Playboy based upon the web site's unauthorized copying of Playboy's copyrighted images), *aff'd*, 168 F.3d 486 (5th Cir. 1999); Playboy Enters., Inc. v. Russ Hardenburgh, Inc., 982 F. Supp. 503 (N.D. Ohio 1997) (finding bulletin board liable for direct and contributory infringement for posting Playboy's copyrighted and trademarked images for access by paying subscribers); Playboy Enters., Inc. v. Frena, 839 F. Supp.

The overall problem that there are too few punitive damages awards in cyberspace appears to be due to the huge costs involved in tracking down anonymous wrongdoers. It is likely that few consumers have the technical expertise to determine who is tracking their click-streams, unleashing viruses, or sending fraudulent offers. The small number of punitive damages cases may be partially explained by the fact that defendants may be mice who are difficult to trace. In traditional torts, it is generally not a problem to determine the identity of a wrongdoer. In contrast, cyber-tortfeasors are not physically present at the scene of the misdeed. Computers can be the target of a tortious act, such as when information is misappropriated from a database or a computer network. Furthermore, a network or web site may be the target of viruses or vandalism that constitutes a property tort.

Owners of famous trademarks such as Playboy, Mattel, Victoria's Secret, and America Online have been successful litigants in cyberspace because of their superior legal resources. These companies have used the courts to not only vindicate their traditional rights against Internet mice but also to expand intellectual property protections in this new medium.[158] In many cases, large national enterprises were filing lawsuits against companies that existed only in cyberspace. In *Playboy Enterprises, Inc. v. Webbworld, Inc.*,[159] for example, a web site was found liable for copyright infringement for offering a subscription service to adult images protected by copyright.[160]

Mice, on the other hand, have far more flexibility and can disappear at the click of a mouse or seek an offshore haven. The anonymity of individual Internet users makes it easy to commit civil wrongs without consequence. Enforcement by individuals is frustrated by the ease with which individual users may simply disappear from cyberspace. Individuals subject to various cyberspace laws or controls may simply "'exit' from the regime defined by those laws."[161]

1552, (M.D. Fla. 1993) (finding that a small company's web site infringed Playboy's trademarks and copyrights in posting images to its site).

158 The typical complaint by a trademark owner against the owner of a domain name is litigated under diverse causes of action, including (1) trademark infringement, (2) trademark dilution (federal and state), (3) domain name piracy, (4) false designation of origin, and (5) unfair competition. Trademark owners frequently seek injunctive relief to enjoin the use of the domain name or a transfer of the domain name. Courts may enjoin commercial content on a domain name's web sites but are reluctant to enjoin the use of the domain name for noncommercial purposes.

159 991 F. Supp. 543 (N.D. Tex. 1997), *aff'd*, 168 F.3d 486 (5th Cir. 1999).

160 *Id*. at 548.

161 Elizabeth Longworth, *The Possibilities for a Legal Framework for Cyberspace*, *in* THE INTERNATIONAL DIMENSIONS OF CYBERSPACE LAW 16 (UNESCO Publ'g 2000).

An Italian designer, Alfredo Versace, for example, was enjoined from marketing clothing and other items in the United States because the federal court ruled that he was using trademarks confusingly similar to trademarks registered by the famous designer, Gianni Versace.[162] Undeterred by the federal court order, Alfredo simply used offshore Internet sites to advertise and distribute his products in the United States.[163]

c. Anti-Spam Initiatives Against Online Mice

Punitive damages lawsuits against commercial e-mailers accounted for approximately 10% of all awards. In every punitive damages award, it was the ISP, rather than the consumer, who won punitive damages, even though the injuries were suffered primarily by consumers through spam e-mail. For example, an unsolicited bulk e-mail health solicitation was sent to millions of AOL subscribers stating: "The answer to cancer has been know [sic] for years. This website proves that eating inexpensive apple seeds and/or apricot seeds completely cure [sic] most cancers. The theory also states that by eating just a few seeds per day will [sic] 99.95% guarantee that you will never develop cancer."[164] The commercial e-mail messages made claims regarding their "cancer cures" and typically directed recipients to a web site where they could purchase products such as Laetrile, a videotape, and a book promoting the defendant's cancer treatment.[165]

In the vast majority of the cases, it is the ISP rather than the consumer who seeks punitive damages and other relief against the spammer. AOL, for example, "has undertaken various technical efforts to permit its members to opt out of receiving messages from domains and IP addresses that are or have been the subject of member complaints regarding unsolicited bulk e-mail."[166] However, the wily spammer continually develops new methods for bypassing ISP controls. The spammer transmits e-mail "from multiple and varying domains, employ[s] random and varying user names, relay[s] their messages through the servers of innocent third parties, or falsif[ies] the headers on their e-mails to indicate that their messages are from domains that AOL

162 Gianni Versace, S.p.A. v. Versace, No. 01 Civ. 9645, 2003 U.S. Dist. LEXIS 14858, at *47-48 (S.D.N.Y. Aug. 27, 2003).

163 *Id*. at *15-16.

164 Am. Online, Inc. v. Christian Bros., No. 98 CIV 8959, slip op. at 9 (S.D.N.Y. Dec. 9, 1999) (quoting example of defendant's bulk e-mailing practices), *available at* http://legal.web.aol.com/decisions/dljunk/christian.html.

165 *Id*. at 10.

166 *Id*. at 11.

does not filter (*e.g.*, 'msn.com' or 'aol.com')."[167] Despite the best efforts of the ISP community, computer systems are unable to detect and filter much of the tidal wave of unsolicited bulk e-mail targeting consumers.

This tidal wave of spam has greatly increased the costs associated with running an ISP. For example, a director of one ISP claimed "that [spam] [had] added 500 percent to 700 percent to the ISP's costs over nearly three years."[168] Punitive damages are increasingly being used by large ISPs in punishing and deterring the widespread social problem of spam e-mail. Amazon.com, for example, has recently filed lawsuits seeking punitive damages against eleven e-mail marketers who spoofed the company's e-mail addresses.[169] The e-mail forgeries were "promoting, among other things, home appliances and penis enlargement."[170]

In one case, a California software manufacturer was sued for deceptive business practices in a Washington class action.[171] The software vendor used deceptive Internet advertising banners that impersonated computer error messages with "headings that read 'security alert,' 'warning' and 'message alert,' with messages that include[d]: 'you[r] computer is currently broadcasting an Internet IP address. With this address, someone can immediately begin attacking your computer.'"[172] Internet users receiving this message were urged to click "OK" to the message.[173] Allegedly, "viewers who click an 'OK' button [were] forwarded to a commercial Web site promoting Bonzi software for preventing Internet intrusions or speeding up Internet connections."[174] The lawsuit, filed on behalf of consumers in eight states, was settled when the company agreed to label its "security alert" as an advertisement.[175]

In a typical day, the average consumer has an e-mail inbox full of offers to make fast money. ISPs such as America Online seek to enjoin these unsolicited advertisements to their millions

167 *Id.*

168 Drew Clark, *E-Commerce: Internet Firms Share Horror Stories About Costs of Spam*, NAT'L J. TECH. DAILY, May 1, 2003, *at* LEXIS, Nexis Library NAT'L J. TECH. DAILY File.

169 Matthew Heller, *Lost in the Cyber-Kudzu*, L.A. TIMES, Dec. 21, 2003 (Magazine), at 24.

170 *Id.*

171 *Software Manufacturer Accused of Using Deceptive Internet Ad Banners*, MEALEY'S LITIG. REP.: CLASS ACTIONS, Dec. 19, 2002, at 4.

172 *Id.*

173 *Id.*

174 *Id.*

175 *Error Copycat Pop-up Will Be Labeled as Ad*, CAP. TIMES (Madison, Wis.), May 29, 2003, at 6E.

of subscribers by arguing that these unwanted messages trespass upon their personal property. Consequently, ISPs such as America Online were the first to employ punitive damages as an anti-spam remedy.[176] A large service provider such as AOL suffers damages due to spammers' use of false return addresses. In responding to subscriber complaints regarding spam e-mail, AOL incurs costs in wasted bandwidth, traffic slowdowns, decline in user productivity, and time.[177]

America Online employs punitive damages to punish those who flood their subscribers with unwanted e-mail. In *America Online, Inc. v. National Health Care Discount, Inc.*,[178] the court found that the spammer's e-mail actions constituted a trespass to chattels as well as a violation of state and federal computer abuse laws.[179] The court calculated damages by charging the spammer $2.50 per thousand pieces of spam for a total of $337,500.[180]

In yet another case, *America Online, Inc. v. Prime Data Systems, Inc.*,[181] the court entered a default judgment granting a permanent injunction and awarding compensatory and punitive damages.[182] The court found that the mass e-mailer's conduct warranted the "imposition of punitive damages both to punish defendants' conduct and to deter others' tortious behavior that threatens the vitality of Internet e-mail communication."[183] The magistrate judge set the level of punitive damages at "three times AOL's proven per-message cost of $.00078."[184] Thus, punitive damages were assessed at a rate of $.00234 per message.[185] The court found that the punitive damages assessed were consistent with treble damages authorized by state and federal statutes for aggravated misconduct.[186] However, the *Prime Data* court was forced to reduce the punitive damages award due to a 1988 tort reform statute that required judges to reduce awards to the upper limit of $350,000.[187]

176 *See, e.g.*, Am. Online, Inc. v. IMS, 24 F. Supp. 2d 548, 549 (E.D. Va. 1998) (awarding punitive damages against a spam e-mailer).

177 Am. Online, Inc. v. IMS, No. 98-0011-A, 1998 U.S. Dist. LEXIS 20448, at *3 (E.D. Va. Nov. 20, 1998).

178 174 F. Supp. 2d 890 (N.D. Iowa 2001).

179 *Id*. at 900.

180 *Id*. at 901.

181 No. 97-1652-A, 1998 U.S. Dist. LEXIS 20226 (E.D. Va. Nov. 20, 1998).

182 *Id*. at *14-16.

183 *Id*. at *10.

184 *Id*. at *13.

185 *Id*.

186 *Prime Data Systems*, 1998 U.S. Dist. LEXIS 20226, at *13-14.

187 *Id*. at *11 (citing VA. CODE § 8.01-38.1).

Fraudulent uses of unsolicited commercial e-mail victimize millions of Internet users. Accordingly, ISPs have filed hundreds of lawsuits seeking punitive damages to punish spammers, but tort law is just beginning to accomplish this goal. Even a corporate elephant such as America Online must muster substantial resources to successfully litigate against elusive spam e-mailers who engage in such deceptive practices as falsified or redirected addresses.

Despite the havoc that spam creates for Internet consumers, no individual plaintiff has ever won a victory against a spammer outside of small claims court judgments. A Pennsylvania court expressly ruled that the federal Telephone Consumer Protection Act[188] could not be used by consumers to punish and deter the sending of solicited commercial e-mail.[189]

The CAN-SPAM Act of 2003[190] that went into effect on January 1, 2004 prohibits consumers and ISPs from filing lawsuits against spam e-mailers under the federal statute.[191] Section 7 of the CAN-SPAM Act provides for exclusive enforcement by the FTC and certain other agencies, rather than by ISPs or consumers.[192] State attorneys general are not permitted to file anti-spam lawsuits if there is a pending federal civil or administrative enforcement action by the FTC.[193] Furthermore, the new federal anti-spam statute preempts all state anti-spam legislation, even those that provide consumers with a cause of action against commercial e-mailers.[194] A number of states enacted anti-spam statutes that permitted consumers to sue e-mail senders who used misleading subject lines, transmission paths, or third-party domain names without permission.[195] In 2001 alone, anti-spam statutes were introduced in twenty-six states, and each of these statutes is preempted by CAN-SPAM.[196] The nationalization of anti-spam legislation further marginalizes the role of consumers in directly redressing abuses due to unsolicited e-mail. In the end, commercial e-

188 47 U.S.C. § 227 (2003).

189 Aronson v. Bright-Teeth Now, LLC, 824 A.2d 320, 320-21 (Pa. Super. Ct. 2003).

190 Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act of 2003), Pub. L. No. 108-187, 117 Stat. 2699 (codified as amended in scattered sections of 15 U.S.C., 18 U.S.C., 28 U.S.C., and 47 U.S.C.).

191 *See* CAN-SPAM Act § 7.

192 *Id*.

193 *Id*.

194 *Id*. § 8. Section 8 supersedes any state statute or regulation governing commercial e-mail, but it does not address the use of tort remedies against spam. *Id*.

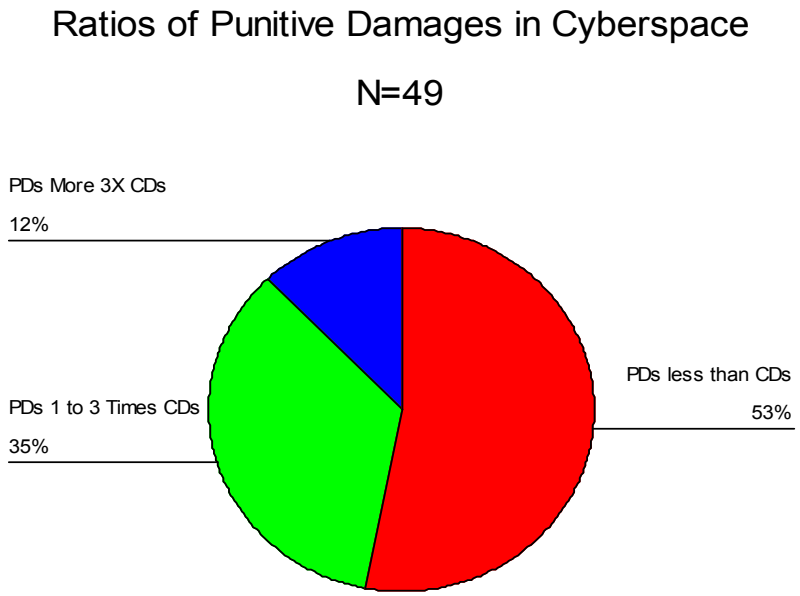
195 *See, e.g.*, State v. Heckel, 24 P.3d 404, 407, 413 (Wash. 2001) (upholding state of Washington anti-spam statute and rejecting defendant's argument that it unduly burdened interstate commerce).

196 RUSTAD & DAFTARY, *supra* note 76, at § 5.03[E].

mailers will no longer be subject to consumer lawsuits under state anti-spam statutes.

7. Punitive Damages Are Low-Ratio Awards Often Lower Than Compensatory Damages

Table Seven



In *State Farm Mutual Automobile Insurance Co. v. Campbell*,[197] the U.S. Supreme Court struck down a $145 million punitive damages award on the grounds of substantive due process.[198] The Court observed that "[c]ompensatory damages 'are intended to redress the concrete loss that the plaintiff has suffered by reason of the defendant's wrongful conduct'" whereas "punitive damages . . . are aimed at deterrence and retribution."[199] The Court's constitutional analysis of punitive damages requires the plaintiff to make a showing that the defendant's misconduct is sufficiently reprehensible in order to satisfy due process.[200] The Court's recent revisit of damage award

197 123 S. Ct. 1513 (2003).

198 *Id*. at 1519-21.

199 *Id*. at 1519 (quoting Cooper Indus., Inc. v. Leatherman Tool Group, Inc., 532 U.S. 424, 432 (2001)).

200 *Id*. at 1521. The Court has also noted that reprehensibility is higher where the "target of the conduct had financial vulnerability." *Id*.

ratios in *Campbell* should have little effect on cyberlaw punitive awards. The Court held that a jury's award of punitive damages of $145 million and compensatory damages of $1 million (145:1) was unconstitutionally excessive.[201] The Court came close to stating a per se rule that extreme ratios are presumptively unconstitutionally excessive.[202] Punitive damages in cyberspace are often much smaller in proportion to the compensatory damages. In 53% of the cyberlaw awards, the punitive component of the verdict was actually less than the compensatory damages. In only six instances (12%) were punitive damages three or more times greater than the compensatory award.

Table Seven confirms that there is no problem with skyrocketing punitive damages in cyberspace. The function of punitive damages in the first decade of Internet litigation was generally to assist companies in protecting their rights and consolidating control of the Internet. The traditional role of punitive damages in products liability, premises liability, medical malpractice, and other substantive fields is to provide consumer protection. In cyberspace, consumers were conspicuously missing from the punitive damages equation. Courts have been reluctant to impose legal duties on corporate defendants for inadequate Internet security and for preventing third parties from unleashing viruses, hacking, or stealing consumer information. Furthermore, courts have yet to extend products liability standards to computer software or web sites.

201 *Id*. at 1524.
202 *Id*.

8. Punitive Damages Were Rarely Appealed By Defendant

Table Eight

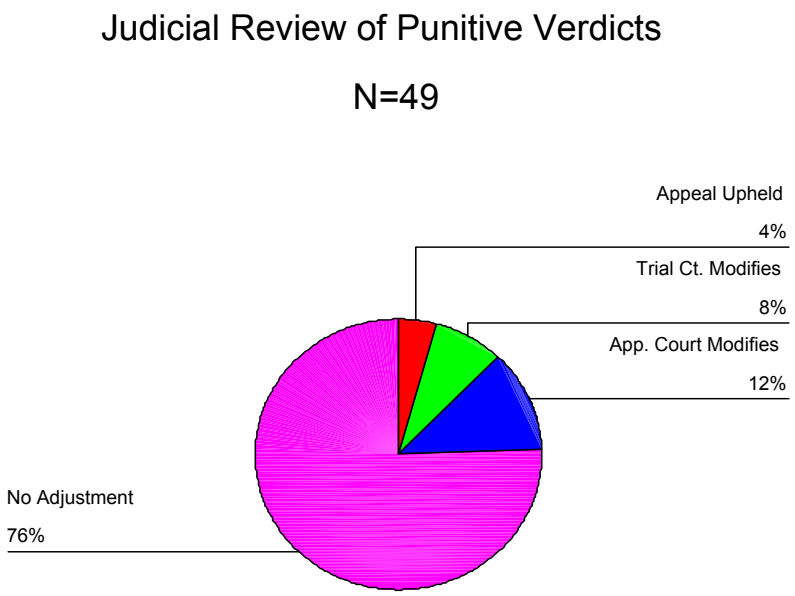


Table Eight reveals that relatively few judicial adjustments were made to punitive damages in cyberspace cases. No appeal or post-verdict adjustment occurred in thirty-seven of the forty-nine cyberlaw punitive damages awards. One reason for so few adjustments is that the ratio of punitive to compensatory damages is generally proportional or lower. The median punitive damages award was only 82% of the size of the compensatory damages, with a mean award only 1.7 times the size of the compensatory component.

Interestingly, defendants who actually challenged punitive damages were frequently successful in getting a reversal or remittal of the award. In the twelve cases where a judicial modification occurred, the trial judge reduced or reversed the punitive damages awards in four instances. Of the eight punitive damages awards reviewed by appellate courts, six verdicts were reduced or reversed. The small number of appeals can be explained by the large number of default judgments in the sample as well as the large number of low ratio awards discussed above. For example, in many of the high profile punitive damages cases, the primary defendant disappeared with a click

of the mouse, and for several of the largest punitive damages awards, the Internet mice disappeared or defaulted.[203]

In a few cases, punitive damages in favor of large corporate actors were capped or limited by tort reforms that were originally enacted to protect companies. The traditional critique of punitive damages is that large corporations suffer at the hands of "jackpot juries."[204] The tort reform movement to limit punitive damages arises from the perception that it is the corporations that are victimized by greedy individual claimants and their lawyers. In 2003 alone, the corporate community convinced legislators in seventeen states to file proposed statutes limiting punitive damages as well as the doctrine of joint and several liability.[205]

One of the unanticipated consequences of tort reform is that it may end up hurting its corporate advocates. The business community in Texas, for example, viewed then governor George W. Bush as "the right man to break the back of the litigious culture in the Lone Star State."[206] As Governor of Texas, Bush "signed seven major bills into law, including ones that capped punitive damages at no more than twice actual damages plus $750,000."[207] In his State of the Union address in January 2003, President Bush noted the importance of enacting federal tort reforms.[208] However, legal backfire, or the law of unanticipated consequences, posits "that a [new] law produces or will produce results directly contrary to one or more of those intended. Legal backfire claims are pervasive, yet potentially misleading and harmful argumentation used primarily to undermine existing law (or policy) or to forestall the enactment of new law."[209]

Any new technology will frequently produce legal backfire because social changes inevitably impact legal institutions in entirely unpredictable ways. The legal backfire from tort reform is that it impairs the corporate community's ability to vindicate its rights in cyberspace. Corporate tort reformers paint the "image of a monstrously destructive civil justice system" that is

203 *See, e.g.*, Kremen v. Cohen, 337 F.3d 1024 (9th Cir. 2003) (imposing liability for conversion against domain name registrar in case in which primary defendant defaulted in $65 million punitive damages award); Jere Longman, *Videotaped Athletes Victorious in Court*, N.Y. TIMES, Dec. 5, 2002, at D8.

204 A search in LEXIS's current news file produced 669 "hits" for the search "jackpot w/5 jury or juries."

205 Mark Ballard, *17-Front Tort War*, NAT'L L.J., May 12, 2003, at 1.

206 Christopher O'Leary, *Lone Star Litigation: Are Huge Jury Awards in Texas a Relic?*, CORP. LEGAL TIMES, May 2003, at 43, 46.

207 *Id*. at 48.

208 *See Doctors and Tort Reform*, WASH. POST, Feb. 16, 2003, at B6.

209 Robert A. Hillman, *The Rhetoric of Legal Backfire*, 43 B.C. L. REV. 819, 819 (2002).

sapping American productivity and competitiveness.[210] Many of the tort reform arguments could be applied with more validity to large corporate stakeholders using litigation to enclose the Internet commons. "Neo-conservatives often employ the theme of a 'culture of victimization gone wild' to ridicule [individual] plaintiffs seeking" redress for personal injury.[211] The general public is amused, angered, and perplexed by accounts of loony tort filings publicized by tort reformers. However, many of the widely disseminated tort stories are totally false or presented in a misleading and pejorative fashion.[212]

The corporate opponents of punitive damages portray the civil justice system "as greedy vulture lawyers against poor oppressed businesses."[213] Ironically, it appears that corporations are actually using punitive damages as a tool to protect their rights in cyberspace. In the tort reform debates, corporate America is not seeking limitations on punitive damages in this area. If punitive damages are evolving as a corporate sword rather than as a shield in cyberspace, the tort reformers may wish to revise their demands to eliminate or cripple the remedy.

Tort reform has played a role in capping punitive damages sought by companies. In the *Simon Property Group* case discussed earlier in this Article, the trial judge reduced a punitive damages award for a state unfair competition claim from $10 million to $50,000.[214] As the court explained, "Indiana law limits punitive damages to the greater of $50,000 or three times compensatory damages."[215] In a Virginia case, a federal court awarded the plaintiff $675,000 including $350,000 in punitive damages, that state's upper.[216] The Virginia cap of $350,000 has also limited punitive damages awards to America Online in their cases against spammers.[217]

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210 Rustad & Koenig, *Taming the Tort Monster*, *supra* note 30, at 3.

211 *Id*.

212 THOMAS H. KOENIG & MICHAEL L. RUSTAD, IN DEFENSE OF TORT LAW 173 (2001). For example, "[t]ort reformers frequently cite the case of a woman who received $2,699,000 in punitive damages after injuring her back opening a pickle jar." *Id*. However, in the actual case, the court justified the punitive damages based on the defendant's conduct of nearly five years, including retaliation, which was found to be "'willful, mean-spirited acts indicative of an intent to cause physical or emotional harm.'" Marc Galanter, *An Oil Strike in Hell: Contemporary Legends About the Civil Justice System*, 40 ARIZ. L. REV. 717, 730 (1998) (quoting Vandevender v. Sheetz, Inc., 490 S.E.2d 678, 693 (W. Va. 1997).

213 Christina Johns, *Tort Reform*, *at* http://www.cjjohns.com/c_law/tort_reform.html (last visited Dec. 1, 2003).

214 Simon Prop. Group, L.P. v. mySimon, Inc., 282 F.3d 986, 990 (7th Cir. 2002).

215 *Id*.

216 Graham v. Oppenheimer, No. 00CV57, 2000 WL 33232110 (E.D. Va. Oct. 2000); Kathleen Fay, *Defamed MD Awarded Maximum Punitive Damages Award in Va.*, E-COM. L. & STRATEGY, Jan. 2001, at 12.

217 *See, e.g.*, Am. Online, Inc. v. Bluecard Publ'g, No. 98-905-A, slip op. at 9-10 (E.D.

Cyberspace punitive damages flip the historic role of punitive damages in which individuals normally filed suit against powerful companies. The typical plaintiff in Internet punitive litigation is a large corporation suing a defendant in the dark side of the Net. Internet defendants are typically cybersquatters, online pornographers, spammers, or anonymous critics located in an offshore haven.

Few legislators who supported tort reform could have anticipated that one consequence was to handcuff information-industry leaders such as America Online, eBay, and Amazon.com in punishing and deterring spammers and other Internet predators. Lord Devlin approved a large punitive damages award in an aggravated assault case observing that one should think of punitive damages as "a fine which has to hit the defendant hard if he has disregarded the rights of others and show that that sort of conduct does not pay."[218] Punitive damages "should reflect 'the enormity of [the defendant's] offense'" rather than some arbitrary ratio of punitive damages to compensatory damages.[219] The deterrent power of punitive damages is significantly eroded when Internet wrongdoers can compute the cost of wrongdoing in advance.

The next part of this Article explains why punitive damages have yet to develop in cyberspace and why they are necessary to fortify existing consumer protection in cyberspace.

II. EXTENDING PUNITIVE DAMAGES TO INTERNET CONSUMERS

Internet-related consumer fraud complaints skyrocketed from 49,957 to 75,063 from 2001 to 2002.[220] Forty-six percent of the Internet fraud complaints were for losses from online auction fraud with a median loss of $320.[221] The non-delivery of goods accounted for just under a third of complaints with a median loss of $176.[222] Consumer confidence in cyberspace is impaired by worries about the lack of information security, data protection, confidentiality, and the failure of web merchants to deliver goods and services in a timely manner.[223] The Internet is a borderless

Va. Jan. 5, 2000) (reducing punitive damages in cases involving numerous deceptive practices of the spammers to mask their identity), *available at* http://legal.web.aol.com/decisions/dljunk/bluecard.html.

218 Loudon v. Ryder, [1953] 2 Q.B. 202, 209 (1953).

219 BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 575 (1996).

220 IFCC 2002 INTERNET FRAUD REPORT, *supra* note 16, at 4.

221 *Id*. at 6-7.

222 *Id*. at 6.

223 David Byrne, Cyberspace and Consumer Confidence, Address at the Annual Conference of the Kangaroo Group of MEPs (Sept. 18, 2000), *at* http://europa.eu.int/comm/

medium, which makes it imperative that consumers have "access to the legal system and courts in their *own country* [as] an essential part of consumer confidence[.]"[224]

The FTC is the most active Internet enforcer, but even this pro-active agency lacks the necessary resources to patrol cyberspace. It is as if the FTC is trying to hold back a tidal wave of cyberfraud with a broom.[225] The FTC is seeking to increase efforts in Internet-related enforcement, such as the regulation of e-mail list marketing, online auction practices, and e-mail sending software.[226]

Hardly a day goes by without new media reports of consumers harmed in cyberspace, yet punitive damages in Internet cases are rare.[227] Punitive damages awards, sometimes called exemplary, vindictive, penal, or retributory damages, are designed to punish and deter. Section 908(2) of the Restatement (Second) of Torts provides that "[p]unitive damages may be awarded for conduct that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others."[228] Consumers are harmed every day in Internet chat rooms, news groups, and computer bulletin boards by conduct that calls for the deterrent hammer of punitive damages. Online chats may seem informal and relaxed, but an online posting in a chat room or on a web site may become the basis of a defamation lawsuit.[229] Few consumers have the resources to vindicate their rights in the online world.

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dgs/health_consumer/library/speeches/speech55_en.html.

224 *Id*.

225 Internet enforcement is only one small sector of the FTC's responsibilities to protect consumers from unfair and deceptive trade practices:

> The [FTC] enforces 46 federal laws, including many laws that apply to web sites. Under the Federal Trade Commission Act, 15 U.S.C. §§ 41-58, the Commission seeks to: (a) prevent unfair methods of competition, and unfair or deceptive acts or practices in or affecting commerce; (b) obtain money and other relief for injured consumers; (c) define and prevent unfair or deceptive practices; and (d) investigate the business, practices, and management of entities engaged in commerce.

Federal Trade Commission Actions Affecting Web Sites & E-Commerce, *at* http://www.keytlaw.com/FTC/ftcactions.htm (last modified Sept. 2, 2003).

226 *FTC Examining Spam Lists and E-Mail Sending Programs*, WASH. INTERNET DAILY, March 28, 2002, at 1 (LEXIS, CURNWS Library).

227 *See, e.g.*, *Over the Counter – American Websites Selling Fake UK Degrees*, OVERSEAS OVERWHELMED (Higher-Edge), Mar. 12, 2003, *at* http://www.higher-edge.com/oov-archive.htm (shutting down web sites selling fake degrees from universities which used an address in Palmers Green, North London, to make their operations appear respectable, defrauding hundreds of thousands of mostly U.S. customers).

228 RESTATEMENT (SECOND) OF TORTS § 908(2) (1979).

229 *See, e.g.*, Carlson, *supra* note 35, at A33; Am. Online, Inc. v. Anonymous Publicly Traded Company, 542 S.E.2d 377, 379 (Va. 2001); Graham v. Oppenhiemer, No. 00-CV-57, 2000 WL 33381418, at *1 (E.D. Va. Dec. 15, 2000).

A. Why Punitive Damages Have Not Developed For Consumers

1. CDA Immunity Breeds Irresponsibility

The most significant reason why there are so few consumers using the remedy of punitive damages in cyberspace is the blanket immunity granted to ISPs by Congress. One of the unintended consequences of 42 U.S.C. § 230, the Communications Decency Act of 1996 ("CDA"),[230] is that it immunizes unfair, deceptive, and predatory practices in cyberspace. One of the statutory purposes of § 230 was to protect the "infant industry" of online service providers, such as America Online, CompuServe, and Prodigy, from tort liability arising out of postings by customers.[231] Section 230 of the CDA immunizes ISPs for torts committed by subscribers and third parties.[232] The long-term consequence of § 230 is to grant blanket immunity to ISPs for many torts in cyberspace. The courts have extended ISP immunity to nearly every conceivable information-related tort, including invasion of privacy,[233] and negligence.[234] The result has been that ISPs have prevailed in nearly every tort-related case in the last decade.[235] This broad immunity lessens the incentive for ISPs to develop technologies that will detect or control third party wrongdoing on their systems.[236]

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230 47 U.S.C. § 230 (2001).

231 Zeran v. Am. Online, Inc., 129 F.3d 327, 330-31 (4th Cir. 1997) (stating that one of Congress's purposes was to insulate providers from potentially staggering tort liability).

232 *Id*. at 331.

233 Does v. Franco Prods., No. 99 C 7885, 2000 U.S. Dist. LEXIS 8645, at *13-14 (N.D. Ill. June 21, 2000) (holding that ISPs that host web sites are not liable for postings by customers), *aff'd sub nom.*, Doe v. GTE Corp., 347 F.3d 655 (7th Cir. 2003).

234 In *Lunney v. Prodigy Services Co.*, 723 N.E.2d. 539 (N.Y. 1999), the court held that Prodigy was not negligent in failing to prevent an imposter from opening up an account, posting vulgar messages, and sending threatening e-mails. 723 N.E.2d at 543. The court recognized that if a duty was imposed on an ISP to prevent people from opening up false accounts and committing these types of defamatory acts, it would require an inordinate amount of time and money to study the transactions of millions of subscribers. *Id*. The court reasoned that if Prodigy was held liable for the actions of third parties, it would "open an ISP to liability for the wrongful acts of countless potential tortfeasors committed against countless potential victims." *Id*.

235 *See, e.g.*, Smith v. Intercosmos Media Group, No. 02-1964, 2002 U.S. Dist. LEXIS 24251, at *14-15 (E.D. La., Dec. 17, 2002) (holding that Intercosmos was entitled to immunity under the Communications Decency Act of 1996 for both damages and injunctive relief for defamation, libel, or negligence based on allegedly defamatory web sites set up by its customers); Doe One v. Oliver, 755 A.2d 1000, 1003-04 (Conn. Super. Ct. 2000) (holding America Online immune from improper e-mail messages sent to plaintiff mother's employer), *aff'd*, 792 A.2d 911 (Conn. App. Ct. 2002), *cert. denied*, 796 A.2d 556 (Conn. 2002); Schneider v. Amazon.com, Inc., 31 P.3d 37, 43 (Wash. Ct. App. 2001) (dismissing defamation lawsuit against Amazon.com for third party's posting of negative comments about the author's book on site).

236 Section 230 immunity for tort liability for ISPs is reminiscent of how the courts constructed harsh doctrines such as contributory negligence, the assumption of risk, and the fellow servant rule to protect nascent industry during the industrialization of America. *See generally* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW,

Courts have extended the impact of § 230 by insulating defendants from an even greater range of tort-based lawsuits filed by consumers.[237] In *Doe v. GTE Corp.*,[238] a court dismissed an action against an ISP that "provided web hosting services to [pornographic web] sites such as 'youngstuds.com' at which the hidden-camera videos were offered for sale."[239] The ISP did not produce or sell the tapes but "provided the usual package of services that enables someone to publish a web site over the Internet."[240] The package of services that GTE provided the X-rated company consisted of:

> (1) static IP (Internet protocol) addresses through which the web sites may be reached (a web host sometimes registers a domain name that corresponds to the IP address); (2) a high-speed physical connection through which communications pass between the Internet's transmission lines and the web sites; and (3) storage space on a server (a computer and hard disk that are always on) so that the content of the web sites can be accessed reliably.[241]

The advertisements for the X-rated tapes passed over GTE's network and were stored on its servers.[242] However, the federal district court held that GTE was entitled to immunity under § 230(c)(1).[243] The court reasoned that this section was not only a definition but also served as immunity in blocking "civil liability when web hosts and other [ISPs] *refrain* from filtering or censoring the information on their sites."[244] The Seventh Circuit affirmed the finding that GTE was neither a publisher nor a speaker and therefore it was immunized under § 230.[245]

In *Barrett v. Rosenthal*,[246] a California appeals court became the first U.S. court to hold that § 230 does not immunize an ISP who republishes defamatory statements authored by a third party after acquiring knowledge that the statements were

1780-1860, ch. 3 (1977) (arguing that the courts subsidized economic growth through the legal system by replacing just compensation for limited liability in tort and other substantive fields of law).

237 Blumenthal v. Drudge, 992 F. Supp. 44, 50 (D.D.C. 1998) (dismissing claim on § 230 grounds in case involving defamatory postings). *See also* Lunney v. Prodigy Servs. Co., 723 N.E.2d 539 (N.Y. 1999) (finding that commercial online service provider was not liable for defamation claim since it did not "publish" allegedly defamatory e-mail message).

238 347 F.3d 655 (7th Cir. 2003).

239 *Id*. at 657.

240 *Id*.

241 *Id*.

242 *Id*.

243 Doe v. GTE Corp., 347 F.3d at 657.

244 *Id*. at 659.

245 *Id*. at 662.

246 9 Cal. Rptr. 3d 142 (Cal. Ct. App. 2004).

false.[247] The plaintiffs, Dr. Polevoy and Dr. Barrett, were two medical doctors "primarily engaged in combating the promotion and use of 'alternative' or 'nonstandard' healthcare practices and products."[248] The plaintiffs maintained Internet "[w]eb sites that expos[ed] 'health frauds and quackery' and provid[ed]" consumers with information about health care alternatives.[249]

One defendant, Rosenthal, was an alternative health practitioner who reprinted and distributed a number of false accusations about the plaintiffs. The defendant's web postings accused the two doctors of running a "Slea[z]y 'Quackbuster' Scam."[250] Dr. Polevoy was accused of stalking women and being a quack.[251] The defendants refused to retract the statements and the plaintiffs filed suit for libel, conspiracy, and libel per se.[252] The trial court struck down their complaint on the grounds that it violated California's anti-SLAPP statute.[253] The trial court also ruled that § 230 protected the defendant from liability and that the defamation claims were not supported by sufficient proof that the plaintiffs suffered monetary losses.[254] The appellate court affirmed the application of the anti-SLAPP statute as to Dr. Barrett, but not as to Dr. Polevoy.[255] The appellate court also ruled that the trial court erred in requiring Dr. Polevoy to prove damages since the defamatory language posted on the web site was libel per se.[256]

The court ruled that the federal immunity of § 230 was inapplicable since Rosenthal was a "user of an interactive computer service" and a primary publisher who was strictly liable for libelous statements.[257] The court ruled that § 230 does not "abrogate the common law principle that one who republishes defamatory matter originated by a third person is subject to [distributor] liability if he or she knows or has reason to know of its defamatory character."[258] The court refused to follow a Fourth Circuit opinion that § 230 "immunized providers and users of interactive computer services from liability not only as *primary*

247 *Id*. at 167.
248 *Id*. at 144.
249 *Id*.
250 *Id*. at 146 (alteration in original).
251 *Barrett*, 9 Cal. Rptr. 3d at 149.
252 *Id*. at 145.
253 *Id*. at 143-44. The court noted that the California statute barred strategic lawsuits against public participation. *Id.*
254 *Id*. at 146.
255 *Id*.
256 *Barrett*, 9 Cal. Rptr. 3d at 146-47.
257 *Id*. at 151.
258 *Id*. at 152 (quoting RESTATEMENT (SECOND) TORTS, § 581(1)) (emphasis omitted).

publishers but also as *distributors*."[259] The court reasoned that providers or users who knowingly distribute defamatory materials produced by third parties should be subject to liability.[260] The court noted that § 230, on its face, did not clearly address whether Congress intended to overthrow the well-established common law principle of distributor liability.[261] However, after a review of the legislative history, the court observed that the survival of distributor liability was consistent with § 230.[262]

It may be that the *Barrett* case is ushering in a new era when courts will begin to retrench and reform § 230 to the balance between immunity and tort responsibility. The court in *Barrett* compared the "lack of clarity as to the boundary of the immunity [in the CDA to] the specificity of the immunity granted under the Digital Millennium Copyright Act" ("DMCA").[263] It may be proper to grant immunity for publishing content supplied by third parties; however, it is improper to extend that liability to transmitting knowingly libelous statements. Congress should make it clear that distributorship liability may be imposed for transmitting defamatory statements after acquiring notice. Congress could, for example, enact safe harbor provisions that parallel the intermediary liability standards of the Digital Millenium Copyright Act. One promising reform would be to implement a "take-down" policy like the one Congress enacted in the DMCA.[264] The DMCA's safe harbor provisions,[265] unlike § 230 of the CDA, balance freedom of expression against copyright infringement.[266]

The DMCA limits the potential liability of ISPs only if they satisfy the safe harbor provisions.[267] With few exceptions, a

259 *Id*. at 153-54 (declining to follow Zeran v. Am. Online, Inc., 129 F.3d 327 (4th Cir. 1997)).

260 *Id*. at 152.

261 *Barrett*, 9 Cal. Rptr. 3d at 155-58.

262 *Id*. at 167.

263 *Id*. at 158 n.11 (citing 17 U.S.C. § 512).

264 The DMCA limits online providers' liability for users' copyright infringement so long as the provider takes down the offending material promptly upon notice. 17 U.S.C. § 512(c) (1996 & Supp. 2003). The DMCA was signed into law by President Clinton in 1998. U.S. COPYRIGHT OFFICE, THE DIGITAL MILLENNIUM COPYRIGHT ACT OF 1998: U.S. COPYRIGHT OFFICE SUMMARY 1 (1998), available at http://www.copyright.gov/legislation/dmca.pdf. The DMCA amends the federal Copyright Act in Title 17 of the United States Code to develop greater protection for materials transmitted in the Internet environment. *Id*. at 3. One of the more controversial provisions of the DMCA is the prohibition against circumventing technological measures controlling access to works provided by the Copyright Act. 17 U.S.C. § 1201 (1996 & Supp. 2003).

265 17 U.S.C. § 512(a), (c).

266 *Barrett*, 9 Cal. Rptr. 3d at 158 n.11.

267 The DMCA does not confer an absolute immunity upon ISPs like 42 U.S.C. § 230 because the immunities of ISPs are limited to specific functions they perform. *See* 17

party satisfying the requirements for one of the safe harbors cannot be liable for monetary, injunctive, or other equitable relief.[268] A reconstructed § 230 of the CDA would only grant ISP tort immunity if it fulfilled the requirements for a safe harbor. An ISP could, for example, be immune from tort liability unless it knew or should have known that the tortious activity was occurring on its system and aided in the accomplishment of the direct tortfeasor's purpose by allowing the postings to continue.

2. Internet Usage of Trade That Waives Consumer Protection

a. Adhesive Internet Consumer Contracts

Another significant reason why punitive damages have not yet evolved to protect consumers in cyberspace is because of contracts of adhesion.[269] Consumers are largely foreclosed from the possibility of seeking punitive damages by adhesive license agreements and web site terms of service agreements.[270] The U.S. Internet and software industry universally require consumers to waive any meaningful warranties and tort remedies and to agree to litigate disputes in distant and inconvenient forums.

i. Internet Choice of Forum Clauses

"Choice of forum" is a contractual provision that predetermines the judicial or arbitral forum in the event of a dispute arising out of an Internet or web site agreement. For example, Disney requires all disputes to be decided in a state or federal court located in Los Angeles County,[271] and Nokia requires disputes to be submitted to an arbitrator in Finland.[272] In addition, America Online's forum selection clause for its members provides that "'exclusive jurisdiction for any claim or

U.S.C. § 512(a), (c).

268 17 U.S.C. § 512 (providing a rather narrow exception under § 512(j)).

269 *See generally* Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 632 (1943) (noting that the concept of adhesion contracts refers to contracts in which the weaker party must adhere to the stronger party's terms).

270 *See, e.g.*, Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1150-51 (7th Cir. 1997) (enforcing an arbitration clause in a shrink-wrap license); ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449 (7th Cir. 1996) (enforcing shrink-wrap license term). *See generally* Michael Rustad & Lori E. Eisenschmidt, *The Commercial Law of Internet Security*, 10 HIGH TECH. L.J. 213, 289-93 (1995).

271 *Jurisdictional Clauses in Current Shrinkwrap and Clickwrap Contracts*, Consumer Project on Technology, *at* http://www.cptech.org/ecom/ucita/licenses/jurisdiction.html (last visited Jan. 31, 2004) (citing clause in Disney's terms of service or license agreement) [hereinafter *Jurisdictional Clauses*].

272 *Id.*

dispute with AOL or relating in any way to your membership with or your use of AOL resides in the courts of Virginia."[273]

ii. Internet Choice-of-Law Clauses

Internet merchants use choice-of-law clauses to predetermine the legal remedies that apply for disputes involving the online contract. Dell Financial Services, for example, requires that the law of Texas govern all claims relating to its web site.[274] The Alturian GPS Software web site applies the law of Belgium in the event of disputes.[275] The licensing agreement of RealNetworks, Inc. requires consumers to resolve all disputes before binding arbitration applying Washington state law.[276]

If, for example, a consumer violated the RealNetworks license agreement by exceeding the scope of its use restrictions, the company could seek an injunction in federal court, a right not granted to consumers.[277] United States courts have been inclined to enforce Internet or software license agreements with terms inimical to consumer welfare such as pro-vendor forum selection clauses, anti-warranties, and limitations of remedies.[278] In general, courts have been willing to enforce Internet contracts so long as the user has an opportunity to review the terms of the contract and manifest assent to the license agreement.[279] During the 1990s, companies were able to avoid many contractual

273 Freedman v. Am. Online, Inc., No. 3:03cvl048, 2003 U.S. Dist. LEXIS 22019, at *2 (D. Conn. Dec. 5, 2003) (quoting America Online Member Agreement), *vacated*, No. 3:03cv1048, 2004 U.S. Dist. LEXIS 1388 (D. Conn. Jan. 30, 2004).

274 *Jurisdictional Clauses*, *supra* note 271.

275 *Id*.

276 *REALNETWORKS, INC. END USER LICENSE AGREEMENT*, RealNetworks, Inc., *at* http://web.nps.navy.mil/nssliao/realplayer/playrlic.html (last visited Jan. 31, 2004).

277 *Id*. RealNetworks ("RN") requires consumers to waive access to U.S. courts while reserving its own rights. For any violation of RN intellectual property rights, "RN may seek injunctive relief, or any other appropriate relief, in any court of competent jurisdiction." *Id*.

278 *See, e.g.*, Hughes v. McMenamon, 204 F. Supp. 2d 178, 181 (D. Mass. 2002) (finding that subscriber agreed to the license agreement and the forum selection clause was enforceable); Caspi v. Microsoft Network, L.L.C., 732 A.2d 528, 530, 532-33 (N.J. Super. Ct. App. Div. 1999) (upholding forum selection clause where subscribers to online software were required to review license terms in scrollable window and to click "I Agree" or "I Don't Agree"); Groff v. Am. Online, Inc., No. PC 97-0331, 1998 WL 307001, at *6 (R.I. Super. Ct. May 27, 1998) (holding user was bound by forum selection clause in online license agreement); Barnett v. Network Solutions, Inc., 38 S.W.3d 200, 204-05 (Tex. App. 2001) (upholding forum selection clause in online contract for registering Internet domain names that required users to scroll through terms before accepting or rejecting them).

279 *See, e.g.*, *Caspi*, 732 A.2d at 532 (enforcing mass market agreement even though the user could assent without scrolling to the bottom of the license agreement by clicking the "I agree" icon on the screen). *See generally* Christina L. Kunz et al., *Click-Through Agreements: Strategies for Avoiding Disputes on Validity of Assent*, 57 BUS. LAW. 401, 402-03 (2001) (citing cases that consider the user's ease or difficulty of viewing terms as a major factor in enforcing licensing agreements).

disputes with consumers by convincing courts to enforce one-sided choice-of-law provisions and other adhesive Internet contracts.

The U.S. market-based approach assumes that it is enough consumer protection for Internet merchants and software vendors to simply make adequate disclosures that the consumers are waiving their legal rights and remedies. The theory underlying "adequate disclosure" is that consumers will choose vendors with more favorable license terms.[280] However, this is not possible in the Internet industry where consumers are required to waive their rights and remedies. The practical reality is that consumers have no legal recourse against Internet merchants.

It is improbable that a U.S. consumer will opt to file a claim that must be filed across the country or in an overseas venue. "[R]equiring consumers to travel to a foreign and oftentimes remote forum to seek redress in an unfamiliar legal system . . . would in many cases effectively deny consumers access to judicial redress."[281]

The Internet challenges choice-of-law principles because it "is not a physical or tangible entity, but rather a giant network which interconnects innumerable smaller groups of linked computer networks."[282] Punitive damages arising out of consumer transactions in cyberspace will be stillborn if U.S. courts continue to enforce choice-of-law and forum-selection clauses. Punitive damages cannot develop if choice-of-law and forum clauses are considered to be "prima facie valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable' under the circumstances."[283]

b. Waiver of Internet Consumer's Right to Seek Tort Remedies

A Dilbert cartoon lampoons these adhesion contracts by depicting a licensee who unwraps the shrink-wrap only to learn that he has become Bill Gate's towel boy.[284] In the cartoon, Dilbert states, "I didn't read all of the shrink-wrap license agreement on my new software until after I opened it.

280 Jean Braucher, *Delayed Disclosure in Consumer E-Commerce as an Unfair and Deceptive Practice*, 46 WAYNE L. REV. 1806, 1810 (2000).

281 Karen Stewart & Joseph Matthews, *Online Arbitration of Cross-Border, Business to Consumer Disputes*, 56 U. MIAMI L. REV. 1111, 1126 (2002).

282 CompuServe Inc. v. Cyber Promotions, Inc., 962 F. Supp. 1015, 1018 (S.D. Ohio 1997).

283 The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 10 (1972).

284 Scott Adams, *Dilbert*, L.A. TIMES, Jan. 14, 1997, at D2.

Apparently, I agreed to spend the rest of my life as a towel boy in Bill Gates'[s] new mansion."[285] Shrink-wrap and web-wrap contracts are standard form contracts for the electronic age. The standard form contract dominates cyberspace just as it dominates every other domain of everyday life.[286]

In the typical mass-market license agreement, consumers routinely waive their right to seek punitive damages and foreclose the possibility of all but the most limited remedy under the UCC. Online users are offered "take it-or-leave it" web-wrap or terms of service consumers agreements that foreclose the possibility of punitive damages and any other tort remedy.[287] Nearly every Internet merchant dictates the choice-of-law as a condition for accessing its services or using its goods. No consumer negotiates with Bill Gates or Jeff Bezos in the Internet economy. Requiring consumers to waive their rights to a jury trial is a controversial practice because the Internet industry is unwilling to give even the most rudimentary implied warranties of quality. One can read thousands of click-stream, click-wrap, shrink-wrap, and terms of service agreements and never find a single Internet vendor willing to provide meaningful warranties or remedies for its software, software products, or services.

The typical Internet-related mass-market license agreement provides no warranties of any kind and forecloses any remedy by requiring the consumer to litigate in a forum of the vendor's choice, which is often in a distant forum. The following anti-warranties clause of an online pharmacy is fairly typical of what consumers encounter in cyberspace:

> Disclaimer of Warranties. YOU EXPRESSLY UNDERSTAND THAT AND AGREE THAT:
>
> a. YOUR USE OF THE SERVICE IS AT [YOUR] SOLE RISK. THE SERVICE IS PROVIDED ON AN "AS IS"

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285 *Id*.

286 Shrink-wrap contracts are the newest form of standard form contracts that predominate our everyday life. Professor Slawson wrote in 1971 that:

> Standard form contracts probably account for more than ninety-nine percent of all the contracts now made. Most persons have difficulty remembering the last time they contracted other than by standard form; except for casual oral agreements, they probably never have. But if they are active, they contract by standard form several times a day. Parking lot and theater tickets, package receipts, department store charge slips, and gas station credit card purchase slips are all standard form contracts.
>
> . . . The contracting still imagined by courts and law teachers as typical, in which both parties participate in choosing the language of their entire agreement, is no longer of much more than historical importance.

W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 529 (1971).

287 *See* Braucher, supra note 260, at 1832.

> AND "AS AVAILABLE" BASIS. PHARMACY CHOICE EXPRESSLY DISCLAIMS ALL WARRANTIES OF ANY KIND, WHETHER EXPRESS OR IMPLIED, INCLUDING, BUT NOT LIMITED TO THE IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE AND NON-INFRINGEMENT.
>
> b. PHARMACY CHOICE MAKES NO WARRANTY THAT (i) THE SERVICE WILL MEET YOUR REQUIREMENTS, (ii) THE SERVICE WILL BE UNINTERRUPTED, TIMELY, SECURE, EFFICIENT, OR ERROR FREE, (iii) THE RESULTS THAT MAY BE OBTAINED FROM THE USE OF THE SERVICE WILL BE ACCURATE OR RELIABLE, (iv) THE QUALITY OF ANY PRODUCT, SERVICE, INFORMATION, OR OTHER MATERIAL PURCHASED OR OBTAINED BY YOU THROUGH THE SERVICE WILL MEET YOUR EXPECTATIONS, AND (v) ANY ERRORS IN THE SOFTWARE WILL BE CORRECTED.
>
> c. ANY MATERIAL DOWNLOADED OR OTHERWISE OBTAINED THROUGH THE USE OF THE SERVICE IS DONE AT YOUR OWN RISK AND DISCRETION. YOU WILL BE SOLELY RESPONSIBLE FOR ANY DAMAGE TO YOUR COMPUTER SYSTEM OR LOSS OF DATA THAT RESULTS FROM THE DOWNLOAD OF ANY SUCH MATERIAL.
>
> d. NO ADVICE OR INFORMATION, WHETHER ORAL OR WRITTEN, OBTAINED BY YOU FROM PHARMACY CHOICE OR THROUGH OR FROM THE SERVICE SHALL CREATE ANY WARRANTY NOT EXPRESSLY STATED . . . .
>
> e. NEITHER PHARMACY CHOICE NOR YOU MAY MODIFY OR WAIVE THE DISCLAIMERS PROVIDED FOR IN THIS SECTION . . . . NO ORAL MODIFICATIONS OR WAIVER OF THIS DISCLAIMER SHALL BE VALID OR BINDING ON PHARMACY CHOICE.[288]

Amazon.com's terms of service agreement forecloses consumers from seeking punitive damages or any other type of tort damages.[289] The most popular search engine, Google.com, has a term of service that precludes the possibility of obtaining

288 *Pharmacy Choice Terms and Conditions of Service*, *at* http://www.pharmacychoice.com/home/terms.cfm (last visited Jan. 26, 2004).

289 *Conditions of Use*, *at* http://www.amazon.com/exec/obidos/tg/browse/-/508088/102-6759433-7263313 (last visited Jan. 26, 2004) ("AMAZON.COM WILL NOT BE LIABLE FOR ANY DAMAGES OF ANY KIND ARISING FROM THE USE OF THIS SITE, INCLUDING, BUT NOT LIMITED TO DIRECT, INDIRECT, INCIDENTAL, PUNITIVE, AND CONSEQUENTIAL DAMAGES.").

punitive damages:

> Under no circumstances shall Google be liable to any user on account of that user's use or misuse of Google Web APIs. Such limitation of liability shall apply to prevent recovery of direct, indirect, incidental, consequential, special, exemplary, and punitive damages whether such claim is based on warranty, contract, tort (including negligence), or otherwise, [(]even if Google has been advised of the possibility of such damages).[290]

The eBay User Agreement requires its users to "read, agree with and accept all of the terms and conditions contained in this User Agreement and the Privacy Policy, which include those terms and conditions expressly set out below and those incorporated by reference," before they can access the eBay system.[291] One of the terms of service for eBay is the absolute prohibition on seeking punitive damages under any doctrinal theory.[292]

c. Mandatory Consumer Protection in Cyberspace

The solution to adhesive Internet contracts is to either extend punitive damages to cyberspace or adopt a system of "thick" regulations such as the European Union regime of mandatory consumer protection terms.[293] None of the countries of the European Union other than the United Kingdom recognize the doctrine of punitive damages.[294] The Brussels Regulation, for

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290 *Terms and Conditions for Google Web API Service*, *at* http://www.google.com/apis/api_terms.html (last visited Jan. 26, 2004).

291 *User Agreement*, *at* http://pages.ebay.com/help/community/png-user.html (last visited Jan. 26, 2004).

292 The user agreement states:

> UNDER NO CIRCUMSTANCES SHALL EBAY BE LIABLE TO ANY USER ON ACCOUNT OF THAT USER'S USE OR MISUSE OF EBAY TOOLBAR. SUCH LIMITATION OF LIABILITY SHALL APPLY TO PREVENT RECOVERY OF DIRECT, INDIRECT, INCIDENTAL, CONSEQUENTIAL, SPECIAL, EXEMPLARY, AND PUNITIVE DAMAGES WHETHER SUCH CLAIM IS BASED ON WARRANTY, CONTRACT, TORT (INCLUDING NEGLIGENCE), OR OTHERWISE, (EVEN IF EBAY HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES).

User License Agreement, http://pages.ebay.com/ebay_toolbar/download.html (last visited Jan. 26, 2004).

293 The European Union ("EU") was formed in the 1950s and now includes fifteen member states located in the Eurozone. James E. Pfander, *Member State Liability and Constitutional Change in the United States and Europe*, 51 AM. J. COMP. L. 237, 239 (2003). The EU is set to add another ten member states in 2004. *Id.* "The *European Council* refers to meetings of the heads of state of the 15 [EU] member states." RUSTAD & DAFTARY, *supra* note 76, at § 8.02[A]. The European Union's key consumer protection directives address distance selling, data protection, and e-commerce. *Id.*

294 *See* Christopher Hodges, *Multi-Party Actions: A European Approach*, 11 DUKE J. COMP. & INT'L L. 321, 330 (2001) ("No European jurisdiction generally permits punitive damages . . . ."). *But see* Rookes v. Barnard, 1964 A.C. 1129, 1131 (H.L. 1964) (appeal taken from Eng.) (noting that in the United Kingdom, a restricted form of exemplary damages is recognized in a handful of aggravating circumstances).

example, gives consumers the right to sue suppliers in their home court.[295] It provides that if a business "pursues commercial or professional activities in the Member State," then the consumer may sue in the court where he or she is domiciled.[296] The far-reaching consumer provisions also apply to U.S. companies targeting European consumers in Internet transactions.[297] Therefore, European Union rules will likely become the *de facto* consumer protection law for the Internet since non-European Union countries will be subject to its rules.

The European Union model tacitly assumes that mandatory consumer protection is required in cyberspace and elsewhere. The Distance Selling Directive, for example, requires sellers to provide consumers with information about the identity of the supplier, the main characteristics of goods and services including taxes, delivery costs, arrangements for payment, the existence of a right of withdrawal, the period for which the offer remains valid, and the minimum duration of the contract.[298]

The European Directive on Consumer Goods contains provisions that apply equally well to Internet sales.[299] The Directive, for example, gives consumers a two-year period to exercise rights as to defective products.[300] The Directive presumes that any non-conformity found in the first six months after delivery existed at tender, and European consumers under the Consumer Goods Directive have a right of repair or replacement without charge or inconvenience.[301] Under the Directive, any waiver of rights in a contractual agreement signed by European consumers is not binding.[302]

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295 The European Union countries are promulgating some of the most extensive regulations of cyberspace. Council Regulation 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2001 O.J. (L 12) 1. The Brussels Regulation replaces the 1968 Brussels Convention effective March 2002. *Id*. at 14, 16. The Brussels Regulation applies to all EU countries that signed the Brussels Convention of 1968 except Denmark. Id. at 3. The new Brussels Regulation has not yet supplanted the Lugano Convention of 1988. *Id*. at 1, 14-15. The Brussels Regulation governs jurisdiction in civil and commercial disputes between litigants and provides for the enforcement of judgments. *Id*. at 3, 11.

296 *Id*. at 6. Article 15(1)(c) extends the consumer home forum rule to entities that direct activities to Member States. *Id*.

297 *See id*. at 7. The Brussels Regulation has legal force in the Member States of the European Union. However, U.S. companies with a presence in a Member State and conducting business with European consumers would be subject to the pro-consumer home court rule. Thomas C. Vinje and Ann-Charlotte Hogberg, *Whose Law Governs in EU?: Draft "Rome II" Regulation Threatens Certainty of 2000 Directive*, N.Y. LAW JOURNAL, April 30, 2001, at S3.

298 European Parliament & Council Directive 97/7/EC, 1997 O.J. (L 144) 19-27.

299 European Parliament & Council Directive 1999/44/EC, 1999 O.J. (L 171) 12.

300 *Id*. at 15.

301 *Id*.

302 *Id*. at 16.

Internet contracts with European consumers must also comply with the Unfair Terms Directive.[303] The Directive has an express policy of policing unfair terms where there is an imbalance of power between the company and consumer.[304] It applies to a wide range of one-sided Internet contracts where the terms are offered on a "take-it-or-leave-it" basis. Any ambiguity in a consumer contract is construed against the company in favor of the consumer.[305] The central provision of the Unfair Terms Directive is that contractual terms found to be unfair are unenforceable.[306] In contrast, the U.S. market-based approach tends to be opposed to such pro-welfaristic consumer protection regimes. The extension of punitive damages to protect consumers is consistent with the U.S. pro-market approach with its emphasis on flexibility and pragmatism.

B. Extending Punitive Damages for Consumer and Individual Protection in Cyberspace

Few consumer lawyers have the resources to pursue an Internet wrongdoer capable of fleeing the jurisdiction with the click of the mouse. Even if the Internet wrongdoer can be located, there remains a problem with default judgments. Consumers will be more likely to obtain collectible judgments from Internet elephants rather than elusive mice, but may not be aware that attorneys are available to work on a contingency basis. Alternatively, the amount of money involved may be so miniscule for any one Internet user that the victim may not feel that he or she has the time, energy, or expertise to prosecute a fraudulent Internet merchant. Many Internet users may each have a small loss resulting from a pattern and practice of dishonesty.

1. Remedy for Socially Compensable Damages

The legal environment of the Internet is a perfect venue for an expanded remedy of punitive damages. Judge Guido Calabresi drew the classic distinction between specific deterrence that makes the wrongdoer pay the price of wrongdoing and the larger social sanction of general deterrence, which vindicates the harm to society.[307] The concept of general deterrence may be seen in the earliest exemplary damages cases where awards were

303 Council Directive 93/13/EEC, 1993 O.J. (L 95) 29.

304 *Id*.

305 *Id*.

306 *Id*.

307 A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 877 & n.13 (1998).

made "for example's sake."[308] Punitive damages against spam e-mailers are good examples of what Judge Calabresi defines as "socially compensatory damages."[309] The purpose of socially compensatory damages is "to make society whole," as opposed to compensatory damages, which are "assessed to make the individual victim whole."[310] Tort law's capacity to efficiently punish and deter conduct through socially compensable damages is central to Judge Calabresi's theory of punitive damages.[311] Judge Calabresi argues that in many cases "compensatory damages are . . . an inaccurate measure of the true harm caused by an activity."[312]

Consumers need a fortified punitive damages remedy precisely for purposes of optimal deterrence. Ordinary damages are an insufficient deterrent where the gain to the defendant exceeds any compensable injury. General deterrence requires punitive damages to convince other Internet wrongdoers that there is no profit in wrongdoing. Merely requiring an Internet company to disgorge the amount by which it was unjustly enriched is an insufficient deterrent. Without the threat of uncapped punitive damages, it would be beneficial for the fraudulent Internet business to wait until it was discovered or sued before disgorging what was owed. As the court stated in *Wangen v. Ford Motor Co.*,[313] if it were not for punitive damages then "[s]ome may think it cheaper to pay damages or a forfeiture than to change a business practice."[314] The purpose of punitive damages in cyberspace is the same as in the bricks-and-mortar world of compensating the larger society for uncompensated external costs.[315] Punitive damages are "an appropriate way of making the injurer bear all the costs associated with its activities."[316] In the first decade of cyberspace punitive damages, there have been some notable examples where the remedy served to root out socially harmful web site activity.

2. Serving as a Death Penalty to Internet Harassment

"Cyberstalking refers to the use of the Internet, e-mail, or other electronic means to repeatedly threaten, follow, or harass

308 Tullidge v. Wade, 95 Eng. Rep. 909, 909 (K.B. 1769).

309 Ciraolo v. City of New York, 216 F.3d 236, 245 (2d Cir. 2000) (Calabresi, J., concurring).

310 *Id*. (Calabresi, J. concurring).

311 *Id*. at 243, 245 (Calabresi, J. concurring).

312 *Id*. at 244 (Calabresi, J. concurring).

313 294 N.W.2d 437 (Wis. 1980).

314 *Id*. at 451 (citing Walker v. Sheldon, 179 N.E.2d 497, 499 (N.Y. 1961)).

315 *In re* Simon II Litig., 211 F.R.D. 86, 159 (E.D.N.Y. 2002).

316 *Ciraolo*, 216 F.3d at 244 (Calabresi, J. concurring).

another person."[317] Internet wrongdoers, for example, have harmed women by maliciously posting personal information on sadomasochistic web sites and by using new morphing technologies to superimpose their victim's face onto pornographic pictures.[318] For example, an online stalker who posted profane, derogatory, and harassing messages threatening violence to female musicians was assessed with punitive damages.[319]

In *Hitchcock v. Woodside Literary Agency*,[320] Jayne Hitchcock, a University of Maryland teaching assistant, alleged she was the victim of a campaign of electronic terror by an online company.[321] Ms. Hitchcock's nightmare began when she answered a web site advertisement soliciting writing samples from "'published and unpublished authors.'"[322] After submitting a writing sample, she received a letter from Woodside Literary Agency ("WLA") praising her writing and soliciting her to forward a full manuscript to the agency, "along with a $75 'reading and market evaluation fee.'"[323] She mailed a second sample of her writing to WLA using her maiden name.[324] WLA responded with a virtually identical letter save for soliciting a $150 reading fee.[325] Ms. Hitchcock concluded that WLA was nothing more than a scam soliciting bogus fees from consumers seeking to become writers.[326] She posted warnings about WLA on various Internet bulleting boards observing that "legitimate literary agencies did not charge 'reading fees.'"[327]

Hitchcock allegedly became the target for a systematic campaign of online harassment by anonymous parties.[328] The harassment took diverse forms, including the posting of messages that falsely claimed that Hitchcock was the author of pornography.[329] She also received a number of crude e-mail messages, which placed her in fear of sexual assault.[330] Her e-mail accounts were flooded, and offensive messages were sent to

317 RUSTAD & DAFTARY, *supra* note 76, at § 5.03[A] (emphasis omitted).

318 *See, e.g.*, Butler v. Krebs, No. 96-1204096, 1998 WL 2023763 (Tex. Dist. Ct. June 8, 1998) (awarding punitive damages against airline and pilot for superimposing nude image of female pilot on web site and intranet).

319 Stockdale v. Baba, 795 N.E.2d 727, 730-33 (Ohio Ct. App. 2003).

320 15 F. Supp. 2d 246 (E.D.N.Y. 1998).

321 *Id*. at 249.

322 *Id*. at 248.

323 *Id*. at 249.

324 *Id*.

325 *Hitchcock*, 15 F. Supp. 2d at 249.

326 *Id*.

327 *Id*.

328 *Id*.

329 *Id*.

330 *Hitchcock*, 15 F. Supp. 2d at 249.

third parties under her name.[331] Despite this clear pattern of systematic online harassment, the federal court dismissed Hitchcock's RICO[332] claim for failure to state a claim since the defendants could not, by law, constitute a criminal enterprise.[333] In the end, the consumer had no remedy available for such pervasive e-mail harassment and the "e-mail bombs" that shut her e-mail account down. The *Hitchcock* case illustrates the need for strong consumer self-help remedies to punish egregious misconduct in cyberspace.

Punitive damages are beginning to be employed to restrain web sites threatening violence. In *Planned Parenthood of Columbia/Williamette, Inc. v. American Coalition of Life Activists*,[334] anti-abortion activists posted "GUILTY" posters identifying the names, addresses, and photographs of physicians that provided abortions.[335] The web site developed by the American Coalition of Life Activists ("ACLA") personally identified the plaintiffs on "Deadly Dozen 'GUILTY'" posters.[336] Additionally, ACLA compiled the "Nuremberg Files" to collect evidence against abortion doctors so that they could one day be placed on trial for crimes against humanity.[337] "The 'GUILTY' posters identifying specific physicians were circulated in the wake of a series of 'WANTED' and 'unWANTED' posters that had identified other doctors who performed abortions before they were murdered."[338]

The plaintiffs argued that the distribution of the Old West-style Deadly Dozen "WANTED" posters identifying the abortion providers constituted a threat of force under the federal Freedom of Access to Clinics Entrances Act.[339] In three prior incidents, a "wanted"-type poster identifying a specific doctor who provided abortion services was circulated, and the doctor named on the poster was killed.[340] The jury returned a verdict in the

331 *Id*.

332 The Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968 (2003), requires that the plaintiff demonstrate "that a defendant, employed by or associated with an enterprise affecting interstate or foreign commerce, conducted or participated in the conduct of this enterprise's affairs through a pattern of racketeering activity." *Hitchcock*, 15 F. Supp. 2d at 249 (internal quotation marks omitted).

333 *Id*. at 249-50.

334 290 F.3d 1058 (9th Cir. 2002), *cert. denied*, 123 S. Ct. 2637 (2003).

335 *Id*. at 1062.

336 *Id*. at 1064.

337 *Id*. at 1062.

338 *Id*.

339 *Planned Parenthood*, 290 F.3d at 1062. "[The Freedom of Access to Clinics Act] gives aggrieved persons a right of action against whoever by 'threat of force . . . intentionally . . . intimidates . . . any person because that person is or has been . . . providing reproductive health services.'" *Id*. (quoting 18 U.S.C § 248 (a)(1), (c)(1)(A)).

340 *Id*. at 1063-64.

physicians' favor, including $108.5 million in punitive damages.[341] The district court also "enjoined ACLA from publishing the posters or providing other materials with the specific intent to threaten [the physicians]."[342] The court found that the defendants had "acted with specific intent and malice in a blatant and illegal communication of true threats to kill, assault or do bodily harm to each of the plaintiffs and with the specific intent to interfere with or intimidate the plaintiffs from engaging in legal medical practices and procedures."[343]

On appeal, the Ninth Circuit held that the web site constituted a true threat as defined under the Freedom of Access to Clinics Entrances Act and affirmed the ACLA's liability, but vacated the $108.5 million punitive damages award for the district court to determine whether it comported with due process.[344] Due to the Ninth Circuit's decision, the threat of further punitive damages awards has resulted in a number of providers unplugging the "Nuremberg Files" site and other anti-choice sites, including the "AbortionCams" web site, "which features thousands of photographs and videos of abortion clinic staff, patients and escorts."[345]

Spam e-mailers are continually engaging in cost-benefit analyses to determine whether a given activity is worth the price.[346] In the calculation of expected profits, the Internet wrongdoer will likely allow for possible refunds to those victims who object too vigorously, and will be perfectly content to bear the additional cost of litigation as the price for continuing an illicit business. "It stands to reason that the chances of deterring [people] are materially increased by subjecting [them] to the payment of punitive damages."[347]

3. Punishing Incendiary Flame Wars in Cyberspace

Punitive damages have begun to evolve as a social control against incendiary e-mail exchanges or web site postings. Consider the case of a 27-year-old British lawyer who received a

341 *Id*. at 1066 n.4.

342 *Id*. at 1063.

343 Planned Parenthood of Columbia/Williamette, Inc. v. Am. Coalition of Life Activists, 41 F. Supp. 2d 1130, 1154 (D. Or. 1999), *aff'd in part, rev'd in part*, 290 F.3d 1058 (9th Cir. 2002).

344 *Planned Parenthood*, 290 F.3d at 1063, 1086.

345 Frederick Clarkson, *New Version of Nuremberg Files Yanked Off Web*, *at* http://www.womensenews.org/article.cfm/dyn/aid/1627/context/archive (last visited Jan. 28, 2004). "The American Coalition of Life Activists subsequently folded, though most of its leaders remain active anti-choice militants." *Id*.

346 *See generally* GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 68-69 (1970).

347 Walker v. Sheldon, 179 N.E.2d 497, 499 (N.Y. 1961).

spicy e-mail message at work from his girlfriend.[348] The tactless lawyer forwarded the e-mail to several others, "boasting, 'Now THAT'S a nice compliment from a lass, isn't it?'"[349] A week later, the firm's web site "crashed after receiving 70,000 hits in a single day."[350] The lawyer's careless e-mail caused him to be disciplined by his law firm and castigated in the court of public opinion. This case is an example of the types of e-mails that can cause a suit for punitive damages.

In *Mathis v. Cannon*,[351] the plaintiff filed a defamation claim against an Internet poster who accused him of being a thief and a crook in an online forum addressing concerns about a solid waste recovery facility.[352] The Internet-related postings were the result of impassioned debates over the expenditure of the county's resources for the ill-fated facility.[353] However, the plaintiff was barred from seeking punitive damages because he did not seek a retraction, which was a prerequisite to filing his defamation complaint.[354]

C. Protecting Individual Reputations in Cyberspace

Punitive damages are evolving to restrain abusive information-based torts in cyberspace. For example, a University of North Dakota physics professor filed a lawsuit against a former student who posted an article about him on the Internet.[355] The student accused the professor "of being a pedophile and having odd sexual habits."[356] The professor won his case and received a punitive damages award for the student's postings.[357]

Damages awarded in online defamation cases frequently involve head-on collisions with the First Amendment. The facts of *Griffis v. Luban*[358] exemplify the typical online defamation case, arising out of an incendiary exchange of e-mails and postings to a web site. In *Griffis*, a Minnesota resident was assessed damages in an Alabama court default judgment after being sued for posting Internet messages challenging the

348 Jeffrey Rosen, *In Lieu of Manners*, N.Y. TIMES, Feb. 4, 2001 (Magazine), at 46.
349 *Id*.
350 *Id*.
351 573 S.E.2d 376 (Ga. 2002).
352 *Id*. at 377, 379.
353 *Id*. at 378-79.
354 *Id*. at 386.
355 Carlson, *supra* note 35, at A33.
356 *Id*.
357 Wagner v. Miskin, 660 N.W.2d 593, 595-96 (N.D. 2003), *cert. denied*, 124 S. Ct. 1156 (2004).
358 646 N.W.2d 527 (Minn. 2002), *cert. denied*, 538 U.S. 906 (2003).

credentials of an Egyptologist.[359] The Minnesota resident posted on a web forum that the Alabama scholar had "obtain[ed] her degree from a 'box of Cracker Jacks.'"[360] The Alabama court entered a default judgment for $25,000 in money damages and an injunction to prevent future defamatory postings.[361] In an unpublished decision, a Minnesota Court of Appeal overturned the Alabama injunction as an invalid prior restraint in violation of the First Amendment.[362] The Minnesota Supreme Court ruled that the Alabama judgment was not entitled to full faith and credit because the Alabama court lacked personal jurisdiction.[363] The court ruled that the Alabama court's exercise of jurisdiction was in error because the postings by the plaintiff were not aimed at the Alabama forum.[364]

D. Expanded Consumer Protection Through Punitive Justice

Deterrence will only occur when the tortfeasors are held accountable for their conduct in cyberspace. Given the difficulty Internet consumers have in detecting, let alone pursuing, Internet fraudsters, the cost of wrongdoing must be steep enough to convince even the Internet mice not to repeat the conduct. Internet elephants must also be punished in excess of their profit in order to deter similar future behavior. Accordingly, effective deterrence cannot be achieved without at least the threat of uncapped punitive damages.

Punitive damages are necessary in cyberspace to punish and deter wrongful acts such as improper billing, excessive charges, and consumer chiseling. Suppose an ISP decides to skim $10 off each consumer's account over a two-year period. The provider can count on the likelihood that only a small fraction of consumers will detect the excessive charges. It is also likely that not every consumer who detects the skimming will successfully sue for her $10 charge. Limiting an Internet consumer to purely contractual remedies will result in under-deterrence. It is the unpredictability of tort law and the remedy of punitive damages that make the Internet seller or entrepreneur think twice before engaging in wrongful conduct that is profitable but a serious social problem to society. Predatory Internet sellers may perform a cost-benefit analysis deciding that it is profitable to cheat consumers where the probability of detection is low. Punitive

359 *Id*. at 530.

360 *Id*.

361 *Id*.

362 Griffis v. Luban, No. CX-01-1350, 2002 WL 338139, at *6 (Minn. Ct. App. Mar. 5, 2002).

363 *Griffis*, 646 N.W.2d at 537.

364 *Id*. at 536-37.

damages are a deterrent to a company because producers cannot balance the benefit of chiseling Internet users against the costs of detection with any certainty.

The cheating of countless consumers in cyberspace is comparable to the societal wrong described in *Walker v. Sheldon*,[365] where the New York Court of Appeals observed:

> [T]hose who deliberately and cooly [sic] engage in a far-flung fraudulent scheme, systematically conducted for profit, are very much more likely to pause and consider the consequences if they have to pay more than the actual loss suffered by an individual plaintiff. An occasional award of compensatory damages against such parties would have little deterrent effect. A judgment simply for compensatory damages would require the offender to do no more than return the money, which he had taken from the plaintiff. In the calculation of his expected profits, the wrongdoer is likely to allow for a certain amount of money, which will have to be returned to those victims who object too vigorously, and he will be perfectly content to bear the additional cost of litigation as the price for continuing his illicit business. It stands to reason that the chances of deterring him are materially increased by subjecting him to the payment of punitive damages.[366]

If the probability of detection is low, there is a greater potential that a spam e-mailer will send millions of unwanted e-mails. For the Internet merchant tempted to cheat consumers, he or she must not be able to coldly calculate the worst-case scenario of paying only what was owed in the first place. Wrongdoers must know that their financial existence may be threatened if they violate Internet business norms. In *Emery-Waterhouse Co. v. Rhode Island Hospital Trust National Bank*,[367] the First Circuit Court of Appeals portrayed the retention of money not belonging to a bank as conduct analogous to theft.[368] Accordingly, the First Circuit upheld a punitive damages award against the assignee.[369] There are analogous circumstances in this case when it comes to protecting consumers in cyberspace. The punishment of Internet defendants who intentionally or recklessly breach their obligation to treat consumers fairly sends a signal to the information industry. It is entirely appropriate that the states punish conduct that violates a recognized public interest and there is no lesser interest in cyberspace.

365 179 N.E.2d 497 (N.Y. 1961).
366 *Id*. at 499.
367 757 F.2d 399 (1st Cir. 1985).
368 *Id*. at 408.
369 *Id*. at 401.

The awarding of punitive damages serves the additional purpose of limiting the defendant's ability to profit from its fraud by escaping detection and (private) prosecution. If a tortfeasor is "caught" only half the time he commits torts, then, when he or she is caught, the tortfeasor should be punished twice as heavily in order to make up for the times that he or she actually escaped punishment. As a result, the tortfeasor will be forced to consider the cost of being caught, not merely the odds of escaping, even if the tortfeasor is only held accountable for a small portion of his conduct.

Punitive damages also serve as a mechanism for ensuring that the "wrongdoer bears all the costs of its actions, and is thus appropriately deterred from causing harm, in those categories of cases in which compensatory damages alone result in systematic underassessment of costs, and hence in systematic underdeterrence."[370] The social cost of underdeterrence is that actors "will have an incentive to undertake activities whose social costs exceed their social benefits."[371] Online thieves are using a new technique called "phishing" to steal the identity and credit card numbers of consumers. As briefly mentioned earlier in this Article, phishing is the transmittal of e-mails, which appear to come from major corporations, to consumers.[372] The predator directs consumers to fraudulent web sites that mirror the companies' real sites and obtain bank account or credit card information from the consumers by asking them to verify or update their accounts.[373]

The punishment of intentional or reckless breaches of the obligation to treat Internet consumers fairly is a necessary signal to new industries. The strong arm of punitive damages is called into play to punish firms who play fast and loose with Internet users' money, data, identity, and right to privacy. Punitive damages are the only remedy that is tailored to punish and deter e-businesses from engaging in actions contrary to the public interest. The underlying public purpose is to teach fraudulent Internet companies that "tort does not pay."[374] Punitive damages encourage plaintiffs to act as "private attorneys general" and serve as an incentive to encourage a plaintiff to sue when there is widespread harm.[375]

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370 Ciraolo v. City of New York, 216 F.3d 236, 243 (2d Cir. 2000) (Calabresi, J. concurring).

371 *Id*. (Calabresi, J. concurring).

372 James Covert, *Amazon Sues to Stop E-Mails That Use Its Name*, WALL ST. J., Aug. 27, 2003, at D4. *See supra* notes 11-13 and accompanying text.

373 *Id*.

374 Rookes v. Barnard, 1964 A.C. 1129, 1227 (H.L. 1964) (appeal taken from Eng.).

375 *See, e.g.*, Leslie E. John, Comment, *Formulating Standards for Awards of Punitive*

Deterrence cannot be achieved unless the costs of wrongful conduct are sufficient to induce fraudulent Internet wrongdoers and others tempted by ill-gotten gains not to repeat the conduct again. The awarding of punitive damages against Internet defendants will send a clear message to an e-business corporate headquarters or offshore haven that it is risky to defraud consumers. The ultimate goal of punitive damages is to punish by taking away the "ill gotten" gain, setting an example, and deterring future conduct of a like nature.

Punitive damages are an efficient remedy to punish and deter intentional and reckless torts in situations where "the probability of detection is very low and the probability of harm is very high."[376] Lowering the probability of enforcement implies that enforcement costs can be minimized. The lower that the probability of detection is, the fewer the resources devoted to enforcement need to be, and the fine can be set high enough so that the fine multiplied by the probability of its being imposed (the "expected fine") reaches the optimal level for deterrence.[377] A large punitive damages award is necessary to achieve optimal deterrence where the probability that any one Internet user will uncover wrongdoing is minimal.[378]

The Fifth Circuit in *Jackson v. Johns-Manville Sales Corp.*[379] stated that "punitive damages reward individuals who serve as 'private attorneys general' in bringing wrongdoers to account."[380] Private attorneys general provide a backup in situations in which government enforcement agencies fail to adequately protect the public. Fraud in the e-business executive suites will typically be more difficult and expensive to detect and prosecute than crime in the streets.

Damages in the Borderland of Contract and Tort, 74 CAL. L. REV. 2033, 2051-52 (1986) (arguing that punitive damages are an incentive to sue where the plaintiff might not otherwise do so or when the defendant is unlikely to be prosecuted criminally). *See also* Susan Abramson, Note, *Crawling Out from Under* Boulder, 34 CASE W. RES. L. REV. 303, 337-38 (1984) (arguing that private damage remedy fulfills "private attorney general" functions). The policy behind attorney fee shifting is also justified on a "private attorney general" rationale. *See* Thomas D. Rowe, *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 653 (1982) ("[T]he 'private attorney general' theory justifies a fee award on the basis of the public usefulness of advancing a particular type of claim.").

376 Thomas Koenig, *The Law Arises Out of Fact, Even for a "Poet Laureate,"* 28 SUFFOLK U. L. REV. 1021, 1033 n.47. *See generally* WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 160-61 (1987).

377 *See generally* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 190-93 (1968).

378 *See* A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880, 880-81 (1979).

379 781 F.2d 394 (5th Cir. 1986), *abrogation recognized by* Centennial Ins. Co. v. Ryder Truck Rental, Inc., 149 F.3d 378 (5th Cir. 1998).

380 *Id*. at 403.

IV. CONCLUSION

The remedy of punitive damages is particularly well-suited to assist consumers in unmasking deliberate, concealed economic harms, like those suffered by the victims of computer viruses, fraudulent Internet sales and services, and the routine invasions of privacy that compromise the identity of users.[381] Without exemplary damages, the predatory Internet wrongdoers run little probability of detection if they injure a large number of consumers in relatively minor ways such as through pop-up ads, spam e-mail, or hidden charges. A popular misconception contends that punitive damage awards have spun out of control, threatening big, vulnerable companies. This is simply not so. Punitive damages are appropriate where a cyberspace defendant has acted in reckless indifference of the rights of large groups of consumers with the calculated purpose of making illicit profits.[382]

Limiting a consumer cheated in a cyberspace transaction to purely contractual remedies will certainly result in diminished deterrence. Despite the theoretical promise of punitive damages for protecting consumers, the remedy is stillborn. Punitive damages are particularly needed to punish and deter conduct on the borderline between the law of torts and criminal law in cyberspace. Punitive damages are needed now more than ever by consumers to detect and punish fraudsters, predators, and other online criminals on the World Wide Web. In cyberspace, punitive damages have a potentially useful role of deterring reprehensible conduct that, although arguably rational from the standpoint of the particular Internet predator, has widespread social costs for consumers and for society. Internet wrongdoers must know they cannot estimate the cost of their misdeeds by coldly calculating the cost of paying compensatory damages. Internet con artists must know that their financial existence may be threatened by shortchanging Internet users, violating their privacy, or trading upon their identity.

381 *See* William M. Landes & Richard A. Posner, *New Light on Punitive Damages*, REGULATION, Sept.-Oct. 1986, at 33.

382 For example, punitive damages have been deemed appropriate against insurance companies that chisel small amounts from their policyholders. *See, e.g.*, Hawkins v. Allstate Ins. Co., 733 P.2d 1073, 1085 (Ariz. 1987).

APPENDIX

Research Methods for Study of Punitive Damages in Cyberspace

The term "Internet" appeared in 1,559 state and federal opinions issued in 2002 but only a small percentage of these cases appear in the sample because the role of the Internet was only incidental in most of this litigation.[383] This study examined all Internet-related cases in which there was an equitable or legal remedy during the years 1992-2002.

Since no international, federal, or state agency systematically collects data on Internet-related cases, all available published and unpublished data sources were searched. The following sources were exhaustively examined: (1) trial verdict reporters;[384] (2) LEXIS and WESTLAW's federal and state databases and news services;[385] (3) cyberspace research libraries of law firms;[386] (4) national, regional, and local verdict reporters;[387] (5) reports of domain name disputes;[388] (6)

383 For example, in Kootenai Tribe of Idaho v. Veneman, 313 F.3d 1094 (9th Cir. 2002), the court reviewed the United States Forest Service's "Roadless Area Conservation Rule." *Id*. at 1104. The court's reference to the Forest Service's posting of the rule on its web site is not sufficient to qualify the case for the study of cyberspace litigation. *Id*. at 1119.

384 The combined jury verdicts and settlements database of LEXIS reports verdicts from Alaska, Alabama, Arizona, Arkansas, California, Connecticut, District of Columbia, Florida, Georgia, Idaho, Indiana, Kentucky Louisiana, Maine, Maryland, Massachusetts, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Texas, Utah and Vermont. Most state verdict reporters cover the entire period of this study (1992-2002). In addition, I examined the National Jury Verdict Review & Analysis, and the Combined Jury Verdicts and Settlements sources.

385 I examined all federal district court decisions, federal appellate decisions, and state appellate decisions reported in WESTLAW and LEXIS. Searches were conducted for internet-related cases using the following searches: (1) hlead (internet or e-mail or web or world wide web or worldwide web) and damages or injunction; (2) internet or website or web site or world wide web or www and damage or award or injunct! and date aft 1992; (3) atleast3 (Internet or cyberspace or world wide web or e-mail) and verdict or judgment and date aft 1992.

386 I searched the 300-plus Internet law cases published in the Phillips Nizer Internet Law Library. Martin H. Samson, *Internet Library of Law and Court Decisions*, *at* http://www.phillipsnizer.com/internetlib.htm (last visited Feb. 15, 2004). The Seattle law firm of Perkins, Coie publishes the *Internet Case Digest*, which is an online "compilation of cases designed to bookmark, collate and monitor important developments in Internet law, including cases that have significant implications for Internet legal issues even if they are not directly related to the Internet. The Digest includes both filed and decided cases to capture the most recent developments as well as new judicial precedents." *Internet Case Digest*, *at* http://www.perkinscoie.com/casedigest/default.cfm (last visited Feb. 15, 2004). The Finnegan, Henderson, Farabow, Garrett & Dunner, LLP web site was an important resource because of its exhaustive collection of Internet-related trademark cases. *Internet Trademark Case Summaries*, http://www.finnegan.com/publications/index.cfm?info=trademark (last visited Feb. 19, 2004).

387 In WESTLAW, I reviewed the Combined Jury Verdicts and Settlements, which included: (1) Association of Trial Lawyers of America ("ATLA"); (2) California Jury Verdicts and Judgments; (3) Florida Jury Verdict Reporter; (4) Jury Verdict and

individual cyberspace cases reported on law firm web sites;[389] (7) law school research centers;[390] (8) American Law Reports ("ALR") annotations;[391] (9) all Internet-related Mealey publications;[392] (10) e-commerce law secondary sources;[393] (11) Internet treatises;[394] (12) legal news services;[395] (13) Security and Exchange Commission ("SEC") filings;[396] and (14) general news[397]

Settlement Summaries; and (5) Verdict Settlements. All of these sources had complete data for the years studied.

388 I searched the combined domain name disputes and decisions but did not include cases channeled to the Uniform Dispute Resolution Procedures ("UDRP") developed by World Intellectual Property Organization ("WIPO"). Since the end of 1999, most domain name disputes have been decided by one or three person alternate dispute resolution panels rather than by the federal courts. As part of the process of registering a domain name, the registrant agrees to submit complaints filed by third parties to alternative dispute resolution panels. These proceedings are quick, inexpensive, and adjudicate domain name disputes between litigants in different countries. Panels have the limited power of ordering the transfer or cancellation of domain names and cannot award damages, attorney's fees, or costs. Unlike court cases, the UDRP are informal, non-appealable, and stare decisis is not followed. The sample of domain name cases is limited to those filed in federal court under the Federal Dilution Act of 1995 and the Anti-Cybersquatting Act of 1998.

389 Law firms frequently report individual "victories" in their web site marketing materials. A number of law firms compile cyberlaw verdicts won by other firms.

390 The UCLA Online Institute for Cyberspace Law and Policy compiles the leading Internet law cases by year. *The UCLA Online Institute for Cyberspace Law and Policy*, *at* http://www.gseis.ucla.edu/iclp/hp.html (last visited Feb. 15, 2004). The Berkman Center for Internet & Society at Harvard Law School was also searched. *The Berkman Center for Internet & Society*, *at* http://cyber.law.harvard.edu/home (last visited Feb. 15, 2004).

391 An online database of all Internet-related annotations in American Law Reports ("ALR") was extensively searched.

392 My content analysis of reported cases focused upon Cyber Tech & E-Commerce: Mealey's Litigation Report, Emerging Insurance Disputes: Mealey's Litigation Report, Intellectual Property: Mealey's Litigation Report, Litigation: Mealey's Combined Reports, Patents: Mealey's Litigation Report, and Trademarks: Mealey's Litigation Report.

393 I searched the commercial law, computer law, and e-commerce secondary literature. I conducted searches of Matthew Bender's UCC Reporter and Digest as well as the following Bender treatises: E-Commerce and Communications: Transactions in Digital Information, Nimmer on Copyright, Gilson on Trademark Protection & Practice, Intellectual Property Counseling and Litigation, Computer Contracts, Computer Law, and Law of the Internet.

394 During the period of the study, I updated four editions of the *E-Business Legal Handbook* (2003). All of the cases uncovered in each year's edition were included in the research universe. Other treatises searched were: Julian S. Millstein et. al., DOING BUSINESS ON THE INTERNET (2002); Kevin J. Connolly, LAW OF INTERNET OF SECURITY & PRIVACY (2002); Ian Ballon, E-COMMERCE & INTERNET LAW (2001).

395 The principal source here was the LEXIS library of legal news newsletters and publications. However, I also surveyed the general news databases as well as the combined news databases from the states compiled by WESTLAW. WESTLAW includes all Dow Jones magazines, newspapers, and wires, as well as other magazine databases. Both services have extensive libraries of newswires and news services providing additional information on case developments.

396 Corporate annual reports to shareholders were examined on LEXIS's FEDSEC database, as well as the SEC Edgar databases. Companies are required to disclose pending or settlement cases that may affect stock prices. LEXIS has complete SEC filings and exhibits in its online database.

397 Newspapers and popular magazines were analyzed on many LEXIS and WESTLAW databases.

and information services.[398] The sample excludes all criminal cases as well as dispositions for convicted offenders who are challenging the constitutionality of Internet postings of their criminal records and personal information.[399] The sample excluded Internet-related small claims actions because there is no reliable reporting service.[400] The sample does not include discovery orders to produce computer tapes or other information. The dataset does not include disputes decided under alternative dispute resolution such as the Uniform Domain Name Resolution Policy.

Furthermore, the sample does not include criminal prosecutions, regulatory actions brought by governmental units, or bankruptcies. Regulatory, criminal, and dot-com insolvency involves the government as the adjudicator of rights. These public law subjects are sharply different than private litigation, so they will be examined in a separate article.[401] The focus of this Article is on the role of private litigants in Internet litigation. Foreign litigants are included only to the extent that actions are tried in U.S. state and federal courts.

398 I systematically searched the extensive collection of computer law and cyberlaw publications on LEXIS and WESTLAW. Sources include: all Andrew Publications Newsletters on Internet-related topics, Computer Law Newsletters, Leader Publications Newsletters, and the published outlines of the Practicing Law Institute.

399 This Article focuses on civil litigation rather than criminal or quasi-criminal cyberspace cases where the plaintiff was a governmental agency or prosecutor.

400 In the state of Washington, there are newspaper reports of small claims courts ordering commercial e-mailers to compensate consumers. However, the complete absence of written opinions or other records makes it impossible to determine what role these informal tribunals play in the overall picture.

401 The research includes a content analysis of every FTC litigation report and SEC litigation release from 1995 to 2003. The FTC asserts broad investigative and law enforcement authority to police Internet fraud. The FTC uncovers many of its cases by enlisting volunteers to surf web sites in order to uncover get rich schemes, false advertising, miracle cures, privacy infractions, online pyramid schemes, credit card billing schemes, and other deceptive sales practices. Most FTC actions are based on the Commission's broad enforcement authority to restrain "unfair or deceptive acts or practices in or affecting commerce." 15 U.S.C. § 45(a)(1) (2003). Similarly, the SEC has been active in extending federal securities law to the enforcement of predatory, anti-fraud and anti-competitive practices in cyberspace. SEC actions may be brought for insider trading, pyramid schemes, fraudulent investment opportunities, and false and misleading information about securities and the companies that issue them. *U.S. Securities and Exchange Commission*, http://www.sec.gov (last visited Feb. 15, 2003).

Basic Choices in the Law of Auto Finance: Contract Versus Regulation

Alvin C. Harrell[*]

I. INTRODUCTION

It is widely thought that American society is polarized as to fundamental issues regarding the role of government in regulating private transactions.[1] Such a polarization has historical roots,[2] and it seems to be widening rather than contracting. It has also been noted that this is occurring at a time of unprecedented long-term national prosperity,[3] with serious economic recessions seemingly a distant memory. This suggests an obvious question: what will happen to this political divide, and its effect on American society, in the context of the inevitable serious economic crisis? Your author does not know the answer to that question, but the question itself suggests a need for society to maximize its efforts to address, illuminate, and, as possible, rationally reconcile its conflicting views in a timely manner.

At the center of this polarization is the law, and more precisely for our purposes, commercial and consumer law. A primary role of any legal system is to provide a mechanism for the peaceful resolution of private controversies.[4] This function,

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1 *See, e.g.*, Tim Rutten, *Fact or Opinion? Yes, It Really Does Matter*, L.A. TIMES (Orange County ed.), Dec. 27, 2003, at E1 (noting that this divide extends to journalism and positing that this may threaten the vital center that draws commercial funding to support our news media infrastructure).

2 *Id*. *See also* JAMES GRANT, MONEY OF THE MIND: BORROWING AND LENDING IN AMERICA FROM THE CIVIL WAR TO MICHAEL MILKEN (First Noonday Press 1994) (1992) (analyzing the historical growth of borrowing and lending).

3 *See* Rutten, *supra* note 1, at E1.

4 LEGAL INSTITUTIONS TODAY: ENGLISH AND AMERICAN APPROACHES COMPARED 32 (Harry W. Jones ed., 1977). It is surely ironic that our modern legal system, with its emphasis on such things as due process, fundamental fairness, and consumer protection, arose from a feudal system in England designed primarily to maintain the effects of the Norman conquest while balancing the needs of the king against the baronial courts. The Magna Carta of 1215 is merely the most famous manifestation of this reconciliation; notably this process, designed to provide procedures and some substantive rules for resolving jurisdictional disputes between the barons and the king, led ultimately to the

however, requires some consensus as to how such controversies should be resolved. The consensus must extend to substantive as well as procedural law, and must be articulated by legislatures, courts, and lawyers in the form of widely understood and universally applicable principles and rules.[5] This is the nature of commercial and consumer law. The consensus must also be broad and it must serve as a legal middle ground that represents a workable means to facilitate common transactions. But how can that be possible in a polarized profession and society? Whatever middle ground that exists seems inherently at risk when legal debates focus on the fringes of a polarized profession.[6] Thus, a central question for our time is whether the traditional middle ground, as it has existed in western society for hundreds of years, can be preserved as the basis for a broad legal consensus in the twenty-first century. A determinant of this outcome is the basic choice between the common law system, particularly contract common law, and regulation as the primary legal basis for effecting private transactions.[7]

The choice between contract and regulation implicates a number of other legal and policy issues, considerations, and choices. Part II of this Article highlights some of these issues. Part III notes the impact on current issues in vehicle finance and

development of the common law system. *See* WILLIAM SHARP MCKECHNIE, MAGNA CARTA: A COMMENTARY ON THE GREAT CHARTER OF KING JOHN 295 (Lawbook Exchange 2000) (1914).

5 This is, of course, a narrow concept of law, as a system of rules to govern human relations. There are other broader and more philosophical directions that one can take, but these would change the focus of this article into an inquiry concerning the nature of jurisprudence. Roscoe Pound described law in the first sense as "the legal order [as that term] is used to mean the regime of ordering human activities and adjusting human relations through the systematic application of the force of a politically organized society." 1 ROSCOE POUND, JURISPRUDENCE 13 (Lawbook Exchange 2000) (1959). Your author will accept this as good enough for present purposes, and as consistent with the concept of "consumer law" as generally understood today. *See id*. at 12-14; FREDERICK H. MILLER ET AL., CONSUMER LAW: CASES, PROBLEMS AND MATERIALS 4-5 (1998). *See also* Clare Dalton, *An Essay in the Deconstruction of Contract Doctrine*, 94 YALE L.J. 997 (1985); Patrick J. Kelley, *A Critical Analysis of Holmes's Theory of Contract*, 75 NOTRE DAME L. REV. 1681 (2000); John E. Murray, Jr., *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1 (1969).

6 *See* Rutten, *supra* note 1, at E1. A focus on fringe issues will inevitably emphasize broad, philosophical differences that realistically cannot be bridged, thereby emphasizing the divisions between the participants. In contrast, a debate that focuses on narrow, more practical questions will tend to reduce the scope of the controversy to matters where there is a greater opportunity for consensus. This is not to suggest that any kind of debate should be limited or discouraged, but only to note that if consensus as to a middle ground is desired, success is more likely in the context of narrow practical issues as opposed to broader philosophical ones. The common law of contracts, as discussed in this article, is a particularly effective mechanism for achieving precisely that success. *See also* Alvin C. Harrell, *Commentary: Common Law or Regulation – Which is Better?*, 58 CONSUMER FIN. L.Q. REP. (forthcoming 2004).

7 Mark L. Movsesian, *Two Cheers for Freedom of Contract*, 23 CARDOZO L. REV. 1529, 1547-48 (2002) (book review).

the ways that alternative policy choices relate to those issues. Part IV is a conclusion designed to summarize the basic points derived from this discussion.

It can be conceded from the outset that your author believes that freedom of contract is an important part of civil society. As such, it should only be constrained with caution. Regulation of private transactions, even in the name of consumer protection, is inherently a constraint on that freedom.[8] That is not to say that regulation is always inappropriate; however, it is to say that regulation is not cost-free. Like all policy decisions, the decision to let public institutions regulate rather than defer to the wishes of the parties to the transaction logically requires a realistic cost-benefit analysis in terms of both social and individual interests. This Article considers some of the factors that may be appropriate for consideration in such analysis.

II. POLICY CHOICES IN A POLARIZED SOCIETY

There are some clear analytical benefits in debating these issues. The current emphasis on the polarization of American political thought may help to present society with a set of more clearly articulated policy alternatives regarding the basic elements, practices, transactions, and remedies of commercial and consumer law. Articulation of these choices may help to resolve or at least narrow policy differences. The following discussion will consider some of these basic policy choices.

A. Contract Versus Regulation

The choice between freedom of contract and regulation is one of the most basic of all policy choices and, to a significant extent, will influence the other choices noted below (and vice versa). The simple fact is that there are only two basic ways of determining the terms of private consumer transactions: 1) persons decide for themselves, or 2) someone else decides for them. The choice is party autonomy effectuated via contract or its opposite. The former is decision by private agreement, *i.e.*, freedom of contract. The latter is the absence of or restrictions on choice, *i.e.*, regulation of the terms or availability of the transaction by an external source.[9]

8 Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 763-64 (1983).

9 *See* JAMES D. GWARTNEY & RICHARD STROUP, ECONOMICS: PRIVATE AND PUBLIC CHOICE 32-33 (3d ed. 1983). Of course, consumer law is full of such restrictions. That is the nature of consumer protection law in the United States today. But that does not change the nature of the choice between party autonomy and regulation, or the cost of the latter in terms of the former. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF

Regulation has an inevitable paternalistic effect since consumers are presumably protected from making bad decisions. Freedom of contract, on the other hand, includes the option to make bad choices. It is unlikely that we could reliably eliminate bad choices without also limiting good ones. Nonetheless, it is apparently human nature for us to believe that we can make better choices for others than they can make for themselves; indeed, education apparently tends to reinforce this belief and higher education even more so. Thus, we may tend to assume that if we are well educated we can make better decisions than those who are not, even as to matters personal to other persons. Who among us would not like to assume the role of benevolent dictator? So, paternalistic regulation is often an easy sale politically. Its purported benefit of protection is easily promised, but its costs are seldom fully understood.[10]

The common law, although biased towards freedom of contract, has always recognized a role for paternalistic oversight by public officials and the judiciary in order to protect against fraud, deception, duress, unconscionability, and incapacity.[11] Such protections, however, have generally been implemented through the courts on the basis of specific evidence and in limited circumstances rather than being imposed across-the-board by regulation on the basis of broad-scale presumptions that effectively bar whole classes of common transactions.[12]

The hesitancy of the common law to broadly prohibit or prescribe in detail the terms of common transactions apparently stems partly from a recognition that regulation is inherently alien to freedom of contract and therefore carries a very high and commonly misunderstood social price.[13] A basic truth that cannot be reasoned away is that regulation, no matter how minimally paternalistic it may be, takes away some freedom of

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LAW (4th ed. 1992) [hereinafter POSNER, ECONOMIC ANALYSIS] (examining the common law and regulatory approaches from an economic perspective).

10 The costs sometimes include the social and economic costs of litigation run amok. *See, e.g.*, Stuart Taylor Jr. & Evan Thomas, *Civil Wars*, NEWSWEEK, Dec. 15, 2003, at 43 (the headline on the cover of this issue reads "Lawsuit Hell: How Fear of Litigation is Paralyzing Our Professions"); Alvin C. Harrell, *Commentary: It's a Mad, Mad, Mad, Mad World*, 57 CONSUMER FIN. L.Q. REP. 86, 95 (2003) [hereinafter Harrell, *Mad World*]; Jim Copland, *Tort Law Represents a Growth Industry*, THE DAILY OKLAHOMAN, Mar. 2, 2004, at 12A. These references are not intended as the definitive answer to the issues raised, only to suggest that the issue has indeed been raised.

11 *See* 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 5.1 (2d ed. 1998); JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS §§ 9-1 to 10-5 (3d ed. 1987).

12 FARNSWORTH, *supra* note 11, § 5.1.

13 *See* CALAMARI & PERILLO, *supra* note 11, § 1-3 ("[T]he movement of the progressive societies has hitherto been a movement from Status to Contract.") (quoting HENRY MAINE, ANCIENT LAW 165 (3d Am. ed. 1873)).

contract.[14] It may be fully appropriate as to certain transactions such as those involving duress, fraud, or incapacity, but those traditional confines should not be extended without caution and careful consideration.

Of course, if one does not believe that contracts can be products of equitable bargaining, it will be easy to lose faith in contract law and the related economic freedoms it protects. Much academic discourse has recently been dedicated to the notion that private consumer contracts, specifically form contracts, are a myth because they are often contracts of adhesion rather than a result of detailed negotiations.[15] But this is something of a "straw man," setting up unrealistic perfection as the goal and then rejecting anything less than perfect as a failure. No modern society could function without form contracts, and most consumers do not have the legal expertise needed to draft a contract that would comply with today's consumer protection laws. Form contracts, however, do not prevent consumers from regularly negotiating the important terms of big-ticket items (such as houses, cars, home improvements, employment contracts, and many services), and smaller-ticket items are sold in mass markets, which are not susceptible to individual haggling. Both categories of transactions are commonly subject to advertised sale pricing, comparison-shopping, coupons, Internet deals, special offers, and other competitive practices that create marketing conditions somewhat equivalent to pricing negotiations.

Of course, not everyone gets the same deal as the shrewdest consumer. Each of us has negotiating strengths and weaknesses, greater interest and sophistication in some areas than in others (and hopefully a learning curve in each), as well as inherent variations in our personalities and tastes. Our personalities are

14 *See* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1211-12 (2003); Alvin C. Harrell, *Introduction: Predatory Lending, Part Three*, 56 CONSUMER FIN. L.Q. REP. 2, 57 (2002) (discussing the cost to consumers of predatory lending laws). Of course, the general statement in the text applies primarily to substantive restrictions; disclosure requirements do not directly interfere with party autonomy. However, even disclosure requirements are not cost-free, *e.g.*, in terms of compliance costs and litigation risks. Like any cost of doing business, these costs ultimately will be passed to consumers in some form (*e.g.*, higher prices and/or reduced competition and/or reduced transaction availability), thereby pricing some consumers out of the market and interfering with freedom of contract in various ways. *See* Benjamin Hoorn Barton, *Why Do We Regulate Lawyers?: An Economic Analysis of the Justifications for Entry and Conduct Regulation*, 33 ARIZ. ST. L.J. 429, 460 (2001).

15 *See* Edward L. Rubin, *Types of Contracts, Interventions of Law*, 45 WAYNE L. REV. 1903, 1906-07 (2000). *See generally* Symposium, *Consumer Protection and the Uniform Commercial Code*, 75 WASH. U. L.Q. 1 (1997); Symposium, *Reconsidering Grant Gilmore's* The Death of Contract, 90 NW. U. L. REV. 1 (1995).

too diverse for it to be otherwise. Thus, in a given transaction, some will be perceived as getting a better deal, although we will probably find much disagreement as to what constitutes the "best" deal in a given scenario. All of this, however, is evidence of the functioning of free markets, not the contrary.[16]

B. The Future of Contract Law

By historical standards, contract law is relatively new. Modern contract law has its roots in the common law of sixteenth century England.[17] Controls on private agreements, including essential terms such as price, have been common historically and have long been vigorously defended.[18] Freedom of contract for consumers is therefore a relatively rare and modern phenomenon. Political dynamics may explain why contract law is so recent in human history,[19] and perhaps more consideration is needed on this subject. Today, those of us who enjoy freedom of contract are likely to take it for granted, and we are also likely to take for granted the benefits of our economic freedom that come with the ability to contract. But then again, perhaps it is natural for us to want to have our cake and eat it too, to want freedom of contract without the risks that it entails.

Obviously, freedom of contract does not come without risks. Freedom of contract inherently includes the freedom to make bad deals and other mistakes. We all do that everyday and we will generally defend our right to try again tomorrow. It is appropriate for the law to make reasonable provisions to protect those who are unable to conduct their own transactions and to protect everyone from clearly abusive practices; however, drawing these lines is inherently difficult.[20] Consistent with the common law, it is best to leave that task to the courts or their equivalent (*e.g.*, arbitration in appropriate cases). It should always be remembered that laws and regulations are a blunt and dangerous instrument, governed themselves by the law of

16 Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 254 (1998). *See also* GWARTNEY & STROUP, *supra* note 9, at 38-39 (explaining how diverse consumer choices translate into the economic "law" of demand).

17 S.F.C. MILSOM, HISTORICAL FOUNDATIONS OF THE COMMON LAW 279 (1969). *See also* CALAMARI & PERILLO, *supra* note 11, § 1-3.

18 *See* James L. Brown, *An Argument Evaluating Price Controls on Bank Credit Cards in Light of Certain Reemerging Common Law Doctrine*s, 9 GA. ST. U. L. REV. 797, 798 (1993).

19 *Id*. (explaining political dynamics as a popularly-based sentiment favoring price controls). Your author would add a suggestion that the intricacies of contract law, and their relation to economic well-being, are often understood at a level of articulation by relatively few, including few in policy-making positions. Thus, the implications are easily misunderstood.

20 Camerer et al., *supra* note 14, at 1211-12.

unintended consequences.[21] Freedom from mistake may sound appealing but is unlikely to be achieved, because that protection can only come at some cost to party autonomy – a price that many of us probably would prefer not to pay.[22]

Perhaps the most vigorous modern argument against contract law in consumer transactions is that it favors giant, sophisticated corporations instead of unsophisticated consumers:[23] Influenced by advertising schemes that rely on popular emotions, consumers are often lured into merchants' establishments and reportedly induced into unwittingly signing adhesion contracts with onerous terms that cannot be viewed as representing consensual transactions.[24] This may seem an appealing characterization (who among us does not resent large corporations?), but more consideration is needed before reaching a conclusion based on this scenario.

Like contract law itself, this argument is not new, and, indeed, probably had even greater force in the sixteenth century than it does today. When contract law was created, consumers were far less sophisticated, both in absolute terms and relative to merchants, than they are today. With near-universal education and literacy (at least in the U.S.), widespread dissemination of product information, and vigorous world-wide competitive forces at work, there have never been more opportunities for consumers to inform themselves and make rational choices than there are today.[25] Moreover, the Internet and global competition have enhanced consumers' competitive bargaining position relative to merchants across a spectrum of transactions. The playing field has never been so level. That we as consumers do not make even greater efforts to inform ourselves and seek alternatives is largely a function of choice and how we wish to spend our time,

21 *See* David B. Spence & Lekha Gopalakrishnan, *Bargaining Theory and Regulatory Reform: The Political Logic of Inefficient Regulation*, 53 VAND. L. REV. 599, 608 (2000).

22 *See, e.g.*, Ira Carnahan, *Predatory Lawmaking*, FORBES, Jan. 12, 2004, at 61 (noting the cost of predatory lending initiatives, in terms of credit availability).

23 This appears self-evident to so many that it is often taken as a given in much of the academic literature. *See, e.g.*, GRANT GILMORE, THE DEATH OF CONTRACT 104 (Ronald K. L. Collins ed., 2d ed. 1995) ("It seems apparent to the twentieth century mind . . . that a system in which everybody is invited to do his own thing, at whatever cost to his neighbor, must work ultimately to the benefit of the rich and powerful . . . ."). Of course, Gilmore's brief statement does not purport to adequately describe modern contract law, and, as noted below, in your author's experience that statement is often not accurate as a general proposition. *See generally* GWARTNEY & STROUP, *supra* note 9, at 461-65.

24 *See* Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. Rev. 429, 483 (2002).

25 The rise of the Internet should make this self-evident, but the expansion of federal and state disclosure requirements provides a further example. *See* Camerer et al., *supra* note 14, at 1232-34.

rather than a lack of opportunity.

Advertising is more sophisticated than ever and seemingly less subtle, but the charismatic salesperson, fast-buck artist, and con man have always been with us. The gap between merchant and consumer, in terms of information and bargaining power, has apparently narrowed rather than widened. The best consumer protection of all has always been the consumer's self-interest, and unsophisticated consumers often get the better of larger and more experienced negotiating partners.[26] There can be sharp practices and deception on both sides of a transaction.

Contrary to popular belief, contract law does not necessarily reward large institutions or sophisticated and well-educated parties. Well-educated and other successful professionals are notorious for making foolish investment and consumer decisions. This is evidenced by the list of the rich and famous that will appear in any high-profile investment failure or faddish consumer trend. There is, in fact, often a divide between education and business success. Contract law does reward caution and prudence, and over time most of us learn that. Thus, there is a natural consumer learning curve in which young and unwary consumers are more likely to make mistakes, or at least unwise decisions, in ordering their lives. Hopefully, they learn from those mistakes and ultimately govern themselves more prudently. There also seems to be a generational progress in which children learn from their parents and grandparents.[27]

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26 *See* Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 296 (1995). By now it should be apparent to almost everyone that stature, resources, education, and a high income do not equate to wisdom or shrewdness. Large enterprises have a long and well-documented tendency toward error, atrophy, stagnation, and even disaster. Innovation and product sophistication more frequently are the hallmarks of individuals (including consumers) and small enterprises. *See* Gary Hamel & Lloyd Switzer, *The Old Guard vs. the Vanguard*, WALL ST. J., Feb. 23, 2004, at A17; Gary Hamel, *When Dinosaurs Mate*, WALL ST. J., Jan. 22, 2004, at A12. *See generally* GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN HISTORY, 1900-1916 (Quadrangle Books 1967) (1963) (documenting the tendency of large enterprises to lose touch with their markets and suffer a declining market share). The relative inflexibility of large enterprises derives in part from a need to standardize products and services to achieve the economics of scale necessary to justify the size of the enterprise. This may result in a perception that the large enterprise has unfair bargaining power, due to the firm's reduced ability to accommodate nonconformity, and a resulting reliance on standard contract terms. *See* POSNER, ECONOMIC ANALYSIS, *supra* note 9, § 4.7. But, in fact, this lack of flexibility is an inherent and severe competitive disadvantage, which opens the door to more nimble competitors more willing to accommodate emerging trends, the demand for innovative goods and services, and expanding niche markets.

27 *See* Zamir, *supra* note 16, at 244. Like most everything else, this will vary from person to person, and family to family. *See generally* ROBERT T. KIYOSAKI, RICH DAD, POOR DAD: WHAT THE RICH TEACH THEIR KIDS ABOUT MONEY – THAT THE POOR AND MIDDLE CLASS DO NOT! (2000); THOMAS J. STANLEY & WILLIAM D. DANKO, THE

Those who are incompetent may need special protection, and the law provides such protection in a variety of ways.[28] But for the rest of us, the freedom to develop and apply our own personal prudential standards, and to ascertain and implement the levels and types of risks that we are willing to accept in a given transaction, is an important part of life. It makes it all worthwhile when we see prudent decisions rewarded. For each of us, these risks and choices will be different. Contract law and freedom of contract make it all possible and nothing in the twenty-first century changes this basic analysis.

The debate over contract law will never end, nor should it. It reminds us of the importance of contract law, the need to define reasonable legal boundaries, and the precarious nature of individual freedom. The role of contract law is important to us all, at both the individual and societal level. Fortunately, American contract law in general remains more viable than ever, and as a middle ground, it seems to be holding.[29]

Consumer contracts and contract law are alive and well in the twenty-first century. We may not always like the results, or even the process, but that is the nature of freedom. How many of us would knowingly give up that freedom in return for paternalistic control by someone else? As always, that is the essence of the choice between contract and regulation.

C. State versus Federal Law

A related choice is that between state and federal law. The relationship between this choice and that discussed above does not seem to be widely recognized and understood, despite the obvious impact of the relationship on the legal profession.[30]

MILLIONAIRE NEXT DOOR (1996). It is unfortunate the public schools do not do a better job of supplementing this transfer of generational wisdom, so as to help level the playing field in terms of personal financial literacy. Until an institutional effort is made in this regard, the results likely will continue to be uneven.

On the other hand, America remains a land of opportunity that rewards prudent behavior. Recent information suggests, for example, that immigrants close the economic gap with native-born Americans and join the American middle class within about a ten-year period. *California Here We Come*, WALL ST. J., Feb. 23, 2004, at A16 (citing a University of Southern California study). Some groups do better than others, but overall the effect is widespread, affecting diverse ethnic groups. *Id.* As reported in the media, nearly 90% of U.S. immigrants in the U.S. for twenty years or more make it into the middle class. *Id.* Considering the tremendous challenges faced by any immigrant, this is an extraordinary record of achievement, suggesting a very steep "learning curve" in terms of personal financial expertise.

28 *See, e.g.*, OKLA. STAT. tit. 43A, § 10-104 (2003).

29 Movsesian, *supra* note 7, at 1530. *See also* Alvin C. Harrell, *Case Note: Judge Understands Indirect Auto Finance, Part Two*, 57 CONSUMER FIN. L.Q. REP. 231, 233 (2003) [hereinafter Harrell, *Judge Understands*].

30 Movsesian, *supra* note 7, at 1542-43. *See also* Amy Bizar et al., *Introduction to the 2000 Annual Survey of Consumer Financial Services Law*, 55 BUS. LAW. 1255, 1255-56

These are further issues that deserve attention as a policy and jurisprudential matter.

State contract law, both common and statutory, is primarily derived from the common law.[31] Federal law is largely regulatory, and although there are state regulations, most regulatory law is federal law.[32] Most state regulations are enforced in court in accordance with the common law system; federal regulations are more often enforced in administrative actions.[33] There are many exceptions to all of this, such as the Predatory Lending and Truth in Lending examples discussed below, but these merely prove the general rule.

Consequently, the choice to address an issue or problem at the federal level is often a choice of administrative regulation over common law. The exceptions are not unimportant, including, for example, the current wave of state predatory lending laws, which are somewhat regulatory in nature in the sense that they effectively bar whole classes of parties from voluntary transactions and mandate in detail certain contract terms for others.[34] These state laws are also typically regulatory in the sense of agency oversight and enforcement, although the role of the courts remains an important factor consistent with the common law tradition.[35]

Judicial remedies also are important in the federal law arena, as evidenced by the Truth in Lending Act ("TILA")[36] and the Fair Debt Collection Practices Act ("FDCPA")[37] litigation, which surely must rank among the most extensive in history.[38] In the case of TILA, Federal Reserve Board ("FRB") regulation has played a significant role, providing a level of regulatory detail that is unheard of in the context of a common law

(2000); Lynne B. Barr et al., *Introduction to the 2004 Annual Survey of Consumer Financial Services Law: Where Do We Go From Here?*, 59 BUS. LAW. (forthcoming 2004).

31 *See* Fernanda Nicola, Book Review, 44 HARV. INT'L L.J. 597, 599 (2003). *See also* MILLER ET AL., *supra* note 5, at 7.

32 *See* LEGAL INSTITUTIONS TODAY, *supra* note 4, at 321.

33 *Id*. at 328. *See also* MILLER ET AL., *supra* note 5, at 54-58 (describing Federal Trade Commission enforcement procedures, which are typical of federal agency processes).

34 *See generally* Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption*, 56 CONSUMER FIN. L.Q. REP. 78 (2002). Part of what makes these laws so striking is their departure from traditional norms. Still, they are generally subject to some measure of judicial enforcement, in the common law tradition.

35 *Id*. *See generally Predatory Lending, Part Five*, 57 CONSUMER FIN. L.Q. REP. 131 (2003) (part of a series describing state predatory lending statutes).

36 15 U.S.C. §§ 1601-1667f (2003).

37 15 U.S.C. §§ 1692-1692o (2003).

38 *See* RALPH J. ROHNER & FRED H. MILLER, TRUTH IN LENDING ¶¶ 1.01-1.05 (2000 & Supp. 2002); Laurie A. Lucas & Alvin C. Harrell, *2003 Update on the Federal Fair Debt Collection Practices Act*, 58 BUS. LAW. 1301, 1301 (2003).

structure.[39] This differentiates TILA law from the typical state law in a way that illustrates state-federal law distinctions. Interestingly, much of the TILA litigation occurs in state courts where TILA disclosure errors are asserted as a basis for state law remedies.[40] Although the FDCPA has no implementing regulation equivalent to the FRB's Regulation Z for TILA, the FDCPA itself is very detailed and regulatory in nature, again illustrating the noted distinction between state and federal law.

Thus, when deciding on an approach to resolve social, economic, and legal disputes, the policy choice between state and federal law solutions is to some extent a choice between common law and administrative law mechanisms. It is not surprising that the common law sometimes seems to be losing this competition. Historically, the common law is something of an accidental exception to the natural preference of the governing elite for an administrative structure.[41] The English common law courts were essentially a centralized equivalent of the medieval feudal system, designed to resolve private disputes at the periphery of the King's interest and authority. The judges of the King's Bench quietly grafted the Law Merchant onto the common law in order to accommodate emerging practices and expand the jurisdiction of that court.[42] Much like today's uniform law

39 *See* ROHNER & MILLER, *supra* note 38, ¶¶ 1.01-1.05.

40 *See* Eugene J. Kelley, Jr. & John L. Ropiequet, *Assignee Liability Under State Law After* Jackson v. South Holland Dodge, 56 CONSUMER FIN. L.Q. REP. 16, 18 (2002).

41 As noted briefly, *supra* note 4, the common law itself developed following efforts by the English Crown to centralize justice (and therefore administrative control) following the Norman Conquest. MILSOM, *supra* note 17, at 1. Yet it was the accidental aspects of this process, including the competition for business among the various royal courts, that led to replacement of the old system of feudal land tenures by a daring alternative based on private autonomy. *Id*. at 26-50. The result was that the tendency toward centralization of authority led in this instance to a decentralization of economic decision-making, as feudal tenancies were replaced by the common law of contracts. *See id*. at 271. As with the common law today, the process seems quite haphazard, and perhaps too focused on legal fictions. As Milsom said, "the system was transformed without anything much being changed." *Id*. at 52. But while justice was being centralized, the central courts were adapting to the customs and patterns of local practice. "In England, then, proprietary justice and feudal government were in general harnessed by the royal power rather than opposed to it . . . ." *Id*. at 6. Together with competition between the courts, this created an unusual environment that encouraged the development of new theories of law to accommodate the needs of local practice in the context of more uniform (or "common") rules. The common law was born, at a level of transaction (involving primarily private torts, contracts, and property disputes) largely beneath the level of interest of the king and his royal administrative authorities, aside from the common law courts which had a financial incentive to accommodate these common needs and emerging practices. *Id*. at 58-59. For a good discussion of the role of the Law Merchant (the custom of merchants) as an influence in the development of the common law, see James Steven Rogers, *The Early History of the Law of Bills and Notes: A Study of the Origins of Anglo-American Commercial Law*. Thus, the common law system developed very differently from the more common administrative structures found elsewhere during the same period.

42 *See, e.g.*, MILSOM, *supra* note 17, at 271-86. *See also* JOHN EDWARD MURRAY,

process, these common law courts sought to secure their place by accommodating accepted customs and practices rather than mandating political change. Thus, the common law and its derivatives, like the Uniform Commercial Code ("UCC"), have always been user-friendly.[43] Custom and usage, and not the imposition of new norms by the political elite, are their driving forces.

This principle is alien to the notion of administrative law, which is inherently a top-down approach oriented toward imposition or consolidation of regulatory control and enforcement rather than accommodation of custom and usage.[44] It is not surprising that the governing elite (including the administrative agencies themselves) prefer that approach or that an administrative legal structure has prevailed in most countries throughout most of history.[45] Today, for example, the administrative model is predominant nearly everywhere in Western Europe, Russia, and at the European Union.[46] In the United States it is present at the federal agency level. The continuing vitality of the American common law model at the state level, however, is the most striking characteristic of American law: it distinguishes the U.S. from other, predominantly administrative legal systems.

The contract-based state common law model is amenable to the development of new industries, which can often be created and take root before administrative structures are established to regulate them.[47] The resulting legal flexibility has been essential

JR., MURRAY ON CONTRACTS § 3 (Michie Co. 3d ed. 1990) (1947); Grant Gilmore, *Formalism and the Law of Negotiable Instruments,* 13 CREIGHTON L. REV. 441, 446-50 (1979).

43 *See* MURRAY, *supra* note 42, § 10; Lynne B. Barr et al., *Introduction to the 2002 Annual Survey of Consumer Financial Services Law*, 57 BUS. LAW. 1157, 1157 (2002).

44 For example, compare the mandate to liberally construe the Uniform Commercial Code with the typical regulatory goal of strict compliance. U.C.C. § 1-102 (2002).

45 *See* JOHN HENRY MERRYMAN, THE CIVIL LAW TRADITION 1-3, 133 (2d ed. 1985); HANS JULIUS WOLFF, ROMAN LAW: AN HISTORICAL INTRODUCTION 54 (1951).

46 Czech Republic President Vaclav Klaus recently opined as follows: "The enemies of free societies today are those who want to burden us down again with layer upon layer of regulations. We had that in communist times. But now if you look at all the new rules and regulations of (European Union) membership, layered bureaucracy is staging a comeback." THE OKLAHOMAN, Jan. 5, 2004, at 10A.

47 It should be self-evident that heavily-regulated industries tend to be concentrated among a relatively small number of competitors, and to be somewhat less innovative than unregulated industries. This tendency appears to be inherent in the concept of comprehensive regulation. *See* GWARTNEY & STROUP, *supra* note 9, at 480-83; GEORGE J. STIGLER, *Can Regulatory Agencies Protect the Consumer?*, *in* THE CITIZEN AND THE STATE: ESSAYS ON REGULATION 178, 181 (1975); Paul H. Weaver, *Regulation, Social Policy, and Class Conflict*, 50 PUB. INT. 45, 47-50 (1978). In contrast, rapidly growing, innovating, and evolving industries often tend to be those with a relatively low level of regulation.

to economic growth and innovation since the beginning of the industrial revolution, and it is replicated to some extent today everywhere that strong economic growth exists. Industries that are heavily regulated through a central administrative structure, *e.g.*, a federal agency, as opposed to being governed by more decentralized common law principles and institutions, tend to be dominated by large, stable entities with close relationships to the regulatory agency. This distinction is evident to some extent even within various industries. It is no accident, for example, that national banks tend to be fewer and larger than state-chartered banks.[48] Restaurants are governed largely by state and local law and are even more diverse. This seems to be an inherent consequence of the choice between state and federal law.

There are similar implications for the legal profession. A decentralized state law system will likely foster and support a large number of small, local law firms with relatively low levels of legal fees. A federal law issue is more likely to require the services of one of a small number of national law firms with a close relationship to the federal agency whose interpretations of its own regulations will be dispositive of many matters. The legal fees are likely to be much higher and a centralization of clients, legal authority, and rules will result. A legal and business environment that is more suitable to the operation of large nationwide commercial enterprises is created; smaller, local enterprises are unable to successfully comply with the usual stream of regulatory requirements. A trend that encourages further centralization of commerce, law, and legal practice is reinforced.[49]

Thus, a choice between state and federal law solutions to some extent is also a choice between the common law and administrative law, between contract law and regulation, between small and large enterprises, and between local versus national law firms. While this observation is not without numerous exceptions, and is certainly not dispositive as to which approach is the better one with regard to a particular issue, these

48 State-chartered banks comprise well over half of the banks in the United States, including two-thirds of the new charters in recent years, but have just over 40% of total U.S. banking assets. Joseph A. Smith, Jr., *Federal and State Regulation of Financial Services: Competition and the Search for Comity*, 57 CONSUMER FIN. L.Q. REP. 131, 131 (2003).

49 As noted, this is often favored by larger enterprises. *See, e.g.*, Joseph B. Treaster, *Insurers Want One Regulator Instead of 50*, N.Y. TIMES, Dec. 26, 2003, at C1. "If you freeze the system [through regulation] you will lose its thrust toward progress. But in many ways, GM's life will be easier. So don't look to big business for unequivocal defenses of capitalism. We guess that's up to the folks at XYZ Bumperlight Lens." Robert L. Bartley, *A Bartley Sampler*, WALL ST. J., Dec. 11, 2003, at A18.

factors deserve attention in the matrix of policy elements being considered.[50]

D. Private Versus Public Remedies: Litigation or Administrative Enforcement?

The choice between private and public remedies is one that many policy advocates will reject as unnecessary – the simple answer is to permit both. Perhaps in most consumer law contexts that is indeed the case. Many, though not all, federal consumer laws specifically provide for both private and public remedies, and most state consumer protection laws also have a mixture of such remedies. Still, there are differences and choices as to these issues that should be noted.

For various reasons, state law remedies, including administrative remedies, seem to be enforced primarily through litigation, while federal law remedies are more heavily enforced through administrative action.[51] Again, this is not universal and there are many exceptions, including state administrative enforcement procedures and the TILA and FDCPA litigation as noted earlier. Even so, TILA's greatest impact today is in state court litigation, where TILA disclosure errors are often asserted as a basis for state law claims.[52] At the federal level, public enforcement actions in administrative law courts are more prevalent. Private FDCPA cases are necessarily brought in federal court, so this is an example where the absence of an agency authorized to implement and enforce regulations has created a more common law-like approach, with an emphasis on private statutory remedies.[53] But many other examples illustrate this basic point: Federal Trade Commission ("FTC") enforcement of rules governing fraud and deception in advertising;[54] federal banking agency enforcement of regulations such as the Community Reinvestment Act ("CRA")[55] and Home

50 As noted by Professor Lawrence Friedman: "[T]he law of contract concerns and provides liberal support for the residue of economic behavior left unregulated (the free market). . . ." GILMORE, THE DEATH OF CONTRACT, *supra* note 23, at 7 (quoting LAWRENCE FRIEDMAN, CONTRACT LAW IN AMERICA 20-24 (1965)).

51 For example, many state consumer law administrative remedies are enforced by the state attorney general, who does not maintain a separate judicial system and must pursue litigation in state court to enforce public administrative remedies. In contrast, many federal administrative agencies operate their own systems of administrative law courts.

52 A classic example is the assignee litigation. *See* Kelley & Ropiequet, *supra* note 40, at 18.

53 The detailed and yet ambiguous nature of the FDCPA (together with statutory damages for technical errors and prevailing party attorney fees for even harmless errors) has created a fertile field for such litigation.

54 *See* MILLER ET AL., *supra* note 5, at 53-64.

55 Community Reinvestment Act and Interstate Deposit Production Regulations,

Mortgage Disclosure Act ("HMDA");[56] the Department of Justice Fair Lending settlements of the 1990s;[57] recent FTC privacy law enforcement actions;[58] and money-laundering enforcement actions.[59] In each of these areas of federal law, public enforcement has exceeded the volume of private litigation. On the other hand, in traditional areas of state law (such as fraud and deception in the negotiation of consumer transactions, breach of contract, revocation of acceptance, unfair and deceptive acts and practices) the level of public enforcement, while significant, is dwarfed by the volume of private litigation.[60]

This phenomenon is partly explained by plaintiff's lawyers' preference for state over federal courts.[61] It is also explained by the fact that some federal rules (such as the FTC Act Section 5[62] and the CRA), unlike most state laws, do not provide a private right of action.[63] There are examples where an ambiguous or difficult federal rule has created a compliance nightmare that generates inevitable federal litigation. Such is the case with the FDCPA and the Real Estate Settlement Procedures Act of 1974 ("RESPA").[64] But even TILA, the granddaddy of federal consumer laws, probably generates more state than federal litigation.[65] So the basic point remains valid: state law remedies are enforced primarily through private litigation, while federal

12 C.F.R. §§ 25.11-25.65 (2003). *See, e.g.*, Joseph J. Norton, *"Fair Lending" Requirements: The Intervention of a Governmental Social Agenda into Bank Supervision and Regulation*, 49 CONSUMER FIN. L.Q. REP. 17 (1995) (discussing the CRA); Paul H. Schieber, Decatur Federal *and Its Five (So Far) Progeny: U.S. Department of Justice Fair Lending Settlements*, 49 CONSUMER FIN. L.Q. REP. 68 (1995) (discussing the CRA and fair lending).

56 12 U.S.C. §§ 2801-2809 (2001). *See, e.g.*, Jacqueline S. Akins, *Impact of the Regulation C Revisions*, 56 CONSUMER FIN. L.Q. REP. 289 (2002).

57 *See* Norton, *supra* note 55, at 23; Schieber, *supra* note 55, at 68.

58 *See* Anthony Rollo, *The New New* Litigation *Thing: Consumer Privacy*, *in* CONSUMER FINANCIAL PRIVACY: COMPLYING WITH THE GRAMM-LEACH-BLILEY ACT AND THE FINAL RULES (2000), *reprinted in* 1 CONSUMER FIN. SERVICES LITIG. 975, 988-89 (2001). *See generally Symposium on Privacy*, 55 CONSUMER FIN. L.Q. REP. 4 (2001).

59 *See, e.g.*, Gary L. Betow & Christopher B. Woods, *Overview of the USA PATRIOT Act*, 56 CONSUMER FIN. L.Q. REP. 332, 334 (2002); Jeffrey P. Taft & Christina A. LaVera, *The Changing Landscape of Federal Money Laundering Laws: An Overview of the USA PATRIOT Act and Related Developments*, 57 CONSUMER FIN. L.Q. REP. 109 (2003).

60 *See, e.g.*, Harrell, *Judge Understands*, *supra* note 29, at 231; Robert M. Jaworski, *Subprime Lending Under Siege in the Courts–A Summary of Illustrative Cases*, 55 CONSUMER FIN. L.Q. REP. 70 (2001); David E. Worsley, *Fair Credit Reporting Cases Illustrate Risks for Credit Reporting Agencies, Creditors, and Lawyers*, 56 CONSUMER FIN. L.Q. REP. 68, 69 (2002).

61 *See, e.g.*, Kelley & Ropiequet, *supra* note 40, at 24.

62 The Federal Trade Commission Act, 15 U.S.C. § 45 (1991).

63 MILLER ET AL., *supra* note 5, at 45-46.

64 12 U.S.C. §§ 2601-2617 (2001). *See also* Marsha L. Williams, *Update on RESPA Issues and Developments*, 56 CONSUMER FIN. L.Q. REP. 4, 4 (2002).

65 *See, e.g.*, Kelley & Ropiequet, *supra* note 40, at 20-21 (illustrating a preference of private plaintiffs for state court litigation, even as to enforcement of rights created by a federal statute).

rules are somewhat more prone to public administrative enforcement.

E. Implications

So it seems clear that a policy choice between state and federal law is often a choice between private and public remedies, as well as a choice between contract law and regulation; and a federal law solution is often a choice of administrative law over common law mechanisms. All of this may create a mixed message for partisans of the industry and the plaintiffs' bar, and make some strange political bedfellows. Large enterprises, national law firms, and consumer groups with a preference for centralized administrative authority over contract law may favor federal law solutions at the expense of local attorneys, small companies, and private remedies. Local law firms and legal services lawyers, as well as smaller commercial enterprises less able to bear the burdens of a complex federal regulatory structure, may favor a state common law approach with an emphasis on private remedies in state court (although the latter parties may be less cognizant of the implications of the choices being made).[66]

Since in many cases the ultimate choice between federal regulation and state common law will be made at the federal level, largely at the behest of those with a preference for federal administrative law, it is not surprising that our recent history is a record of expanding the jurisdiction and remedies provided by federal administrative law at the expense of state courts and the common law.[67] What is surprising is that private state law litigation, at the local level, nevertheless remains a dominant part of the landscape of consumer protection law.[68] This is surely a testament to the viability of the common law system and should provide a continuing lesson for policy makers and advocates on both sides of the consumer law policy debates.

III. ISSUES IN AUTO FINANCE

Auto sales finance is a very important part of the consumer credit marketplace. There is no question that both new and used auto sales generate numerous consumer complaints.[69] This

66 *See, e.g.*, Bartley, *supra* note 49, at A18.

67 *See, e.g.*, Jathon Sapsford, *Critics Cry Foul Over New Rules on Bank Review*, WALL ST. J., Jan. 8, 2004, at C1. *See also* Lampe, *supra* note 34, at 78, 81; Smith, *supra* note 48, at 131.

68 *See, e.g.*, MILLER ET AL., *supra* note 5, at 7.

69 *See, e.g.*, PUBLIC CITIZEN, RIP-OFF NATION: AUTO DEALERS' SWINDLING OF AMERICA (2003), *at* http://www.citizen.org/autosafety/dealerscam/.

discussion will note some of the more common issues and consider alternative solutions pursuant to the policy choices noted in Part II above.

A. Spot Delivery

While not a legal term of art, "spot delivery" generally refers to the sale of a vehicle on credit (a "credit sale") prior to finalizing the credit terms.[70] An alternative scenario (not a spot delivery) is where the auto dealer contacts a creditor that purchases retail installment sales contracts (a "RISC") to investigate the likely prospects of a secondary sale of the vehicle buyer's RISC before the RISC is executed between the vehicle buyer and the auto dealer.[71] In this latter scenario, the dealer may feel comfortable finalizing the credit terms with the vehicle buyer at the time the vehicle is delivered because the dealer is comfortable that the vehicle buyer's RISC can be sold to a contract purchaser in a secondary transaction.

In contrast, in a "spot delivery" scenario the auto dealer may not feel comfortable in setting the final credit terms with the vehicle buyer due to uncertainty about the possibility of a secondary sale of the RISC.[72] Thus, a spot delivery involves delivery of the vehicle on the spot, before the credit terms of the RISC have been established. There are obvious risks on both sides of these transactions.

There are also advantages to both parties in a spot delivery. The vehicle buyer gets immediate delivery of the vehicle, which may be important or at least highly desirable to an eager buyer. The auto dealer gets to effectuate a sale that might otherwise be lost if the potential buyer leaves the lot without the vehicle. Thus, spot delivery allows both parties to enter the sales transaction in a timely manner, even in the absence of final credit arrangements. This may be essential for transactions such as weekend sales when some potential contract purchasers are not open for business.

Spot delivery is clearly not illegal. Should it be? It carries the potential for deceptive (and thus illegal) practices on both

70 *See generally* Adam G. Taub, *Yo-Yo Sales: The Predatory Practice of Unscrupulous Car Dealers*, CONSUMER L. NEWSL. (St. Bar of Mich. Consumer L. Sec.), Lansing, Mich., Aug. 2003, at 3, *available at* http://www.michbar.org/consumer/.

71 *See* JOHN O. HONNOLD ET AL., CASES, PROBLEMS AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY 112-22 (2d ed. 1992).

72 *See, e.g.*, Baggett v. Crown Auto. Group, Inc., No. 01-A-01-9110-CV00401, 1992 WL 108710, at *3 (Tenn. Ct. App. May 22, 1992). *See also* Eugene J. Kelley, Jr. et al., *APR Splits: Still Legal After All These Years*, 56 CONSUMER FIN. L.Q. REP. 296, 297-99 (2002) [hereinafter Kelley et al., *APR Splits*] (discussing *Baggett*).

sides. For example, the incomplete nature of a spot delivery transaction means that the vehicle buyer may be susceptible to fraudulent representations by the dealer about credit terms when later finalizing the transaction.[73] With the vehicle buyer in possession of the vehicle (and possibly having proudly shown it to friends and relatives) and any trade-in or down payment in the possession of the dealer, the vehicle buyer may feel constrained to accept whatever credit terms the dealer later claims to be necessary. Of course, this could work both ways: the vehicle buyer has a right to revoke acceptance of the vehicle or otherwise to reject or rescind the incomplete sales contract if the credit terms prove to be unsatisfactory.[74] This allows the vehicle buyer to demand cancellation of the sale and return of any down payment or trade-in while holding the vehicle delivered by the dealer as security for any claims. The consumer has considerable negotiating leverage in these circumstances. So, both parties retain some inherent bargaining power in a spot delivery scenario.

Of course, many consumers may be unaware of their remedies.[75] This is a seemingly unavoidable condition, at least until all consumers enroll in a consumer law seminar. More consumer awareness and education would be beneficial and is always needed. Nevertheless, consumers presumably know they can contact a lawyer or simply refuse to go forward if they are uncomfortable about a pending transaction. These cases are handled constantly and routinely and at reasonable cost by many, mostly small, law firms and legal services offices all around the country.[76] The common law, UCC, and customary

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73 *Baggett*, 1992 WL 108710, at *7. *See also* Kathleen E. Keest, *Recent Developments in Automobile Lending: Hot Spots*, 52 CONSUMER FIN. L.Q. REP. 287, 292 (1998) [hereinafter Keest, *Recent Developments*].

74 There is some dispute over whether spot delivery constitutes a contract with a condition subsequent or a condition precedent. This may depend on the facts and the contract terms, but either way the consumer should have a right to reject the deal. *See, e.g.*, Peter G. Dillon & Alvin C. Harrell, *Revocation of Acceptance Under UCC Section 2-608 as a Remedy in a Consumer Sales Transaction Involving Conflicting Oral Quality Representations and Standardized Quality Warranty Disclaimer Language*, 53 CONSUMER FIN. L.Q. REP. 330, 330-31, 338 (1999).

75 Perhaps surprisingly, given the resources being devoted to consumer protection, issues relating to consumer education and debt counseling remain largely unaddressed in our society. *See, e.g.*, Dale Ellis, *Introduction to the Symposium: Why Consumer Bankruptcies Will Continue Like a Plague – Structural Forces that Institutionalize Bankruptcy as a Way of Life in America*, 47 CONSUMER FIN. L.Q. REP. 391, 391-92 (1993); Karen Gross, *Making Sense of Cents: Concrete Ways to Improve Financial Literacy Skills*, 54 CONSUMER FIN. L.Q. REP. 233, 233 (2000); Karen Gross, *Preliminary Proposal on Debtor Education Program Options*, 51 CONSUMER FIN. L.Q. REP. 23, 23-24 (1997); David A. Lander, *Snapshot of an Industry in Turmoil: The Plight of Consumer Debt Counseling*, 54 CONSUMER FIN. L.Q. REP. 330, 330-31 (2000).

76 *See, e.g.*, *Symposium: Consumer Litigation*, 52 CONSUMER FIN. L.Q. REP. 287 (1998) (illustrating the range of remedies available in such cases).

consumer protection remedies seem quite adequate in this context, and are easy for general jurisdiction courts to understand and apply. This is the common law in action, and thus far the basic common law and UCC remedies have proved more effective in providing a practical consumer remedy in these scenarios than the most elegant federal statute or regulation.[77]

Would a more onerous regulatory regime be more effective? Regulatory advocates may prefer detailed rules prescribing (or prohibiting) certain contract terms and practices.[78] Spot delivery could be flatly prohibited or made effectively so by onerous restrictions like those in the Home Owners Equity Protection Act ("HOEPA")[79] and some state predatory lending statutes. This, however, would interfere with millions of desirable consumer purchase transactions. It would also prescribe a competitive advantage for very large national dealers and creditors who can create in-house sales and financing affiliates, around-the-clock staffing and operations, or automated processing systems. This would mean fewer independent auto dealers, less competition, and probably higher prices for consumers.

The usual political compromise would be to have spot delivery permitted but tightly regulated. This would nevertheless result in the same outcome as described above: smaller, local dealers and creditors would be less able to devote the resources necessary for regulatory compliance. Competition would be reduced and higher prices would result. The advantages of spot delivery would be lost to many dealers and consumers. Moreover, the sheer volume of these transactions means that effective enforcement would be difficult or even impossible unless we are willing to accept some kind of an expanded economic police mechanism.[80] The likely result is that honest small dealers and creditors would be driven from the market by the regulatory costs, risks, and compliance burdens, while fly-by-night operators would have little to lose and little fear of effective enforcement to impede their abusive operations. Larger dealers would gain market share and raise prices (or

77 *See* Kelley & Ropiequet, *supra* note 40, at 20-24.

78 *See* Lampe, *supra* note 34, at 82; Sapsford, *supra* note 67, at C1.

79 Riegle Community Development and Regulatory Improvement Act, Pub. L. No. 103-325, §§ 151-58, 108 Stat. 2190-2198 (1994) (codified as amended in 15 U.S.C. §§ 1601-1604 and scattered sections of 15 U.S.C.).

80 While some might welcome such an expansion, it is not an easy solution. The experience of the FTC is instructive: Despite a large budget, its limited resources mean that only a relatively small number of enforcement actions can be maintained each year, necessarily leaving most remedies to the private sector. *See, e.g.*, Lawrence A. Young, *Identity Theft: Who Are You When Your Identity is Gone, Mrs. Jones?*, 57 CONSUMER FIN. L.Q. REP. 88 (2003); Lawrence A. Young, *The Landscape of Privacy*, 55 CONSUMER FIN. L.Q. REP. 4 (2001).

other fees) to compensate for the compliance risks and costs. Overall the cost to consumers would rise significantly and transaction availability would be reduced. The paucity and cost of HOEPA transactions and enforcement serves to illustrate the point.[81] It is reasonable to question whether the benefits would offset these costs.

It is instructive that after more than thirty years of increasingly active regulation of consumer credit transactions, the simple common law (and UCC) remedies are still the most viable in the vast majority of consumer vehicle sales and finance cases.[82] Advocates of regulation are still seeking a magic regulatory bullet by claiming that additional and more detailed regulation is needed. But this always comes at a cost: reduced competition results in higher costs to consumers and restricted transaction availability. Through it all, the common law remedies have remained the most effective. Spot delivery merely illustrates this basic point.

B. Fraud and Deception, Unequal Bargaining Power, Adhesion Contracts

Fraud and deception come in endless varieties. In fact, the problems with spot delivery are just one variation. Other varieties include misrepresentation as to the condition of the vehicle,[83] selling a used car as new,[84] insurance packing,[85] forgery and alteration of contracts,[86] and misrepresenting to the consumer that the dealer will help the consumer get the best financing available.[87]

Much of the analysis above in Part III, Section A regarding spot delivery also applies to this discussion. It is often alleged that the consumer is essentially helpless in these cases; the

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81 *See* Alvin C. Harrell, *Commentary: Conflicting Perspectives on "Predatory Lending,"* 56 CONSUMER FIN. L.Q. REP. 134, 230, 240 (2002).

82 *See* Dillon & Harrell, *supra* note 74.

83 *See, e.g.*, Murray v. D & J Motor Co., 958 P.2d 823, 826-27 (Okla. Civ. App. 1998) (holding that revocation of acceptance for false description of vehicle was permissible despite disclaimer of all warranties). *See also* Dillon & Harrell, *supra* note 74, at 330-31.

84 *See, e.g.*, Rubio v. Bob Crow Chrysler-Plymouth-Dodge, Inc., 145 F. Supp. 2d 1248, 1248-49 (D.N.M. 2001).

85 *See, e.g.*, Anthony Rollo, *A Primer on Consumer Credit Insurance*, 54 CONSUMER FIN. L.Q. REP. 52, 59-63 (2000). This includes abuses in the "forced-placement" of collateral protection insurance. *See, e.g.*, Mark E. Dapier et al., *Collateral Protection Insurance: Legislatures to the Rescue*, 55 CONSUMER FIN. L.Q. REP. 115, 115-16 (2001).

86 *See, e.g.*, Baggett v. Crown Auto. Group, Inc., No. 01-A-01-9110-CV00401, 1992 WL 108710, at *5 (Tenn. Ct. App. May 22, 1992). *See also* Kelley et al., *APR Splits*, *supra* note 72, at 297.

87 *See* Fairman v. Schaumburg Toyota, Inc., No. 94 C 5745, 1996 WL 392224, at *1 (N.D. Ill. July 10, 1996); Bramlett v. Adamson Ford, Inc., 717 So. 2d 772, 775 (Ala. Civ. App. 1996).

consumer is sometimes said to be totally at the mercy of an unscrupulous auto dealer who has greater knowledge and bargaining power and uses adhesion contracts. Sometimes this is all true, although it is not limited to auto transactions. "Buyer beware" remains valuable advice in a variety of contexts, that most of us learn to respect more and more as we gain knowledge and experience. As always, more consumer awareness and education (and prudence) would be desirable. But consumer disadvantages can be overstated, and the common law provides a surprisingly level playing field and ample remedies in these transactions.

The economic leverage is often with the consumer. The auto dealer frequently needs to make the sale more than the consumer needs to buy the auto. The dealer has spent heavily on advertising to attract the consumer to the dealership and may need the sale desperately in order to meet volume quotas and financial commitments. Most vehicle buyers are not that desperate; most can drive their old cars a little longer if the proposed sale does not suit them. In short, in many cases it is easier for the consumer to walk away than it is for the dealer. There are always plenty of other eager dealers if the present one does not make appropriate concessions. The bargaining power advantage is often with the consumer, not the dealer.

True, the RISC is a standard-form adhesion contract. But this is largely true for the dealer as well as the consumer. RISC forms are essentially mandated by secondary market considerations, federal regulations, and consumer credit law requirements, which require them to meet uniform standards.[88] These standards are designed to be fair and consistent. The standard forms contain no surprises, and the most important terms (price, annual percentage rate, term to maturity, monthly payment, etc.) are fully negotiable and are widely known to be negotiable.[89] The dealer's control over these forms is very

88 *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 550 (1971); James J. White, *Form Contracts Under Revised Article 2*, 75 WASH. U. L.Q. 315, 315 (1997).

89 *See* Robert A. Cook, *A Primer on Closed-End Credit Transactions Under the Truth in Lending Act and Regulation Z*, 53 CONSUMER FIN. L.Q. REP. 315, 318-20 (1999) [hereinafter Cook, *Closed-End Credit Transactions*] (summarizing the mandatory disclosures for credit transactions). These disclosures make it difficult for any consumer to be unaware of the basic terms of the transaction. *But see* DAVID E. NORDSTROM, INSIDE SECRETS OF AUTO DEALERS 31-41 (1995) (describing the "tricks of the trade"); Keest, *Recent Developments*, *supra* note 73, at 288-90; Ralph J. Rohner, *Whither Truth in Lending?*, 50 CONSUMER FIN. L.Q. REP. 114 (1996) (discussing problems with the current disclosure regime). *See also* Robert A. Cook, *The Truth in Lending Act–A Review in Light of its Original Purpose*, 49 CONSUMER FIN. L.Q. REP. 357 (1995); Kathleen E. Keest, *Whither Now? Truth in Lending in Transition–Again*, 49 CONSUMER FIN. L.Q. REP. 360 (1995) [hereinafter Keest, *Whither Now?*]. Perhaps for some consumers, disclosure will

limited. The problems in consumer credit transactions generally do not arise from the use of common or standardized forms.[90]

Thus, contrary to common allegations, the bargaining advantage is often with the consumer. Adhesion contracts are essential and their terms normally fair (the risk of the contrary is simply too great), and fraud and deception are inherently dangerous (and foolish) for a dealer or creditor because the consumer remedies are so effective. Exceptions will never be eliminated and remain too prevalent, but the numbers appear to be relatively small considering the huge volume of these transactions. The exceptions, although always unfortunate, are subject to effective common law remedies. Again, the common law system seems to be working quite well.

Would a system of detailed regulation work better? It is difficult to see how any regulatory system could entirely prevent fraud and deception in this volume of private transactions. Effective private remedies for exceptional cases, such as those provided by the common law and the UCC, are preferable. They do not interfere with the vast majority of desirable transactions. Onerous penalties and detailed regulations would be more likely to discourage legitimate competition and increase consumer prices than to effectively discourage the inevitable bad actors.

There will always be legitimate disputes over contract terms, product quality, and the like. No one has devised a better way to resolve them other than by private arbitration or litigation as a means to effectuate common law and related UCC remedies. The infinite variety of these disputes suggests that no system of detailed regulation can ever contemplate and prevent them all. Efforts to do so are likely to devolve into such complexity and create so many compliance burdens as to restrict legitimate transaction availability and increase consumer costs without effectively combating fraud. Again, the HOEPA and the predatory lending experience are instructive.[91]

Thus, an auto dealer's greater experience and inherent command of the sales process is offset to some extent by the

never be enough. *See, e.g.*, Richard E. Speidel, *Unconscionability, Assent and Consumer Protection*, 31 U. PITT. L. REV. 359, 364 (1970) ("There is little evidence that disclosure and informed shopping can be relied upon to put competitive pressure on professionals operating in low income areas."). But this problem has proved resistant to solutions that are compatible with the basic personal freedoms traditionally valued in this country. Your author would quarrel with the notion that low-income consumers are inherently incapable of attending to their own financial affairs. *See supra* note 27 and accompanying text.

90 Based on a review of the case law, most serious problems derive from alleged abuses relating to negotiated terms. *See supra* notes 83-87 and accompanying text.

91 *See, e.g.*, Lampe, *supra* note 34.

vehicle buyer's inherent bargaining power, his or her natural focus on the important terms of the transaction (which are commonly known by all parties to be negotiable), and the general fairness of form contracts. Exceptions are subject to very effective and affordable state law remedies in arbitration or state court, with thousands of lawyers in every state eager to handle the cases. It all works very well to facilitate many millions of satisfactory transactions every year and to adequately handle the abusive exceptions. There is no significant evidence that a detailed regulatory regime could do any better (or even as well).[92]

C. Assignee Issues

Much of the recent high-profile litigation has centered on efforts to hold RISC assignees (contract purchasers) liable for violations of law by assignor auto dealers.[93] This by itself may be sufficient to raise modest suspicions that in some of the class action cases the plaintiffs' lawyers are more interested in pursuing deep pockets for attorney fees than in providing remedies for specific clients.[94] Of course these goals (attorney fees and client relief) are not mutually exclusive, and any suspicion about motives is not necessarily inconsistent with the recognition that many class actions are worthwhile because they play a valuable role in our legal system.[95] Class actions are clearly needed in some cases but can be abusive in others.[96] It is up to the courts to develop standards for distinguishing between the two in a consistent manner (an effort that remains a work in progress).

The efforts to pursue contract purchasers on the basis of auto dealer violations reflect both the problems and the progress in this area of law. The cases have largely rejected assignee liability for dealer actions absent some participation in or knowledge of the dealer's wrongdoing.[97] Some truly creative theories attacking assignees have yielded large rewards for plaintiffs' lawyers,[98] which sustain the hopes for a lawyer's

92 That does not mean that we cannot make it better, but that is easier said than done. *See, e.g.*, Keest, *Whither Now?*, *supra* note 89, at 360; Rohner, *supra* note 89, at 118.

93 *See, e.g.*, Mark E. Dapier et al., *Assignee Liability Under the TILA: Is the Conduit Theory Really Dead?*, 54 CONSUMER FIN. L.Q. REP. 242, 242 (2000); Kelley & Ropiequet, *supra* note 40.

94 *See* Harrell, *Mad World*, *supra* note 10, at 114.

95 *See* MILLER ET AL., *supra* note 5, at 28-36; Thomas M. Byrne, *Demystifying Class Certification*, 54 CONSUMER FIN. L.Q. REP. 277 (2000).

96 *See generally* Eugene J. Kelley, Jr. et al., *Offers of Judgment in Class Action Cases: Do Defendants Have a Secret Weapon?*, 54 CONSUMER FIN. L.Q. REP. 283 (2000).

97 *See, e.g.*, Kelley & Ropiequet, *supra* note 40, at 20.

98 *See, e.g.*, Anne P. Fortney & James Chareq, *Auto Finance Litigation Under the*

windfall. Mostly, however, the courts have handled these matters well, and continuing efforts to reverse this trend seem likely to prove futile. Thus, there is something of a divide between lawyers claiming large fees for settling questionable class action mega-suits and the local practitioners who help needy individual consumers resolve ordinary contract disputes. Often the efforts of the former are directed at assignees and those of the latter at dealers, which makes this a potential point of distinction between two very different types of consumer advocacy.

Surely, this cannot be taken to say that all suits against assignees are frivolous. But by now it should be clear that assignees generally are not liable for wrongdoing by the assignor outside certain specified legal boundaries under the common law,[99] the UCC,[100] and federal consumer laws.[101] Plaintiffs' lawyers who bring abusive class actions against deep-pocket defendants on theories without legal merit (perhaps hoping to settle for an attorney fee payment less than the defendant's litigation costs or hoping for a sympathetic judge or a jury that misunderstands the law, and seeking no significant relief for the consumer class members) do not deserve to be viewed chiefly as champions of the poor. Among other things, the litigation costs and risks for defendants in these cases have significantly raised the cost of doing business in this country and have had adverse consequences for all consumers, especially the poor.[102] One need not disfavor class action litigation in order to note these issues.

Through it all, the common law of assignment has remained paramount and is actually reflected quite well in federal

Equal Credit Opportunity Act, 57 CONSUMER FIN. L.Q. REP. 227, 228 (2003).

99 *See* FARNSWORTH, *supra* note 11, § 11.7; RESTATEMENT (SECOND) OF CONTRACTS § 336 (1979).

100 *See* U.C.C. §§ 3-302:1, 3-305, 9-330 to 9-332, 9-403 to 9-405 (2003).

101 *See, e.g.*, 15 U.S.C. § 1641(a) (1998); 12 C.F.R. § 202.2(l) (2003) (codifying the Equal Credit Opportunity Act ("ECOA") and Regulation B "multiple creditor rule"); 16 C.F.R. §§ 433.1-433.3 (2003) (codifying the FTC "holder in due course rule"). The same is true under state consumer protection laws. *See, e.g.*, Harrell, *Judge Understands*, *supra* note 29, at 231-32. *But see* Fortney & Chareq, *supra* note 98 (discussing assignee liability in ECOA litigation).

102 Poor consumers represent higher default and litigation risks and disproportionately pay more to cover those risks. As these risks increase, so do consumer costs. *See also* Harrell, *Mad World*, *supra* note 10, at 114, 134 (noting the adverse competitive effects of the U.S. litigation explosion on the cost of doing business); *Is Free Trade Immoral?*, WALL ST. J., Feb. 26, 2004, at A10 ("[T]he primary competitive challenge facing manufacturers was not competition from cheaper foreign workers, but the extra cost of doing business in the U.S. The costs contributing to the loss of jobs were high corporate tax rates, mandated employee benefits, tort litigation, regulatory compliance and energy."). *See also* Holman W. Jenkins Jr., *Jobs, Jobs, Jobs (Fibs, Fibs, Fibs)*, WALL ST. J., Feb. 25, 2004, A15 (citing the adverse impact on U.S. employment of "tort lawyers" and "a product liability system that has become a random lottery of wealth distribution").

consumer laws and regulations. The courts have done reasonably well in applying these rules, although the lure of deep-pocket defendants and creative advocacy is continually tempting for the plaintiffs' bar, and, thus, costly for society. Despite these costs, the common law of assignment has provided the legal environment and market liquidity needed to fund many millions of auto sales (and in a somewhat different legal context, many millions of home mortgage transactions).

It seems unlikely that any system of regulation can effectively supplant this common law system. The apparent failures of regulation relating to alleged assignee abuses in the real estate industry are indicative of the hurdles that await any such effort.[103] Efforts to prohibit or micro-regulate common practices such as spot delivery, discounts in assignments of RISCs,[104] and APR splits,[105] are no more likely to be successful than the efforts under RESPA to regulate yield-spread premiums. In the meantime, any serious efforts to substitute a regulatory regime would likely impair the availability of credit to low-income vehicle buyers, thereby imposing a potentially devastating economic cost. Ironically, this impact would fall disproportionately on the purported beneficiaries (the poor and minorities).

IV. CONCLUSION

The current American legal environment for consumer credit continues a late twentieth century policy compromise, evidenced by the enactment of the federal TILA and related laws some thirty-five years ago.[106] It is a compromise that preserves the essential role and principles of the common law (primarily contract and tort law) and the UCC as the foundation for commercial and consumer transactions, while providing for enhanced disclosure of important contract terms under mostly federal law and some related state laws.

Your author was asked recently if he thinks the TILA is a failure.[107] The answer is clearly no; in some ways it has been a

103 *See, e.g.*, Robert M. Jaworski, Culpepper*: An Epic Battle Continues*, 55 CONSUMER FIN. L.Q. REP. 119, 119 (2001); Williams, *supra* note 64 (describing the checkered and frustrating history of RESPA regulation and litigation).

104 *See* Kelley & Ropiequet, *supra* note 40.

105 *See* Kelley et al., *APR Splits*, *supra* note 72. Efforts to do so through litigation are also dubious, since the results (even if successful) would affect only one defendant, merely creating a competitive disadvantage for one among many.

106 *See, e.g.*, ROHNER & MILLER, *supra* note 38, at 11-15.

107 Apparently due to this published comment: "The Truth in Lending Act was turned from a tool to achieve more informed use of credit into a weapon to avoid repayment of debt." Lynne B. Barr et al., *Introduction to the 2003 Annual Survey of Consumer Financial Services Law: Of Statutory Aging and Process Failure*, 58 BUS. LAW.

spectacular success. The APR and Finance Charge calculations and disclosures, while not free of controversy, have become near-universal standards that are widely recognized as a uniform statement of the cost of credit, thus allowing effective credit comparison shopping for the first time. In a credit sale, the TILA disclosures also prominently disclose the sales price (and in all credit transactions, the total of payments, among other things).[108] The system is not perfect or trouble-free, but it makes it difficult for any interested consumer to misunderstand the basic terms of his or her transaction. In this way, common law and UCC principles and mechanisms, and party-autonomy, have been significantly enhanced.

Of course, it has not come without cost. The TILA is one of the most litigated statutes in history.[109] Some of this litigation has been frivolous and much of it has been very expensive to the industry and ultimately to consumers.[110] It is probably no coincidence that much consumer credit is more expensive (in relative terms) than when the TILA was enacted.[111] It would be a surprise if it were otherwise. The TILA has been immensely expensive, in terms of both compliance and litigation costs, and such costs are inevitably borne by consumers in one way or another.

Due to significantly increasing compliance costs, burdens, and litigation, the TILA and similar laws and regulations have

1131, 1132 (2003) (explaining historical events that led to TILA reform in the 1980s).

108 *See, e.g.*, Cook, *Closed-End Credit Transactions*, *supra* note 89, at 316.

109 Neff v. Capital Acquisitions & Mgmt. Co., 352 F.3d 1118 (7th Cir. 2003); Baker v. Sunny Chevrolet, Inc., 349 F.3d 862 (6th Cir. 2003); Anders v. Hometown Mortgage Servs., Inc., 346 F.3d 1024 (11th Cir. 2003); Pechinski v. Astoria Fed. Sav. & Loan Ass'n, 345 F.3d 78 (2d Cir. 2003); Roberts v. Fleet Bank (R.I.), 342 F.3d 260 (3d Cir. 2003); ROHNER & MILLER, *supra* note 38, at 10.

110 *See, e.g.*, Edward L. Rubin, *Legislative Methodology: Some Lessons from the Truth-in-Lending Act*, 80 GEO. L.J. 233, 237-38 (1991).

111 Your author remembers the 1950s and 1960s, when common below-prime consumer credit transactions, *e.g.*, to buy or refinance household goods, were often available at interest rates of 10% or less. Today the rate is likely to be twice that, and even higher in some instances, at a time when the overall level of interest rates is far lower. Of course, other consumer law protections have also contributed to this increase, such as the FTC Rule on Credit Practices, which effectively bars traditional refinancing and other nonpurchase money loans secured by household goods. 16 C.F.R. § 444.2(a)(4) (2003). While the latter rule was legitimately aimed at certain abusive practices, it arguably went too far in barring all nonpurchase money loans on household goods, thereby cutting off consumers from needed transactions and leaving them with only higher cost alternatives. It illustrates again the point that regulatory solutions tend to drive up the cost of consumer credit in various ways. *Cf.* U.C.C. § 9-108(e) (2003) (requiring a more specific description of consumer goods collateral in the security agreement). While the U.C.C. approach has not been fully developed (perhaps due to the FTC rule), it is a contracts-based approach that could offer more promise than the total regulatory ban.

also contributed to consolidation in the credit industry.[112] Competition from small local lenders, who are disproportionately affected by complex regulatory requirements, has been reduced. A manifestation of this is the virtual demise of locally owned community banks, thrifts, and finance companies in some areas and their replacement by larger out-of-state enterprises.[113] Of course, other regulatory factors, such as federal banking regulation, have also played a role. But clearly the credit industry has been remade in the wake of modern federal regulation in ways that are not all beneficial. The TILA and other federal consumer regulations share some of the blame for these changes.

Could the TILA (and the ECOA, FDCPA, etc.) have been done differently and better? Although TILA simplification in the 1980s shaved off many of the roughest edges, the answer to that question is still "undoubtedly so." Clearly the remaining need is for more simplification, not more complexity in disclosures or more cumbersome regulations.[114] The focus should be on more effective disclosure (rather than on more disclosure, litigation encouragement, penalties for inadvertent and harmless errors, or the addition of layers of essentially meaningless requirements). It is never too late to reduce the risks and burdens of regulation. Continual improvement provides the hope that we can eventually get it right.

Of course, laws and regulations must be a compromise and those who do not favor simplicity in the law or freedom of contract may not be eager to enhance contract law. Some plaintiffs' lawyers may disfavor legal simplification because it reduces the chances of creditor error, and therefore, litigation prospects. Large creditors may not be eager to give up the competitive advantages over smaller competitors that come with a complex federal regulatory environment.[115] And, for obvious reasons, regulatory agencies are likely to favor more regulation (and regulatory authority) rather than less. Since these are the most politically active and influential among the interested parties, regulatory reform is as difficult today as ever.

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112 *See, e.g.*, Alvin C. Harrell, *Deposit Insurance Issues and the Implications for the Structure of the American Financial System*, 18 OKLA. CITY U. L. REV. 179 (1993) (focusing on the impact of banking regulation); Alvin C. Harrell, *Penn Square Bank–20 Years Later: Introduction to the Symposium*, 27 OKLA. CITY U. L. REV. 945 (2002) [hereinafter Harrell, *Penn Square Bank*].

113 *See, e.g.*, Harrell, *Penn Square Bank*, *supra* note 112, at 945.

114 *See* Joseph M. Kolar, *Analysis of the Proposed RESPA Rule*, 57 CONSUMER FIN. L.Q. REP. 10 (2003).

115 As the late Robert L. Bartley said in a 1979 Wall Street Journal editorial: "The business giants . . . always have the option of doing everything left-handed and backward, if that's what the government wants . . . ." Bartley, *supra* note 49.

The good news is that the common law system largely works anyway. Absent further genuine reform, the best to be hoped for is a continuing, sometimes expensive, and painstaking evolution of the law in the courts. This is the common law at work, and in the end it appears to be the most effective mechanism for developing and keeping up-to-date a modern system of contract-based consumer law for the twenty-first century. After hundreds of years, because of our common law system, the broad middle ground is still holding and is as viable as ever. Thank you, Lord Mansfield.

Wrong from the Start? North Carolina's "Predatory Lending" Law and the Practice vs. Product Debate

Donald C. Lampe[*]

I. INTRODUCTION

Lawmakers seeking to protect consumers from "predatory" lenders face an initial, critical decision: should the state regulate specific loan products or specific loan practices? North Carolina lawmakers have tried both.

The North Carolina high-cost home loan ("predatory lending") statute, enacted in 1999, was the first state statute of its kind.[1] The basic design of the law has been emulated and followed in nearly forty states, municipalities, and counties.[2] As such, the law has become the *de facto* model for state and municipal "predatory lending" legislation, regulation, and ordinances throughout the country.[3] This initial law emerged from a nearly unregulated setting for mortgage loan originations in North Carolina.[4] It was "threshold-based," meaning it imposed severe restrictions and regulations on loans carrying interest rates and terms above a certain numerical threshold. As observers have noted and experience has shown, threshold-based loan regulation ultimately impacts the basic availability of certain loan *products*.

Laws directed toward mortgage originators and their sales practices regulate the *process* by which consumers obtain those

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1 Kurt Eggert, *Lashed to the Mast and Crying for Help: How Self-Limitation of Autonomy Can Protect Elders from Predatory Lending*, 36 LOY. L.A. L. REV. 693, 711 (2003).

2 See *infra* text accompanying notes 68-83.

3 See *infra* text accompanying note 60.

4 See *infra* text accompanying notes 14-15.

products—without necessarily impairing availability of credit.[5] Despite the attention given the original 1999 statute, the evidence shows that the state's consumer protection objectives were better realized by the enactment of a second law, known as the Mortgage Lending Act.[6] It provided for comprehensive mortgage broker licensure and oversight. The recent upsurge in enactment of residential mortgage lending laws has given rise to a lively debate on whether threshold-based ("product") regulations are appropriate in light of more market-friendly options that reach the sales process and practice.

North Carolina's experience with comprehensive laws of both types is instructive. It suggests that any state that elects to regulate high-cost home mortgage lending by means of a threshold-based law should first examine whether its existing "practice" regulation is adequate. That is, are mortgage loan originators regulated at the state level in a fashion that assures fairness, disclosure, and accountability to the consumer? Is the process by which consumers, particularly vulnerable populations, obtain mortgage credit appropriately regulated? The practices and procedures approach is inherently less intrusive to the marketplace than regulations that effectively prohibit certain types of loans and may even provide a greater level of consumer protection. Moreover, the availability of credit to deserving borrowers will be less seriously impaired by appropriate regulation of sales practices in residential mortgage lending than by effective prohibition of higher-cost mortgage loan products.

II. HISTORICAL BACKGROUND

In the late 1990's, the North Carolina Attorney General's office fielded numerous complaints and assembled substantial data regarding perceived abuses in the residential mortgage loan business.[7] This data led the Attorney General's office and the North Carolina Banking Commissioner to conclude that existing federal law and North Carolina's usury, mortgage banking, and mortgage brokering statutes were not strong enough to protect consumers from overcharging by mortgage lenders.[8] Very often,

5 See *infra* text accompanying notes 85-93.

6 N.C. GEN. STAT. §§ 53-243.01 to 53-244 (2003).

7 Rah Bickley, *Lending Practices Face Checks*, NEWS & OBSERVER (Raleigh), Apr. 6, 1999, at B4. North Carolina Attorney General Mike Easley noted at a public forum that North Carolina was increasingly beset with mortgage brokers and lenders who made costly loans. Alan Hirsch, the head of the Consumer Protection Division of the Attorney General's office, said the issue had exploded over the prior eighteen months and mortgage lending abuse was under investigation. *Id.*

8 *See* Carol Frey, *Lending Law Showing Its Teeth*, NEWS & OBSERVER (Raleigh), Sept. 10, 1999, at D1. The state Banking Commission received well over 1,000 complaints (in 1999) and three-quarters of them were attributable to mortgage brokers and lenders.

the perceived overcharges were manifested in "junk fees"—numerous separately-named and itemized charges imposed by mortgage brokers and lenders.[9] As the debate over residential mortgage regulation took shape, it became apparent that, due to federal preemption, many mortgage lenders doing business in North Carolina were free to impose and collect these charges without state law limitation.[10]

The Attorney General established a "working group" of interested parties to evaluate the need for reform of North Carolina's residential mortgage lending laws. In addition to industry representatives the group included consumer advocacy organizations, such as the Self-Help Credit Union and the Coalition for Responsible Lending.[11] Quickly focusing on the possibility of substantive change, the group discerned that the General Assembly was amenable to a broad overhaul of mortgage lending law.[12] As the discussions continued, consumer advocates (and the Attorney General's staff) brought forth compelling evidence of allegedly abusive mortgage lending practices, including videotapes of national newsmagazine broadcasts dealing with the worst cases of mortgage lending abuse.[13] It was difficult, to say the least, for industry representatives to speak in "support" of such practices.

In North Carolina, the alleged abuses had occurred in a lawless environment. The original North Carolina mortgage banking law, first enacted in 1988, was merely a registration statute.[14] Mortgage bankers and mortgage brokers were not

Id.

9 *Customers Angry About Loan Fees*, NEWS & REC. (Greensboro), May 10, 1999, at B5.

10 *See infra* notes 38-43 and accompanying text.

11 *See Credit Unions Target Unfair Mortgages*, NEWS & REC. (Greensboro), May 7, 1999, at B8. The Coalition for Responsible Lending is "an alliance of financial institutions, religious organizations, community groups and others" that is pushing legislation to end predatory lending practices by mortgage companies. *N.C. Predatory Mortgage Lending Law*, *at* http://www.responsiblelending.org/predlend_nc/faqs.cfm (last visited March 9, 2004). According to the group's website, the law "was developed over five months of intense discussion by the NC Bankers Association, the NC Mortgage Bankers Association, the NC Credit Union Network, the NC Association of Financial Institutions, the NC Association of Mortgage Professionals, the NC Attorney General's Office, and the Coalition for Responsible Lending." *Id.*

12 *See* Glenn J. Kalinoski, *NHEMA Fears Bills Could End Home Equity Lending in State*, NAT'L MORTGAGE NEWS, May 17, 1999, at 16. Senator Roy Cooper said the bill is the result of months of negotiations involving the Attorney General's office, representatives from major banks, representatives from mortgage bankers and brokers groups, and representatives from credit unions. *Id.*

13 Richard A. Oppel Jr. & Patrick McGeehan, *Along With a Lender, Is Citigroup Buying Trouble?*, N.Y. TIMES, Oct. 22, 2000, § 3, at 1. Martin Eakes, the founder of Self-Help Credit Union, piloted carts carrying VCR's into the North Carolina capitol building so that legislators could watch tapes about abusive lending practices. *Id.*

14 N.C. GEN. STAT. §§ 53-233 to 53-243 (1988) (repealed 2002).

subject to examination by the North Carolina Banking Commissioner.[15] In addition, the law exempted all HUD-approved mortgagees (in addition to customary exemptions for banks, credit unions, and savings institutions).[16] Employees and officers were also exempt from registration, meaning that anyone who could find employment with a registered or exempt mortgage firm could make or broker mortgage loans to consumers without registering.[17] Under the original North Carolina law, many, if not most, non-chartered mortgage companies transacted business with little or no state law regulatory oversight.

As first proposed, the North Carolina predatory lending bill, S. 1149, did contain limitations and prohibitions on the practices of mortgage bankers and mortgage brokers in addition to its threshold-based provisions.[18] Almost simultaneously, a second bill focusing more comprehensively on regulation and licensing of mortgage bankers and brokers, S. 866, also reached the Assembly.[19] But S. 866 did not pass, and S. 1149 was finally approved without its provisions for mortgage-banking regulation.[20] In effect, the General Assembly had decided, despite significant issues surrounding compliance, to focus its legislative efforts on thresholds, choosing to regulate loan terms and products rather than brokers, bankers, and originators. In retrospect there is something fateful about this outcome: had the General Assembly instead chosen to emphasize licensing and regulation, the nationwide trend of sweeping "predatory lending" legislation might never have begun at all.

Contrary to some portrayals, the "predatory lending" law did not receive unanimous support from the lending industry in North Carolina. Representatives of the consumer finance industry never formally endorsed it, and community banks and

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15 *Id.* § 53-234(6)(a) (repealed 2002). *See also* Joseph A. Smith, Jr., *North Carolina's Predatory Lending Law: Its Adoption and Implementation* (July 26, 2002), *available at* http://www.banking.state.nc.us/commissionerpage.htm. Commissioner Smith observed that:

> Prior to the adoption of the Mortgage Lending Act, some mortgage bankers and all mortgage brokers in North Carolina were required to be registered with OCOB. The registration was required only of the firms engaged in these activities, not of individual loan originators. There were several general normative prohibitions in the predecessor law but limited bases for enforcement and little in the way of enforcement measures and resources.

Id. at 5.

16 N.C. GEN. STAT. § 53-234(6) (repealed 2002).

17 *Id.*

18 S. 1149, 1999 Gen. Assem., Reg. Sess. (N.C. 1999).

19 *See* S. 866, 1999 Gen. Assem., Reg. Sess. (N.C. 1999).

20 1999 N.C. Sess. Laws 1999-332 (codified at N.C. GEN. STAT. §§ 24-1.1A to 24-10.2 (2003)).

credit unions could not comprehend at the time how the complex law would affect them.[21] Many mortgage brokers, however, were pleased by a statute that purported "reform" but failed to directly regulate them.

As noted, the regulatory provisions rejected in 1999 did follow S. 1149 into law as the Mortgage Lending Act[22] after further negotiations with consumer advocacy groups, the Attorney General's office, and industry representatives.[23] The new law, discussed *infra* at Section VI, came about with the support of the same parties who had pressed for S. 1149 in 1999,[24] and was, in effect, a continuation of the original effort to reform predatory lending.[25] As such, it created a strong practice-oriented framework for the regulation of residential mortgage lending in North Carolina. In contrast to S. 1149, the Mortgage Lending Act has proven itself a law that works to prevent lending abuse while sustaining marketplace freedom. But the broad effects of S. 1149 had already been felt, both in North Carolina and nationwide.

III. THE SCOPE OF S. 1149

S. 1149 was based on the federal Home Ownership and Equity Protection Act ("HOEPA").[26] Passed in 1994 as part of the federal Truth in Lending Act, HOEPA, in tandem with Section 32 of Federal Reserve Board Regulation Z,[27] established certain fee- and interest rate-based "triggers." When the terms of a loan exceed these thresholds, the loan is deemed to be covered by the law, and a host of disclosure requirements and prohibitions on loan terms are imposed.[28] Under the federal law, states are left free to impose broader restrictions or more restrictive triggers if they so choose.

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21 Kalinoski, *supra* note 12, at 16. NHEMA opposed the two predatory lending bills in North Carolina out of fear that they would wipe out home equity lending. *Id.* Some lenders were angered by the unnecessary government intrusion into the free market. Paul Donohue of MoneyNet Mortgage Planning Services stated the law was dangerous precedent. Meredith Barkley, *"Predatory Lending" Law Aids Buyers But Lenders Say it May Keep Some Buyers Out of the Market*, NEWS & REC. (Greensboro), Nov. 14, 1999, at G1.

22 *See* N.C. GEN. STAT. §§ 53-243.01 to 53-243.16 (2003).

23 Press Release, North Carolina Attorney General, Cooper Applauds House Passage of Bill Toughening Predatory Lending Laws (Aug. 16, 2001), http://www.jus.state.nc.us/in/press/081601.htm.

24 *Compare N.C. Predatory Mortgage Lending Law, supra* note 11, *with* Press Release, North Carolina Attorney General, *supra* note 23.

25 *See* 2001 N.C. Sess. Laws 2001-393.

26 Riegle Community Development and Regulatory Improvement Act, Pub. L. No. 103-325, §§ 151-58, 108 Stat. 2190-2198 (1994) (codified as amended in 15 U.S.C. §§ 1601-1604 and scattered sections of 15 U.S.C.).

27 12 C.F.R. § 226.32 (2003).

28 15 U.S.C. §§ 1602(aa)(1), 1639 (1998 & Supp. 2003).

S. 1149 formed part of the state's general usury (interest rate regulation) statute,[29] and its substance was twofold: threshold-based restrictions and limitations on certain types of home loans, as well as certain restrictions or prohibitions applicable to *all* home loans. The threshold-based portion of the law, following HOEPA, established that if a residential mortgage loan carried an interest rate above a certain annual percentage rate or "points and fees" exceeding a set percentage of the total loan amount, it became a "high-cost loan,"[30] and a wide range of restrictions, limitations, and prohibitions were triggered.[31]

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29 N.C. GEN. STAT. §§ 24-1 to 24-17 (2003).

30 *Id.* § 24-1.1E(a)(4) (2003). The statute defined high-cost loan:

> A "high-cost home loan" means a loan other than a reverse mortgage transaction in which:
>
> a. The principal amount of the loan (or, in the case of an open-end credit plan, the borrower's initial maximum credit limit) does not exceed the lesser of (i) the conforming loan size limit for a single-family dwelling as established from time to time by Fannie Mae, or (ii) three hundred thousand dollars ($300,000);
>
> b. The borrower is a natural person;
>
> c. The debt is incurred by the borrower primarily for personal, family, or household purposes;
>
> d. The loan is secured by either (i) a security interest in a manufactured home . . . which is or will be occupied by the borrower as the borrower's principal dwelling, or (ii) a mortgage or deed of trust on real estate upon which there is located or there is to be located a structure or structures designed principally for occupancy of from one to four families which is or will be occupied by the borrower as the borrower's principal dwelling; and
>
> e. The terms of the loan exceed one or more of the thresholds as defined in subdivision (6) of this section.

Id.

31 N.C. GEN. STAT. § 24-1.1E(b) (2003). The prohibitions included:

> (1) No call provision. —No high-cost home loan may contain a provision which permits the lender, in its sole discretion, to accelerate the indebtedness. This provision does not apply when repayment of the loan has been accelerated by default, pursuant to a due-on-sale provision, or pursuant to some other provision of the loan documents unrelated to the payment schedule.
>
> (2) No balloon payment. —No high-cost home loan may contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments. This provision does not apply when the payment schedule is adjusted to the seasonal or irregular income of the borrower.
>
> (3) No negative amortization. —No high-cost home loan may contain a payment schedule with regular periodic payments that cause the principal balance to increase.
>
> (4) No increased interest rate. —No high-cost home loan may contain a provision which increases the interest rate after default. This provision does not apply to interest rate changes in a variable rate loan otherwise consistent with the provisions of the loan documents, provided the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness.
>
> (5) No advance payments. —No high-cost home loan may include terms under which more than two periodic payments required under the loan are

Notably, only the interest rate threshold was left identical to HOEPA; the other definitions and threshold amounts contained in S. 1149 were modified.[32] In fact, the definition of "points and fees" and the mathematical means to calculate the "ceiling" were drafted from whole cloth and had no exact precedent in federal or state law.

The general restrictions and prohibitions of S. 1149 included a ban on prepayment fees for consumer-purpose, owner-occupied, first-mortgage loans.[33] The bill also included a number of new restrictions applicable to all home loans, including prohibitions on encouraging default and on the financing of credit insurance premiums, as well as a requirement that the borrower receive a real benefit from any refinancing transaction.[34] This latter standard, aimed at the predatory practice of "flipping," required the lender to determine that in any refinance of less than $300,000, the buyer was provided with "reasonable, tangible net benefit . . . considering all of the circumstances."[35]

As a general regulation of loan terms, S. 1149 applied to all lenders making residential mortgage loans in North Carolina, not merely those licensed or chartered by the state. That is, the General Assembly assumed that all residential mortgage lenders were in need of strict and punitive regulation, based not on a lender's legal or regulatory status or track record but solely on loan terms.[36] As a result, even such community and faith-based lenders as Habitat for Humanity were covered by the sweep of S. 1149, and new remedial provisions in the North Carolina statute compounded compliance risk for conforming, law-abiding lenders. Statutory unfair and deceptive trade practice remedies appeared in North Carolina's usury law for the first time, including

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> consolidated and paid in advance from the loan proceeds provided to the borrower.
>
> (6) No modification or deferral fees. —A lender may not charge a borrower any fees to modify, renew, extend, or amend a high-cost home loan or to defer any payment due under the terms of a high-cost home loan.

Id.

32 Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption*, 56 CONSUMER FIN. L.Q. REP. 78, 81 (2002).

33 1999 N.C. Sess. Laws 1999-332 (codified at N.C. GEN. STAT. § 24-1.1A(b)(1) (2003)).

34 1999 N.C. Sess. Laws 1999-332 (codified at N.C. GEN. STAT. § 24-10.2 (2003)).

35 *Id.* "Flipping" is the practice of refinancing a home loan from one consumer home mortgage to another with no discernible benefit to the consumer. *Id.*

36 A participant in the working group later referred to this as a "shotgun" approach to the problem of abusive lending. James Creekman, Group Life President, First Citizens Bank, Remarks at Federal Reserve Public Hearing on Home Equity Lending 30 (July 27, 2000), *available at* http://www.federalreserve.gov/events/publichearings/20000727/20000727.htm.

provisions for attorney fees.[37]

S. 1149 succeeded and was enacted in part because of consumer advocates' distaste for the effects of federal preemption in the residential mortgage-lending arena. In the course of drafting the legislation, federal preemption, particularly by the Alternative Mortgage Transaction Parity Act ("AMTPA"),[38] became a sort of demon for state regulators and consumer advocates.[39] The working group came to realize that capping fees and charges under the usury statute would have limited effect against the many lenders in North Carolina claiming some sort of federal preemption, including AMTPA preemption.[40] S. 1149 was therefore written with full recognition of, if not explicit intent to avoid, federal preemption in residential mortgage lending in North Carolina.[41]

State regulators and consumer advocates in North Carolina also were not pleased with the ability of out-of-state financial institutions to "import" interest rates and fees to North Carolina under preemption theories affirmed by the Supreme Court and lower federal courts.[42] At the North Carolina Bar Association's Real Property Section Annual Meeting in May 1999, while the predatory lending bill was still under consideration by the General Assembly, the state's Assistant Attorney General, McNeil Chestnut, detailed his reservations about federal preemption and interpretations thereof by the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).[43] Chestnut, a member of the working group that advised in the drafting of S. 1149, suggested that the federal banking agencies had, among other things, been misinterpreting the

37 *See* N.C. GEN. STAT. §§ 24-10.2(f) (2003).

38 12 U.S.C. §§ 3801-3805 (2001 & Supp. 2003).

39 *See* Chris Serres, *Court Battle Brewing for N.C. Law*, NEWS & OBSERVER (Raleigh), Oct. 6, 2000, at A1. Alan Hirsch of the Attorney General's office stated "[t]he State Attorney General's Office was aware of the discrepancy between state and federal law when the bill was being written last year." *Id*.

40 Brian Collins, *States Promote Own Lending Laws*, NAT'L MORTGAGE NEWS, Sept. 6, 1999, at 7. Philip Lehman, Assistant Attorney General for North Carolina, stated that the state was very aware of preemption at the state level and did everything possible to make the predatory lending law "preemption-proof." *Id*.

41 Letter from L. McNeil Chestnut, Assistant Attorney General, North Carolina, to Elizabeth H. Eason, Attorney, Law Offices of Patrick W. McKee (July 30, 2001) (on file with the author). The letter states, "More importantly, we believe that the North Carolina Act has been structured in such a manner as to avoid claims of federal preemption." *Id*. at 2.

42 *See*, *e.g.*, Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 313-14 (1978); Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 831 (1st Cir. 1992).

43 L. McNeil Chestnut, A Summary Review of Usury Issues, Paper Presented to 1999 North Carolina Bar Association Real Property Section Annual Meeting (1999) (on file with the author).

federal regulations regarding banks' ability to export interest rates.[44] It follows that the proponents of North Carolina's predatory lending act desired the law to appear in the guise of "consumer protection" rather than in the form of direct limitations on rates and fees.

Since it did not explicitly limit rates, fees, prepayment charges or other purely economic loan terms, S. 1149 arguably had no relationship to federal preemption. Rather, the statute imposed a host of consumer protection and compliance requirements on mortgage lenders, enforced by severe remedial provisions, when they made loans carrying a higher interest rate or fees. To the extent that this part of the statute discouraged federally-preempted lenders from making "high-cost" loans in North Carolina, the statute may be viewed as a "stealth override" of federal preemption.

IV. THE IMPACT OF S. 1149

The impact of the North Carolina "predatory lending" law must be viewed in terms of increased risk to compliance-oriented mortgage lenders and increased compliance costs. Under its strict liability provisions, even the most diligent and risk-averse lenders could be penalized. That is, it included no element of intent; if the triggers are "tripped," the lender becomes liable for not complying with the many resulting additional requirements. The law also troubled lenders with its ambiguous, non-standard definitions and limited opportunity for cure.

As soon as it appeared that the working group was in the process of creating a broad predatory lending bill, lending industry representatives in North Carolina began to express concerns about the potential impact on credit availability.[45] These arguments clearly did not win the day. In an attempt at compromise, the General Assembly did agree to add a rider to S. 1149, providing for the appointment of a legislative study committee to analyze the effect of the law on the availability of credit.[46] But the appointment of this study committee was not mandatory, and the leadership of the General Assembly ultimately chose not to do so.

Generally speaking, consumer advocates in the predatory lending arena believe that high-cost home loans should not be

44 *Id*. at III-6.

45 Kalinoski, *supra* note 12, at 16. Wright Andrews, a partner at Butera & Andrews, commented that the North Carolina Predatory Lending Law would dramatically curtail credit availability for many North Carolina citizens. *Id*.

46 1999 N.C. Sess. Laws 1999-332 § 7.

made available to consumers in the first instance.[47] This was borne out at hearings on HOEPA in North Carolina before the Federal Reserve Board in 2000, where working group participants testified that it was the intent of the legislation to effectively end the making of high-cost home loans to North Carolina consumers.[48]

To a large degree, S. 1149 fulfilled this goal. As detailed *infra*, experience quickly showed that many legitimate lenders would not tolerate the compliance burdens, coupled with the substantial legal risks of non-compliance, not to mention the significant reputation risk. Another measure of the impact can be seen in the incidence of counseling required for high-cost home loans. According to informal statements by the staff members from the Attorney General's office and the North Carolina Housing Finance Authority, very few such counseling sessions have occurred since S. 1149's passage.[49] This is a strong indication that very few such loans have been made, particularly since some loans do not close even after a counseling session has been undertaken. Banks have adopted a novel compliance strategy for the high-cost home loan law: avoidance.[50] Today, no compliance-oriented lender doing business in North Carolina is (knowingly) making loans with costs high enough to trigger the additional restrictions imposed by S. 1149.

Overall, a number of studies show that the North Carolina "predatory lending" law has led to a reduction in the availability of higher cost or "subprime" mortgage loan credit in the state.[51] By contrast, other studies conducted by consumer advocates have attempted to prove that either this is not the case or that, regardless of any reduction, subprime lending continued to have a negative effect on consumers.[52] Taken together, however, the

47 *See* Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 141 (2002).

48 *See* Martin Eakes, President and CEO, Self-Help, Remarks at Federal Reserve Public Hearing on Home Equity Lending 85 (July 27, 2000), *available at* http://www.federalreserve.gov/events/publichearings/20000727/20000727.htm.

49 *See* William Bost, Gen. Counsel, N.C. Ass'n of Mortgage Profs., Remarks at Federal Reserve Public Hearing on Home Equity Lending 52 (July 27, 2000), *available at* http://www.federalreserve.gov/events/publichearings/20000727/20000727.htm.

50 Comptroller of the Currency, Adm'r of Nat'l Banks, *Economic Issues in Predatory Lending 20-21* (July 30, 2003), http://www.mortgagebankers.org/resources/predlend/main.html.

51 *See* Gregory Elliehausen & Michael E. Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law,* 29 J. REAL EST. FIN. & ECON. (forthcoming 2004), McDonough School of Business Credit Research Center, Working Paper No. 66, 2002, *available at* http://www.msb.edu/prog/crc/publications.html; Keith D. Harvey & Peter J. Nigro, *Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. (forthcoming 2004).

52 *See* Keith Ernst et al., *North Carolina's Subprime Home Loan Market After*

studies to date on the impact of North Carolina's statute either support or do not refute the fact that the North Carolina law's "triggers" form usury ceilings on residential mortgage loans made after the effective date of the law.

Whether state law usury ceilings themselves are valid public policy objectives is debatable. Many economists believe that such legislation is undesirable.[53] From the experience in North Carolina, it can be assumed that complex, non-standard, threshold-based, punitive predatory lending statutes establish usury ceilings at the interest rate/APR and "points and fees" thresholds. That is, reputable lenders will simply not assume the costs and risks of making loans that exceed these thresholds. Accordingly, this makes the state-by-state legislative task of deciding "how low to go" for thresholds highly significant and the question of credit availability very important.[54] The recognition of the usury-ceiling effect of these state and local laws by federal banking regulators (and perhaps the United States Congress) should further inform the preemption debate.

The practical impact of S. 1149 on lending in North Carolina has been strong. Few lenders announced publicly that they would leave the mortgage market in North Carolina following the enactment of S. 1149, but such departures occurred nonetheless.[55] Published reports and anecdotal evidence indicate that a number of prime mortgage lenders withdrew from North

Predatory Lending Reform (Aug. 13, 2002), http://www.responsiblelending.org; Roberto G. Quercia et al., *The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment* (June 25, 2003), http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf.

53 *E.g.*, Robert E. Litan, *Unintended Consequences: The Risks of Premature State Regulation of Predatory Lending* 18, http://www.aba.com/NR/rdonlyres/D881716A-1C75-11D5-AB7B-00508B95258D/28871/PredReport200991.pdf (last visited Mar. 9, 2004). *See also* Joseph A. Smith, Jr., *The Federal Banking Agencies' Guidance on Subprime Lending: Regulation with a Divided Mind*, 6 N.C. BANKING INST. 73, 75 (2002) [hereinafter Smith, *Federal Banking*]. The author, now Banking Commissioner of North Carolina, concludes, "Subprime lending can accomplish a social good by providing credit to borrowers in need of a second chance because of damaged credit and to borrowers, primarily low income low wealth borrowers, whose financial status would not otherwise allow them to obtain credit through traditional channels. . . . Public policy has stepped into the subprime market to protect the deposit insurance fund from moral hazard and borrowers from predatory conduct. The result has been an increase in the cost of subprime lending and a reduction in revenue potential. Regulation with a divided mind has, in all probability, resulted in less subprime lending at the margin, desirable and undesirable." *Id*. at 107.

54 *See* Adam Wasch, *Anticipating Revised Fed Rule, Sarbanes Ponders New Legislation*, 77 BANKING REP. 173, 175 (July 2001).

55 Erick Bergquist, *Industry Hits Back On Lending Abuse Laws*, AM. BANKER, Jan 26, 2001, at 1. A well-known national lender "quietly pulled its subprime operations out of North Carolina, citing draconian restrictions in the state's law against predatory lending" as the reason. *Id*.

Carolina completely.[56] Many lower-volume lenders, weighing marginal economic return against significant new compliance costs, may have followed suit.[57]

At a minimum, it is apparent that residential mortgage lenders gave increased scrutiny to product offerings and loan terms. In particular, the "anti-flipping" section of S. 1149, with its "reasonable tangible net benefit" provision, probably caused a greater impact on credit availability than the rest of the statute's provisions combined. It is credited with causing a number of large, otherwise-responsible mortgage lenders doing business in North Carolina to simply stop making subprime loans in the state.[58] Thus, the statute has had an adverse impact on the availability of conforming, lower cost credit as well as targeted "predatory" activities.[59]

V. ENACTMENTS IN OTHER STATES

The debate over the impact of the North Carolina law remains lively, and has assumed additional importance as S. 1149 continues to be used as a model for other states. In fact, many states and municipalities followed North Carolina's threshold-based, HOEPA-like approach. By the beginning of 2004, nearly 40 state and local high-cost home loan laws had been enacted since the passage of S. 1149 in North Carolina.[60]

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56 *Id.*; Smith, *Federal Banking*, *supra* note 53, at 74 n.4.

57 *See* Smith, *Federal Banking*, *supra* note 53, at 107.

58 *See* David Boraks, *B of A: Subprime Is Not Worth The Trouble*, AM. BANKER, Aug. 16, 2001, at 1.

59 *Id.*

> B of A's decision to leave the business has also raised eyebrows among consumer advocates, who typically battle banks over their lending practices to poor and minority customers. Robert Gnaizda, general counsel at the Greenlining Institute in San Francisco, said he was saddened to see B of A pulling out of subprime lending.
>
> "It's not a loss; it's a disaster. B of A has the potential to be the most responsible and the largest subprime lender," Mr. Gnaizda said. The company is currently No. 4 [nationwide], writing $7.8 billion of loans in 2000. But Mr. Gnaizda said he thinks the strict North Carolina law, and legislative rumblings in other states, helped steer the company away from the business. And he blamed the nation's two major bank regulators, the Office of the Comptroller of the Currency and the Federal Reserve, for failing to set strict enough policies.
>
> "I believe that B of A is being forced to pull out of it by the negligence of the OCC and the Federal Reserve," he said. "The two primary regulators have not set a standard for subprime lending, to avoid local legislation like the North Carolina legislation. This puts enormous pressure on financial institutions that might like to do the right thing."

Id.

60 *See 2004 State Predatory Lending Bill Scorecard*, *at* http://www.butera-andrews.com/state-local/b-index.htm (Jan. 16, 2004); *Latest State Legislative and Regulatory Mortgage News*, Mortgage Bankers Ass'n, *at* http://www.mbaa.org/state_

Each state, however, felt the need to "tweak" the North Carolina approach. This resulted in part from development by consumer advocates of their own model laws, including the influential AARP Model Home Loan Protection Act/Model State Statute.[61] The AARP model law, issued on November 1, 2001, was prepared by the same consumer advocates who spearheaded the North Carolina legislative effort,[62] and was based on statutes and regulations from North Carolina, Illinois, Massachusetts, New York, and the District of Columbia.[63] The drafters of this model law, however, made it far stricter than any existing state law or regulation, incorporating such controversial elements as assignee liability and criminal penalties.[64] It was not long until some states, with encouragement from consumer advocates, started contemplating similarly severe, advocacy-driven laws. For example, the Georgia Fair Lending Act,[65] the New Mexico Home Loan Protection Act,[66] and the New Jersey Ownership Security Act[67] each borrow liberally from the language and provisions of the AARP model.

Most states that have evaluated the need for high-cost home loan laws have opted to take the comprehensive, threshold-based approach of the original North Carolina law. Some states, such as Pennsylvania,[68] Ohio,[69] Oklahoma,[70] Florida,[71] Texas,[72] and Kentucky,[73] adopted regulations and statutes that directly tracked HOEPA. Others, including Massachusetts,[74] Illinois,[75] the District of Columbia,[76] Georgia,[77] New Jersey,[78] New Mexico,[79] California,[80] New York,[81] Arkansas,[82] and South

update/index.cfm?STRING=http://www.mbaa.org/state_update/states.asp (last visited Apr. 4, 2004).

61 HOME LOAN PROTECTION ACT: A MODEL STATE STATUTE (AARP Pub. Pol'y Inst. 2001), http://research.aarp.org/consume/d17346_loan.pdf.

62 The model statute was co-written by Mike Calhoun, an attorney with Self-Help Credit Union and a member of the original North Carolina working group. *Id*. at 1.

63 *See id*. at 31.

64 *Id*. at 26-29.

65 GA. CODE ANN. § 7-6A-4 (1997 & Supp. 2003).

66 N.M. STAT. ANN. §§ 58-21A-1 to 58-21A-14 (Michie 1978 & Supp. 2003).

67 N.J. STAT. ANN. §§ 17:3B-1 to 17:3B-46 (West 2000).

68 10 PA. CODE §§ 7.1 - 7.9 (1998), *available at* http://www.pacode.com/secure/data/010/010toc.html.

69 OHIO REV. CODE ANN. § 1.63 (West 1994 & Supp. 2003).

70 OKLA. STAT. ANN. tit. 59, §§ 2081-2093 (West 2000 & Supp. 2004).

71 FLA. STAT. ANN. §§ 494.0078-494.00797 (West 2002 & Supp. 2004).

72 TEX. FIN. CODE ANN. chs. 343-345 (Vernon 1998).

73 KY. REV. STAT. ANN. §§ 294.010-294.990 (Banks-Baldwin 2001 & Supp. 2003).

74 MASS. REGS. CODE tit. 209, § 32.32 (2003), *available at* http://www.state.ma.us/dob/209cmr32.pdf.

75 ILL. ADMIN. CODE tit. 38, §§ 345.10-345.150 (2001).

76 D.C. CODE ANN. § 26-1151.01 to 26-1155.01 (2001 & Supp. 2003).

77 GA. CODE ANN. §§ 7-6A-1 to 7-6A-13 (1997 & Supp. 2003).

78 N.J. REV. STAT. ANN. §§ 17:3B-1 to 17:3B-46 (2000 & Supp. 2003).

79 N.M. STAT. ANN. §§ 58-21A-1 to 58-21A-14 (Michie 1978 & Supp. 2003).

Carolina,[83] have enacted non-standard, unique statutes or regulations that are comprehensive and unprecedented in that particular state's body of law. But generally speaking, all of the threshold-based laws have been "modeled" after North Carolina's statute in much the same way S. 1149 was based on HOEPA.

The widespread legislative surge toward threshold-based laws has created a regulatory Tower of Babel for multi-state residential mortgage lenders, particularly those specializing in non-prime, higher-risk loans. The various state laws now in effect are generally similar, but no two are exactly alike.[84] A compliance-oriented, multi-state lender must deconstruct each of these laws or ordinances to determine their basic application, mathematical rules, and potential downside risk. Again, the design of nearly all of these laws is *product*-based rather than lender type-based, so it is typically imprudent for any particular lender (whether bank, credit union, finance company, mortgage banker, or mortgage broker) to assume that a state or local law will not apply to it.

As threshold-based mortgage lending laws have spread, however, other states have followed the two-step approach ultimately adopted by North Carolina. That is, many states have either included specific provisions aimed at mortgage loan origination (sales) practices in an otherwise threshold-based law, or—like North Carolina—created a parallel state law on banker/broker regulation and reform. This has occurred, for example, in Oklahoma,[85] Kentucky,[86] Nevada,[87] Arkansas,[88] and South Carolina.[89] Additionally, many states have either passed or amended regulatory and oversight laws governing bankers and brokers outside the immediate context of predatory lending, including Washington,[90] Ohio,[91] Florida,[92] and Idaho.[93]

These competing trends demonstrate the states' central role in the "practice vs. product" debate. The debate was first framed

80 CAL. FIN. CODE § 4970-4974 (West 1999 & Supp. 2004).
81 N.Y. PRIV. HOUSE. FIN. LAW §§ 40-41.11 (McKinney 2002).
82 ARK. CODE ANN. §§ 23-39-501 to 23-39-516 (Michie 1987 & Supp. 2003).
83 S.C. CODE ANN. §§ 37-23-10 to 37-23-20 (Law Co-op. 1976 & Supp. 2003).
84 *See* Ted Cornwell, *Servicers Want National Standard*, NAT'L MORTGAGE NEWS, Feb. 23, 2004, at 22.
85 OKLA. STAT. ANN. tit. 59, §§ 2081-2093 (West 2000 & Supp. 2004).
86 KY. REV. STAT. ANN. §§ 294.010-294.990 (Banks-Baldwin 2001 & Supp. 2003).
87 NEV. REV. STAT. ANN. §§ 645B.020-645B.050 (Michie 2000 & Supp. 2001).
88 ARK. CODE ANN. §§ 23-39-503 to 23-39-505 (Michie 1987 & Supp. 2003).
89 S.C. CODE ANN. § 40-58-10 (Law Co-op. 1976 & Supp. 2003).
90 WASH. REV. CODE ANN. § 31.04.102 (West 1986 & Supp. 2004).
91 OHIO REV. CODE ANN. § 1.63 (West 1994 & Supp. 2003).
92 FLA. STAT. ANN. §§ 494.0078-494.00797 (West 2002 & Supp. 2004).
93 IDAHO CODE § 26-310 to 26-316 (Michie 2000 & Supp. 2003).

in Comptroller of the Currency John Hawke's remarks before the Exchequer Club in Washington, D.C. in April 2003.[94] Comptroller Hawke expressed his belief that regulation of mortgage lending practices would be less market disruptive and more effective for consumers than the state-by-state regulation of mortgage products via anti-predatory lending laws.[95] In effect, his remarks highlighted the distinction between advisory letters issued by his office on Predatory and Abusive Lending Practices (AL 2003-2)[96] and Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans (AL 2002-3).[97]

Proponents of practice-based regulation[98] and advocates of threshold-based laws[99] promptly joined the debate. The latter observers, including many consumer advocates, argued that the distinction between practice and product regulation is false, and that threshold-based predatory lending laws prohibit practices rather than products.[100] These proponents, however, miss the point: When laws such as S. 1149 are built of ambiguous definitions and unknown legal, reputational, and economic risks, the laws, in effect, do prohibit products because lenders ultimately will refuse to offer them. And it must again be noted that the product-prohibitive statute was not the final solution to the perceived problem of predatory lending in North Carolina.

VI. NORTH CAROLINA'S MORTGAGE LENDING ACT: A CORRECTIVE STEP

The critical second step in North Carolina's battle against predatory lending, the North Carolina Mortgage Lending Act, was passed in 2001 and took effect July 1, 2002.[101] For the first

94 Press Release, John D. Hawke, Jr., Comptroller of the Currency, Remarks Before the Exchequer Club, Washington, D.C. (Apr. 16, 2003), http://www.occ.treas.gov/scripts/newsrelease.aspx?Doc=NY6CA3Z8.xml.

95 *See id*.

96 David Hammaker, OCC Advisory Letter AL 2003-2, http://www.occ.treas.gov/ftp/advisory/2003%2D2.doc.

97 Julie L. Williams & Emory W. Rushton, OCC Advisory Letter AL 2002-3, http://www.occ.treas.gov/ftp/advisory/2002%2D3.doc.

98 *See, e.g.*, Michele Heller, *In Brief: Focus of Anti-Predator Laws Hit*, AM. BANKER, May 30, 2003, Washington, at 3. Wayne Abernathy, the Treasury Assistant Secretary for financial institutions, stated that to his dismay, anti-predatory lending proposals were more focused on products than on practices. *Id*.

99 *See, e.g.*, Elizabeth Renuart, Commentary, *Toward One Competitive and Fair Mortgage Market: Suggested Reforms in* A Tale of Three Markets *Point in the Right Direction*, 82 TEX. L. REV. 421, 422-23 (2003) (arguing that "[m]uch work remains," despite the passage of HOEPA and numerous similar state statutes); John Taylor, *Anti-Predator Laws Target Practices Not Products*, AM. BANKER, June 20, 2003, Viewpoints, at 6 (commenting on speech by Wayne Abernathy, Assistant Secretary for Financial Institutions, United States Department of the Treasury).

100 Taylor, *supra* note 99, at 6.

101 S. 904 was signed into law on August 29, 2001 (codified as N.C. GEN. STAT. §§ 53-

time ever, North Carolina's law imposed license requirements on individual employees involved in making or brokering residential mortgage loans in the state.[102] These individuals include all employees of licensed mortgage bankers or mortgage brokers who are "loan officers," "branch managers," and "managing principals."[103] All are now required to demonstrate significant levels of experience in the business and must take a course and pass an examination under the Act.[104] Despite the fact that chartered financial institutions (banks, thrifts, credit unions) are exempt from the Mortgage Lending Act, the North Carolina Banking Commissioner's office received over 10,000 individual "loan officer" applications during the initial licensing period.[105] During the first year of the Act's effectiveness, the North Carolina Banking Commissioner denied about 750 of these applications, or approximately seven percent of the total.[106] Under the Banking Commissioner's authority, grounds for rejection include moral turpitude, past criminal record, or misleading application materials.[107]

The Commissioner's new authority under the Mortgage Lending Act also includes investigatory, oversight, and enforcement powers.[108] In November 2003, Commissioner Joseph A. Smith, Jr. commented that his office was headed for a record year in consumer complaints, with seventy-five percent of the complaints arising from conduct by mortgage lenders, brokers, and their loan officers.[109] Assuming that the persons most likely to engage in abusive or predatory practices will be the ones denied the ability to (lawfully) work in the mortgage lending business, the Act should have the effect of reducing abusive or predatory home loans. The licensing, education, and experience requirements simply reinforce this.[110]

Perhaps the most important policy aspect of the Act and parallel laws in other states is that it places responsibility on the mortgage loan originator to conduct the sale in a fair and honest manner. The originator thus becomes directly and personally

243.01 to 53-243.16 (2001)).

102 N.C. GEN. STAT. § 53-243.02 (2003).

103 *Id*. §§ 53-243.01, 53-243.05.

104 *Id*. § 53-243.05.

105 *See* Letter from Joseph A. Smith, Jr., Commissioner of Banks, to Hon. Michael Easley, Governor, North Carolina 1 (Sept. 23, 2003) (on file with author).

106 *Id*.

107 N.C. GEN. STAT. § 53-243.12 (2003).

108 Joseph A. Smith, Jr., The North Carolina Mortgage Lending Act: Results of the First Year, Challenges to Come, Address to Charlotte Area Mortgage Lenders (Nov. 6, 2003), http://www.banking.state.nc.us/commissionerpage.htm.

109 *Id*.

110 N.C. GEN. STAT. § 53-243.02 (2003).

responsible for his or her conduct toward the borrower, with both legal and economic incentives to behave in an ethical and honest manner.[111] This approach removes esoteric and legally complicated doctrines of third party liability, such as assignee and transferee liability for originator wrongdoing, from the legislative and policy debate. By doing so, it enables legislatures to enact straightforward, understandable laws that prevent abusive and unfair mortgage loans from being made in the first place. Stronger regulation of mortgage loan originators is supported by the National Association of Mortgage Brokers ("NAMB"), the leading national trade group for mortgage brokers. NAMB has published a model statute for states that are considering new laws in this area.[112]

Moreover, any state that enacts non-standard, threshold-based legislation aimed at high-cost loans creates serious compliance burdens on all residential mortgage lenders, particularly if the law generally prohibits or limits certain practices. This has occurred repeatedly, in part because non-standard (non-HOEPA-based) statutes inevitably contain novel, ambiguous definitions and calculation tools for determining the thresholds or triggers.[113] Because many of the new statutes and ordinances are not consistent with HOEPA and Regulation Z, compliance with HOEPA does not automatically equate to compliance with state law, creating increased risk of lender confusion and non-compliance. This provides yet another reason why sales-practices reform is preferable.

If a law regulating mortgage sales practices and procedures creates less disruption in the marketplace, minimizes lender confusion, and places culpability with the actual wrongdoer, then it should be given the first opportunity to function. Only if such regulation fails should the state consider a threshold-based law. This is what North Carolina should have done, and it is the lesson that other states should learn. Nationwide, the states that are coupling relatively moderate HOEPA-based product-prohibitive laws with stronger practice-prohibitive laws like S. 904 are taking the preferable approach. States that enact punitive, threshold-based laws that extend liability to remote participants in the mortgage lending process, such as assignees

111 *Id*. §§ 53-243.05, 53-243.12 (2003).

112 MODEL STATE STATUTE INITIATIVE: LICENSING, PRE-LICENSURE EDUCATION AND CONTINUING EDUCATION REQUIREMENTS FOR ALL ORIGINATORS (Nat'l Ass'n of Mortgage Brokers 2002), http://www.namb.org/government_affairs/state_licensing/model_state_statute.pdf.

113 *See CBA Overview of High-Cost Home Loan Statutes, Regulations and Ordinances*, Consumer Bankers Association, http://www.cbanet.org/Issues/Subprime_lending/subprime_lending.html (updated Sep. 2003).

and transferees, are risking market disruption.[114] Whether this is appropriate public policy is open to debate, and whether "stricter" state laws can actually reduce the incidence of predatory practices without disrupting the legitimate flow of loan capital to deserving borrowers is not yet known. The North Carolina experience, as noted, is not encouraging.[115]

VII. BEYOND HOEPA: A SINGLE FEDERAL STANDARD?

Against this background of proliferating state and local laws, a significant question today is whether a "single federal standard" is appropriate. Such a standard would presumably impose a single set of rules, applicable as a matter of federal law, to classes of loans deemed to be in need of closer regulation. A straightforward way to achieve this would be by amendments to HOEPA, coupled with federal preemption of contrary state law.

This approach is exemplified by the proposed Responsible Lending Act,[116] introduced into Congress in 2003 by Reps. Robert Ney (R-Ohio) and Ken Lucas (D-Ky.). The bill would lower HOEPA triggers to encompass more home loans, while also adding consumer protections such as limits on mandatory arbitration and default terms, debt-to-income limits, prepayment penalty limitations, and prohibitions against single-premium credit life insurance for those seeking such loans.[117] In essence, the Ney-Lucas bill seeks to codify, uniformly, most of the key protective limitations and prohibitions that have emerged in the states in the last several years. Finally, it establishes uniform licensing and minimum national standards for mortgage brokers and calls for the oft-suggested creation of a national mortgage-broker database.[118] In short, the bill addresses both products and practices, and, as such, is drawing fire from advocates of the strictly threshold-based, product-based approach.[119]

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114 Subprime lenders plan to cut back loan origination in New Jersey by 70% when the new predatory lending law goes into effect. Erick Bergquist, *N.J. Law Has Lenders Set For Cutbacks*, AM. BANKER, Nov. 25, 2003, at 1. Fitch, Inc. stated they would not rate pools backed by high cost loans because the law allowed for unlimited assignee liability. *Id.* Standard and Poor's Corp. declared that it would no longer rate bonds backed by many loans originated in Georgia, because the law's assignee liability provision made them too dangerous for investors. Erick Bergquist, *Ga. Amended Predator Law After Preapproval by S&P*, AM. BANKER, March 11, 2003, at 1. Lenders argued that, without ratings by the agencies, it would be hard to sell bonds backed by the loans, and thus funding for subprime loans in the state would dry up. *Id.*

115 *See supra* notes 49, 50 & 58 and accompanying text.

116 H.R. 833, 108th Cong. (2003).

117 *See id.* § 102.

118 *Id.* §§ 302-312.

119 *See Poll Shows Support for B&C Rules*, NAT'L MORTGAGE NEWS, Sept. 8, 2003, at 13. "When congressmen Ney and Lucas introduced their bill (H.R. 833) in February, consumer groups panned it, claiming it contained few consumer protections and it

Federally chartered banks, thrifts, and credit unions are not in need of a preemptive federal statute due to a host of preemption rulings and regulations from the federal banking agencies regarding state anti-predatory lending laws.[120] Preemption for federal thrifts and national banks applies to the operating subsidiaries of such institutions, but not to all corporate subsidiaries or affiliates.[121] Obviously, federal banking agency preemption results in a competitive disadvantage to non-federally chartered or non-institution-affiliated mortgage companies, who cannot claim its benefits. Accordingly, a single-point federal standard would better serve non-bank mortgage lenders than sporadic preemption rulings and interpretations by federal banking agencies.

VIII. CONCLUSION

It is well known that the residential mortgage lending industry is national in scope. Most residential mortgage loans, whether originated by banks or mortgage companies, are sold into the securities market.[122] Therefore, originators rely on capital from a national market. If nothing else, the plethora of

weakened the existing federal anti-predatory lending law [HOEPA]." *Id.*

120 *See* Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (Jan. 21, 2003) (Form Letter P-2003-1) (preemption of Georgia Fair Lending Act), http://www.ots.treas.gov/hola03.html; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (Jan. 30, 2003) (Form Letter P-2003-2) (preemption of New York predatory lending law), http://www.ots.treas.gov/hola03.html; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (July 22, 2003) (Form Letter P-2003-5) (preemption of New Jersey predatory lending act), http://www.ots.treas.gov/hola03.html; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (Sep. 2, 2003) (Form Letter P-2003-6) (preemption of New Mexico Home Loan Protection Act), http://www.ots.treas.gov/hola03.html. *See also* Letter from Sheila A. Albin, Associate General Counsel, National Credit Union Association, to Carla J. Cerniglia, Senior Compliance Specialist, New York State Credit Union League Inc. (March 2, 2001) (discussing applicability of state lending regulation to federal credit unions), http://www.ncua.gov/ref/opinion_letters/2000/00-0827.html; Letter from Sheila A. Albin, Associate General Counsel, National Credit Union Association, to Richard P. Kessler, Jr., Macey, Wilensky, Wittner & Kessler, LLP (July 29, 2002) (applicability of Georgia Fair Lending Act to federal credit unions), http://www.ncua.gov/ref/opinion_letters/2002/02-0649.html. As to national banks, see Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7 & 34).

121 *See* Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (Jan. 21, 2003) (Form Letter P-2003-1), http://www.ots.treas.gov/hola03.html; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (Jan. 30, 2003) (Form Letter P-2003-2), http://www.ots.treas.gov/hola03.html; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (July 22, 2003) (Form Letter P-2003-5), http://www.ots.treas.gov/hola03.html; Letter from Carolyn J. Buck, Chief Counsel, Office of Thrift Supervision (Sep. 2, 2003) (Form Letter P-2003-6), http://www.ots.treas.gov/hola03.html; Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (Jan. 13, 2004) (to be codified at 12 C.F.R. pts. 7 & 34).

122 Henry Savage, *Zoning Curbs Loan Prospects*, WASH. TIMES, Jan. 30, 2004, at F23.

state and local anti-predatory lending laws impedes the flow of legitimate capital from national sources to local originators.

Needless to say, whether this reduction in funds available to borrowers is salutary or destructive is part of the debate. Some consumer advocates believe that under existing laws, certain home loans simply should not be made. The design and impact of North Carolina's initial anti-predatory lending law is an example of consumer advocates prevailing in this view.

Consumer Law, Class Actions, and the Common Law

*Michael S. Greve**

I. INTRODUCTION

Even where bodies of law purport to be defined by their subject matter, such as "health care law" or "housing law," they are often distinguished from legal arrangements covering the same area by their underlying presumptions. "Employment law," for instance, covers substantially the same economic transactions as the older labor law and still-older common law doctrines. Those fields differ chiefly in their premises, and consequently, their institutional arrangements. Unlike labor law, which is principally the law of labor unions and their rights and relations vis-à-vis management (under the auspices of the National Labor Relations Board), employment law is individualistic. With few exceptions, the right to remain free from discrimination is the individual employee's, and it can be enforced outside union channels and arbitration regimes.[1] In that respect, employment law resembles the old common law of contract and employment at will, but with a twist. Instead of a fundamental, bilateral freedom not to deal, employment law establishes the employee's unilateral right to remain free from discriminatory treatment.[2] This antidiscrimination principle permits the employee to press the employer into transactions that they would rather avoid, all things considered.[3] The purported extension of common law rights masks their redistribution.

In a similar way, "consumer law" is parasitic on, and transformative of, common law doctrines grounded in contract

* Ph.D. (Government), Cornell University, 1987. I am indebted to Kate Rick for her capable research assistance and to Richard Epstein, Robert Gasaway, Michael Kelly, Jonathan Klick, George Priest, and David Rosenberg for exceptionally helpful suggestions and comments on earlier drafts.

1 That, of course, was the point: seniority rules and other labor union practices often worked to the disadvantage of minority employees. *See, e.g.*, Martin v. Wilks, 490 U.S. 755, 758-59 (1989).

2 *See* RICHARD A. EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS 3 (1992).

3 *Id*. at 5, 73.

and tort. 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.[4] 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.[5]

My point in highlighting these differences is not to argue for the superiority of common law rules over consumer law constructs. I will stipulate that mandatory disclosure rules may be efficient in some settings. For purposes at hand, I will even concede—although I frankly doubt—that a full-fledged consumer law regime might, at a highly abstract and theoretical level, be shown to be just as efficient as an equally stylized common law regime. Rather, my point is that it makes no sense to have the two regimes operate on top of each other and over the same range of transactions. However, that is the system we now have. Just as employment law was superimposed on the pre-existing regime of contractual employment obligations, so too has consumer law been piggybacked on top of common law doctrines governing the promotion and sale of goods and services. This dual regime is extremely unlikely to enhance social welfare or even consumer interests.[6]

II. DEVELOPMENT OF CONSUMER LAW

Handbooks and treatises on "consumer law" often define it as a contradistinction to commercial law, meaning the law governing transactions among merchants.[7] The common law, of

4 *See, e.g.*, The Honorable Sheldon Gardner & Robert Kuehl, *Acquiring an Historical Understanding of Duties to Disclose, Fraud, and Warranties*, 104 COM L.J. 168, 186-88 (1999).

5 *Id*. at 178-79.

6 In commenting on an earlier draft, David Rosenberg has forcefully reminded me that redundant, competing systems of law may be very useful for a number of reasons, such as information discovery and a reduction of the frequency and cost of error. To that extent, the dual system problem dissolves into a coordination problem. This is the correct perspective. The central coordination problem to my mind is this: redundancy has salutary effects so long as in any given case or transaction, each system operates to the exclusion of the other. In such a case, the parties and their disputes can migrate from one to the other and the systems check each other at the margin. However, consumer law and common law rarely operate in this competitive sense of "redundancy." They operate *jointly*, which is bound to compound errors. Even compound errors, one might argue, generate information, but they are unlikely to generate useful operational information at an acceptable cost.

7 *See* MICHAEL M. GREENFIELD, CONSUMER LAW: A GUIDE FOR THOSE WHO

course, made no such distinction; it rested on a robust, across-the-board presumption in favor of freedom of contract.[8] Even the Uniform Commercial Code ("UCC") treats consumer transactions under the same rules that apply to comparable business transactions.[9] However, consumer law theorists and advocates insist that the assumptions that underpin freedom of contract simply do not apply in the context of consumer transactions. Using often-colorful language, consumer lawyers conjure up a world of ignorant, impulsive consumers who stumble helplessly through a world of serial monopolies.[10] In soberer moments, they identify the characteristics that supposedly distinguish consumer markets: asymmetric information (or wholesale consumer ignorance), unequal bargaining power, and irrational consumer preferences.[11] Consumer protection laws attempt to redress these problems by imposing affirmative disclosure obligations[12] through outright prohibitions on abusive, extortionate, or unconscionable contract terms and sales practices,[13] or through mandatory cooling-off or revocation periods.[14]

All these rationalizations prove either too much or too little to define the discrete field of "consumer law." Information is asymmetric in business as well as consumer transactions (the seller almost always knows more than the buyer); still, for good reasons, the general rule remains "buyer beware." Bargaining power is often unequal in the business sector, but within the general framework of protections against fraud and monopoly, we let the parties deal, or not deal, as they wish. Evidence of

REPRESENT SELLERS, LENDERS, AND CONSUMERS 2 (1995); FREDERICK H. MILLER ET AL., CONSUMER LAW: CASES, PROBLEMS, AND MATERIALS 3 (1998).

8 *See* Charles L. Knapp, *Taking Contracts Private: The Quiet Revolution in Contract Law*, 71 FORDHAM L. REV. 761, 769 n.33 (2002).

9 Even with respect to such consumer law chestnuts as unconscionability and warranties, the UCC makes no distinction between merchants and consumers. *See* U.C.C. §§ 2-302, 2-312 to 2-317 (1997 & Supp. 2003). The UCC did contain a few rare distinctions between consumers and businesses, which have been repealed. *See, e.g.*, U.C.C. §§ 9-505, 9-507 (repealed 1999).

10 Even casebooks display that tendency: in consumer transactions, "the position of the parties is such that the consumer is faced with a take-it-or-leave-it proposition, and often few alternative sources of supply offering any substantially different deal." MILLER ET AL., *supra* note 7, at 4.

11 *Id*. at 3-4; Lary Lawrence, *Toward a More Efficient and Just Economy: An Argument for Limited Enforcement of Consumer Promises*, 48 OHIO ST. L.J. 815, 817, 824-25 (1987).

12 *See, e.g.*, Real Estate Settlement Procedures Act of 1974, 12 U.S.C. § 2601 (2001) (commonly referred to as "RESPA"); Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1997); Truth in Lending Act, 15 U.S.C. §1601 (1998); Magnuson-Moss Warranty Act, 15 U.S.C. § 2302 (1998); 12 C.F.R. § 18.4 (2003).

13 *See, e.g.*, Fair Debt Collection Practices Act, 15 U.S.C. § 1692 (1998); 16 C.F.R. §§ 310.4, 453.2-453.3 (2003); 47 C.F.R. § 64.1200 (2002).

14 *See, e.g.*, Truth in Lending Act, 15 U.S.C. § 1635 (1998) (establishing right for consumer—but not lending institution—to revoke mortgage contract within three days without penalty); 16 C.F.R. § 429.1 (2003).

pervasive irrationality is far too conjectural at this point to warrant careless paternalism; at most, it may justify circumspect interventions that protect the irrational from costly mistakes without, in the same process, inflicting costs on the rational.[15]

There is no set of criteria or principles that reliably delineates a discrete "consumer law," and, in truth, the attempt to conjure up such a body of law partook of a broader, explicitly ideological reform movement. Beginning in the 1960s, large numbers of policy advocates and legal scholars argued that common law forms and formalities were an impediment to social reform, the effective management of public problems, and the aspirations and interests of deserving political constituencies.[16] At its zenith, this critique became distilled in an ambitious effort to develop a full-blown theory of "public law," a term that has since lost currency.[17] The venue for the most serious and thoroughgoing version of this argument was environmental law, whose champions claimed that environmental complexities rendered common law distinctions between "mine and thine" "a menace to an imperiled planet."[18] In an interconnected world, human activities become per se externalities.[19] Thus, when an endangered woodpecker decides to build its nest where you decide to build your house, the bird wins and you lose.[20]

15 *See* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1212-14 (2003). Note also that this rationale would often appear to dictate regulatory strategies that are diametrically opposed to actually existing—and well-nigh sacrosanct—"consumer protections." Disclosure obligations for public corporations and broker-dealers, for example, are loudly touted as protections for the proverbial "small investor." Even if equity markets are approximately efficient, the vast majority of those investors should not dabble in the market; they should buy index funds. Merrill Lynch and its ilk complied with every applicable regulation, which did nothing to prevent unsophisticated consumers from entering a bubbly market. By taking those investors as the yardstick, disclosure regulation creates a moral hazard (a kind of deposit insurance for stock market amateurs), while distorting or suppressing information (such as forward-looking information) that *would* be of use to more sophisticated investors. Arguably, an efficient paternalistic regime would license stock buyers, not brokers. *See* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 941-43 (1998).

16 *See generally*, Charles Reich, *The New Property*, 73 YALE L.J. 733 (1964) (arguing for the expansion of property rights to government entitlements).

17 *See generally* RONALD DWORKIN, LAW'S EMPIRE (1986); Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281 (1976); Owen M. Fiss, *The Supreme Court 1978 Term–Foreward: The Forms of Justice*, 93 HARV. L. REV. 1 (1979); Cass R. Sunstein, *Beyond the Republican Revival*, 97 YALE L. J. 1539 (1988).

18 MICHAEL S. GREVE, THE DEMISE OF ENVIRONMENTALISM IN AMERICAN LAW 1 (1996).

19 *See* A. Dan Tarlock, *The Nonequilibrium Paradigm in Ecology and the Partial Unraveling of Environmental Law*, 27 LOY. L.A. L. REV. 1121, 1125 (1994) (noting that all human activities produce negative externalities).

20 Brian Mannix, *The Origin of Endangered Species and the Descent of Man*, AM. ENTERPRISE, Nov.–Dec. 1992, at 58, 58. This paradigm continues to appear in the case law. *See, e.g.*, Nat'l Assoc. of Home Builders v. Babbitt, 130 F.3d 1041, 1052-54 (D.C. Cir.

Environmental law's ambition of managing entire ecosystems in accordance with a coherent political scheme rests on a full-scale repudiation of the common law and its theoretical foundations, including notions of property, harm, and individual injury.[21]

Consumer law advocates could rest their case, at least initially, on a more modest critique of the common law and of a market economy. Affirmative disclosure obligations, they argue, would make for more informed consumers and hence better customers.[22] Such obligations would improve rather than stifle competition.[23] Unlike environmental law, consumer law remains at least superficially tied to production values.[24] Similarly, consumer law advocates need not attack the common law at its roots; they can plausibly rest their case on the enforcement problems and transaction costs that attend common law litigation. Those barriers, the argument runs, may prevent the victims of wrongful conduct from asserting their claims when, as is often the case in consumer transactions, those claims are small.[25] The costs of detecting and proving unlawful conduct—for example, in cases of fraud, which require proof of the defendant's knowing and intentional misrepresentation—may further exacerbate a tendency towards under-enforcement and under-deterrence. That is especially so when even the full enforcement of the available remedies, such as damages under the out-of-pocket rule, leave a lawbreaking defendant no worse off (net of the costs of defending the claims) than his law-abiding competitor.[26]

This thoroughly familiar argument suggests equally familiar remedies. An obvious choice is to entrust public agencies with

1997) (holding that the Federal Endangered Species Act passes constitutional muster under the Commerce Clause due to the interconnectedness of the world).

21 Greve, *supra* note 18, at 6-7.

22 *See, e.g.*, Truth in Lending Act, 15 U.S.C. § 1601 (1998); Magnuson-Moss Warranty Act, 15 U.S.C. § 2302 (1998).

23 *See, e.g.*, 15 U.S.C. §§ 1601, 2302.

24 The unfair competition laws that were to become a principal vehicle for the creation of "consumer law," *see, e.g.*, MILLER ET AL., *supra* note 7, at 5-6, were originally enacted to protect competitors and competition rather than consumers. The Federal Trade Commission Act of 1915 was amended to protect consumer interests after the Supreme Court ruled that the original statute protected competitors exclusively. *See* FTC v. Raladam Co., 283 U.S. 643, 653 (1931); Federal Trade Commission Act, 15 U.S.C. § 41 (1914), *amended by* 15 U.S.C.§ 45(a)(1) (1938). California's Unfair Competition Law, far and away the most draconian consumer statute in the nation, originated as a statute to protect competition and to this day is viewed as embodying that objective. *See* Robert C. Fellmeth, *Unfair Competition Act Enforcement by Agencies, Prosecutors, and Private Litigants: Who's on First?*, 15 CAL. REG. L. REP. 1, 2-3 (1995).

25 *See* Fellmeth, *supra* note 24, at 4 ("One public price paid is a barrier to entry to one who has, in fact, a product or service many would greatly desire—if they could believe claims made about it.").

26 RESTATEMENT (SECOND) OF TORTS § 549 cmt. g (1977).

the definition and enforcement of prohibitions and injunctions against unfair or fraudulent business practices, without having to prove the common law elements of such violations. Another strategy, albeit a crude one, is to increase the rewards for private enforcers. A third strategy, running roughly concurrent with the invention of consumer law, is the bundling of small claims in class actions. While all three strategies predate the invention of modern consumer law by more than a half-century,[27] their use increased enormously during the 1970s when Congress and state legislatures enacted a rash of consumer protection statutes and damages provisions.[28] As a result, jury awards proliferated.[29] Also, in the wake of the 1966 class action reforms, federal and state courts created a novel and remarkably permissive regime for the prosecution and adjudication of mass claims.[30]

That prompt accommodation to perceived consumer needs failed to create an equilibrium where consumer law has come to rest. It is exceedingly difficult to tailor private rewards to deterrence objectives, and, in any event, their effectiveness still depends on the availability of a sufficiently large plaintiff class. Public consumer protection agencies, even when run by consumer advocates,[31] still operate under budgetary constraints and countervailing political pressures. Modern class actions are fraught with a wide array of problems, including substantial transaction costs and sweetheart settlements or "reverse auctions" that dilute the deterrent value of such actions.[32]

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27 *See, e.g.* Clayton Act, 15 U.S.C. § 15 (1914) (treble damages for antitrust violations); Federal Trade Commission Act, 15 U.S.C. § 41 (1914) (authorizing the Federal Trade Commission to regulate unfair or deceptive acts in business commerce), *amended by* 15 U.S.C. § 45(a)(1); Martin Act of 1921, N.Y. GEN BUS. LAW §§ 352-359 (McKinney 1996 & Supp. 2003) (regulating investment security sales in New York and requiring brokers, advisors, etc. to register with the New York Attorney General's office).

28 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) [hereinafter Sovern, *Reconsidering*].

29 *Id*.

30 Apparently, the Civil Rules Advisory Committee had no such goal in mind. *See Class Action Reform Gets a Shot in the Arm*, 69 DEF. C. J. 263, 264 (2002) ("Professor Arthur Miller, who was involved with the work of the committee at that time, tells us that 'Nothing was in the committee's mind . . . . And the rule was not thought of as having the kind of application that it now has.'").

31 During the 1970s, leaders of Ralph Nader's consumer organizations assumed high-ranking government positions: Joan Claybrook ran the National Highway Traffic Safety Administration and Michael Pertschuk the Federal Trade Commission.

32 The latter practice has prompted intense academic debate and a broad range of reform proposals. *See, e.g.*, John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370 (2000); Bruce L. Hay & David Rosenberg, *"Sweetheart" and "Blackmail" Settlements in Class Actions: Reality and Remedy*, 75 NOTRE DAME L. REV. 1377 (2000); Samuel Issacharoff, *Governance and Legitimacy in the Law of Class Actions*, 1999 SUP. CT. REV. 337, 341-42 (1999).

Besides, consumer law itself creates a kind of upward demand spiral. Confronted with a prohibition against competition on some margin (for example, interest rates on consumer loans or mortgages), sellers will compete on some other, less transparent margin, thus creating demands for additional interventions.[33] If more laws and affirmative obligations, bigger government agencies with bigger enforcement budgets, and better incentives for injured consumers do not do the job, the natural move is to mimic environmental law after all: divorce lawfulness from individual harm, legal claims from their common law owners, and legal theories from production values. In fact, the law has moved on this trajectory. Its chief propellant has been the consumer class action. A simple example, based loosely on an actual case that eventually settled for a modest $2.1 billion, illustrates the progression. [34]

III. CONSUMER LAW CLASS ACTIONS

Suppose a company sells a large number of identical computers at a price of $1,000 with an implied or actual promise that the product will function flawlessly. Unfortunately, it turns out that a series of complex operations performed by only a small number of marginal consumers causes the system to crash. What is the sensible assignment of rights?

The common law rule, in a nutshell, is to deter negligent misrepresentation or simple mistake by means of providing redress for those persons, and *only* those persons, who have suffered an injury and who justifiably relied on the manufacturer's representations.[35] Under the out-of-pocket rule, redress includes restitution for the full purchase price minus the residual value of the product, if any.[36] It also includes the user's

33 The literature on banking and consumer loan regulation has amply documented the phenomenon. *See, e.g.*, Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201 (1986); Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 82-83 (2000). In the area of subprime mortgage lending, consumer advocates are pressing—both at the state and the federal level—for the regulation of opaque loan terms whose use was very likely induced by earlier rounds of "consumer protection" legislation, in particular de facto usury ceilings. *See* Michael S. Greve, *Subprime, but not Half-Bad: Mortgage Regulation as a Case Study in Preemption*, FEDERALIST OUTLOOK Sept.-Oct. 2003, at 1, *available at* http://www.aei.org/publications/contentID.20038142219500221/default.asp.

34 Shaw v. Toshiba Am. Info. Sys., Inc., 91 F. Supp. 2d 926 (E.D. Tex. 1999); Andy Pasztor & Peter Landers, *Toshiba to Pay $2B Settlement on Laptops*, WALL ST. J. ONLINE, Oct. 31, 1999, *available at* http://zdnet.com.com/2100-11-516294.html.

35 In addition, a plaintiff must show that the representation was in fact false and made with the intent of inducing the plaintiff to rely on it. 37 AM. JUR. 2D *Fraud and Deceit* § 26 (2001); RESTATEMENT (SECOND) OF TORTS § 552 (1977). Of course, pleading and proof requirements for the historically disfavored tort of fraud are still more demanding. *See* RESTATEMENT (SECOND) OF TORTS § 526 cmt. b (1977).

36 *Id*. § 552B.

opportunity costs (the foregone benefits of purchasing a competing, flawless product).[37] It appears that most courts also award quasi-contractual, benefit-of-the-bargain redress for the consumer's disappointed expectations.[38] Marginal consumers who satisfy the dual requirements of detrimental reliance receive full compensation, and the infra-marginal consumers for whom the product worked as promised receive nothing.

The alternative is to ask what legal regime individuals would choose *ex ante*—that is, prior to the purchase or use of this or any other product. The answer, some scholars have argued, is a rule that creates adequate deterrence for the manufacturer to optimally investment in precautionary measures.[39] On the additional assumption that individuals are risk-averse, the rule will also provide full insurance coverage for all economic losses. However, the rule will not provide compensation *in excess* of the insured amounts, for example, compensation for non-pecuniary losses.[40] This is bad news for consumer-plaintiffs from an *ex post*, wealth-maximizing perspective.

The good news is that from a deterrence-oriented, *ex ante* perspective, common law considerations of injury, inducement, and justifiable reliance are beside the point and quite probably harmful. Those questions go only to the *distribution* of the proceeds, which is separate from and secondary to the determination of the correct deterrence level.[41] To be sure, if damages are set at the right level litigation by the marginal consumers may produce a deterrence level that will generate optimal investments in precautions. But why should we rely on those consumers and their uncertain incentives to extract the seller's windfall? It may make more sense to round up the purchasers all along the demand curve and figure out the difference between the purchase price and the price that consumers would have paid *in the aggregate* had the true characteristics of the product been known.

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37 *See id*.

38 In other words, courts do not attempt to restore the plaintiff to the position that he would have occupied had the misrepresentation never been made; they attempt to put him into the position he would have occupied, had the false communication been true. *Id*. § 549 cmt. g (criticizing the practice but acknowledging its preponderance); Michael B. Kelly, *The Phantom Reliance Interest in Tort Damages*, 38 SAN DIEGO L. REV. 169, 170-71 (2001).

39 CHARLES FRIED & DAVID ROSENBERG, MAKING TORT LAW: WHAT SHOULD BE DONE AND WHO SHOULD DO IT 18-20 (2003).

40 *See id*. at 13-26 (describing this perspective in a non-technical manner).

41 *See generally* David Rosenberg, *Decoupling Deterrence and Compensation Functions in Mass Tort Class Actions for Future Loss*, 88 VA. L. REV. 1871 (2002) [hereinafter Rosenberg, *Decoupling Deterrence and Compensation*].

Increasing numbers of class actions, including some cases of considerable notoriety, proceed from this premise only to push towards a rather more insidious conclusion. A few examples illustrate the pattern:

Williams v. Purdue Pharma Co.[42] was a class action on behalf of purchasers of OxyContin, a potent opioid.[43] The plaintiffs complained that Purdue conducted a deceptive, misleading, and fraudulent advertising campaign that falsely stated the product would provide "smooth and sustained pain relief," and posed little risk of addiction when used as prescribed.[44] The class plaintiffs did not claim that the product failed to work as advertised for them or that they became addicted.[45] Instead, they argued that they were deprived of the full benefit of their purchase bargain because the product failed to work as advertised for some other consumers.[46]

In *Avery v. State Farm Mutual Automobile Insurance Co.*,[47] an Illinois jury and judge awarded $1.18 billion to a class of an estimated 4.5 million State Farm customers in forty-eight states. This award was based upon the company's post-crash repair cost estimates on the basis of cheap and allegedly inferior aftermarket parts.[48] Plaintiffs did not allege that State Farm's policy, which many states encourage or even require to control automobile insurance rates, caused them physical injury or consequential pecuniary losses such as lost resale value.[49] Instead, they prevailed on the claim that aftermarket parts are inherently inferior and therefore fail to satisfy State Farm's contractual obligations to restore vehicles to their pre-loss condition.[50]

In *Price v. Philip Morris Inc.*,[51] another Illinois state court approved a $10.1 billion verdict in favor of a class of Illinois purchasers and consumers of Marlboro Lights and Cambridge Lights.[52] The action did not include claims for personal injury.[53] Rather, plaintiffs claimed that the advertisements of the

42 297 F. Supp. 2d 171 (D.D.C. 2003).
43 *Id*. at 172, 175.
44 *Id*. at 172-73.
45 *Id*. at 172.
46 *Id*. at 175-76 (summarizing plaintiffs' complaint).
47 746 N.E.2d 1242 (Ill. App. Ct. 2001).
48 *Id*. at 1247. The court subsequently reduced the judgment by $130 million. *Id*. at 1261. The case is pending on appeal to the Illinois Supreme Court. Avery v. State Farm Mut. Auto. Ins. Co., 786 N.E.2d 180 (Ill. 2002).
49 746 N.E.2d at 1258.
50 *Id*. at 1259.
51 No. 00-L-112, 2003 WL 22597608 (Ill. Cir. Ct. Mar. 21, 2003).
52 *Id*. at *29.
53 *Id*. at *3.

products as "Lights" and "Lowered Tar and Nicotine" were deceptive, unfair, and calculated to create the false consumer impression that the products were safer or less harmful than regular cigarettes.[54] Plaintiffs claimed to have overpaid in reliance on these misrepresentations.[55] They sought and obtained damages for the difference between the purchase price and the value of the product that they actually received.[56] The trial judge credited a consumer survey conducted by a plaintiff's expert, which estimated the diminution in value at 92.3 percent, and on that basis arrived at "compensatory" class damages of $7.1 billion.[57]

Quite obviously, ordinary notions of detrimental reliance and inducement play a distinctly subordinate role in those cases; otherwise, it is hard to see how a court could possibly certify inchoate classes of consumers who vary greatly in their degree of reliance and injury (if any).[58] From the *ex ante* perspective, these differences are immaterial. The right rule will skim off the entire surplus of the transaction (both the producer and consumer surplus), which the inframarginal consumers, for whom the products worked as advertised, have already received and will get to keep in any event. The rule will provide full insurance compensation for the consumer class and distribute the remaining funds (if any) to someone else, for some other "public use."[59]

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54 *Id*. at *4.

55 *Id*. at *15.

56 *Price*, 2003 WL 22597606, at *15.

57 *Id*. at *16–17.

58 The nationwide class certified in *Avery* is highly problematic in many respects. It could not possibly be sustained in the Seventh Circuit, which covers Illinois. *See In re* Bridgestone/Firestone, Inc., 288 F.3d 1012, 1018 (7th Cir. 2002) ("Because these claims must be adjudicated under the law of so many jurisdictions, a single nationwide class is not manageable."), *cert. denied*, 537 U.S. 1105 (2003). Due to the requirement of complete diversity, however, the case could not be removed to federal court. State Farm's repeated attempts to have the class decertified in state court and an interlocutory petition for certiorari to the U.S. Supreme Court remained unsuccessful. State Farm v. Speroni, 525 U.S. 922 (1998) (denying certiorari); Avery v. State Farm, 746 N.E. 2d 1242, 1257 (Ill. App. Ct. 2001) (affirming class certification).

59 *See* Rosenberg, *Decoupling Deterrence and Compensation*, *supra* note 41, at 1896. The cheerful "public use" appellation conceals grave problems at both ends of the transaction. It suggests that the "public use" is *ipso facto* superior to the producer's "private" use—including, presumably, the production of future goods or services. In this regard, the purveyors of an *ex ante* regime leave themselves open to the charge of playing in a static world. That problem is aggravated when the "public use" of the "excess" is handed over, as often it is, to a private organization with the stated objective of siphoning off the *next* producer's surplus. *See* James R. McCall et al., *Greater Representation for California Consumers—Fluid Recovery, Consumer Trust Funds, and Representative Actions*, 46 HASTINGS L. J. 797, 848 (1995) ("The consumer trust fund created by the court's order in Avco funded . . . [cases involving issues of concern to] low and moderate income consumers in California . . . ."). *See also Price*, 2003 WL 22597608, at *49–50 (awarding unclaimed funds to the Illinois Bar Foundation, eleven law schools, the

Like traditional common law plaintiffs, the members of the plaintiff classes just described at least purchased OxyContin, insurance policies, and Marlboro Lights, and did complain about the characteristics of those products and the sellers' representations. But if we are worried chiefly about deterrence levels, those limitations may be superfluous. Perhaps, *anyone*—bystander, malcontent, plaintiffs' lawyer, public prosecutor—should be permitted to sue and recover, so long as we rely on courts to generate optimal deterrence levels.

Modern "entrepreneurial" class actions, which are instigated and controlled entirely by plaintiffs' lawyers, conform to this pattern.[60] Statutory law has moved in the same direction. Most prominently, California's Unfair Competition Law ("UCL")[61] prohibits "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising."[62] "Unlawful" acts are those that are unlawful under any statute; hence, the UCL sweeps across the entire California Code, including the criminal code.[63] Moreover, compliance with the law is not necessarily a defense since business practices that are not "unlawful" may still be "unfair."[64]

The extraordinary breadth of the UCL is matched by the liberality of its enforcement provisions. The act may be enforced by state and local prosecutors and by literally any private party acting "for the interests of itself, its members or the general public."[65] Anyone can sue anyone else; the only standing

American Cancer Society, and in-state domestic violence, drug, and legal aid programs).

60 As for "plaintiffs' lawyer," it has become generally recognized that consumer class actions are *their* products, not the nominal clients. *See, e.g.*, Issacharoff, *supra* note 32, at 341 ("Class actions almost invariably come into being through the actions of lawyers—in effect, it is the agents who create the principals—and will not emerge without some protection of the entrepreneurial initiative of those lawyers."). As for "bystanders," the requirement that the nominal consumer plaintiffs must at least have purchased the product in question has been rejected explicitly in some cases. For example, the class in *Shaw v. Toshiba America Information Systems, Inc.*, included *potential* purchasers, who were found to have standing to obtain injunctive relief. 91 F. Supp. 2d 926, 938 (E.D. Tex. 1999) ("[I]t is not necessary for someone to actually *own* a defective computer in order to experience continuing, adverse effects from it."). The *Shaw* court affirmed standing "regardless whether Plaintiffs currently own one of Defendants' computers, are thinking about buying one of Toshiba's computers, or are commuting to work over a bridge with design specifications tainted by allegedly faulty [diskette controllers]." *Id*. at 941. From an *ex ante* perspective, this seemingly bizarre position is in fact quite plausible. *See* Francesco Parisi & Jonathan Klick, *Functional Law and Economics: The Search for Value-Neutral Principles of Lawmaking*, 79 CHI.-KENT L. REV (forthcoming Winter 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=441941.

61 CAL. BUS. & PROF. CODE § 17200 (Deering 1992 & Supp. 2003).

62 *Id*. (emphasis omitted).

63 *See* Stop Youth Addiction, Inc. v. Lucky Stores, Inc., 950 P.2d 1086, 1091 (Cal. 1998).

64 *See* McCall et al., *supra* note 59, at 822–25 (discussing case law).

65 CAL. BUS. & PROF. CODE § 17204 (Deering 1992 & Supp. 2003).

requirement is "that the plaintiff can effectively represent the [broader] group's interests."[66] With respect to fraudulent business practices, for example, it is not necessary to show deception, reasonable reliance, or damages to anyone, let alone the plaintiff.[67] Private enforcement may proceed even where the predicate statute manifestly contemplates no such thing.[68] The procedural formalisms and due process safeguards of class actions, which from an *ex ante* perspective are deadweight at best and an invitation to opportunism at worst,[69] have in fact disappeared under the UCL. Actions on behalf of the public, sometimes called "representative actions" or "quasi-class actions," may proceed without conforming to federal or state class action requirements.[70] While private litigants may not sue for damages,[71] they may obtain injunctive relief, as well as restitution and disgorgement under equitable principles.[72] The California courts have created multiple vehicles to facilitate generous monetary relief.[73] In short, "[t]he only apparent limitation upon the practical reach of the UCL is the imagination of man (and woman)."[74]

The best-known UCL plaintiff is Marc Kasky, a self-proclaimed activist who sued Nike over the company's allegedly false statements concerning its corporate practices in Third-World countries.[75] Mr. Kasky himself did not rely on those statements—and certainly not to his detriment. There was no evidence that he had ever purchased a Nike product; in any event, the company's communications concerned its employment practices, not the attributes of its sneakers.[76] Nonetheless, and

66 McCall et al., *supra* note 59, at 826.

67 Podolsky v. First Healthcare Corp., 58 Cal. Rptr. 2d 89, 98 (Cal. Ct. App. 1996).

68 *See, e.g.*, *Stop Youth Addiction*, 950 P.2d at 1093; Consumers Union of U.S., Inc. v. Fisher Dev., Inc., 257 Cal. Rptr. 151, 155 (Cal. Ct. App. 1989).

69 For example, intra-class conflicts and hence inadequate representation of some subclass by a class attorney have greatly troubled the Supreme Court. *See* Ortiz v. Fibreboard Corp., 527 U.S. 815, 856 (1999); Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 627-28 (1997). The *ex ante* perspective, in contrast, pushes towards unified, mandatory class actions, which require a de facto surrender of the due process-based formalities of Rule 23(b). David Rosenberg, *Mandatory-Litigation Class Action: The Only Option for Mass Tort Cases*, 115 HARV. L. REV. 831, 834, 840 (2002). *See also* Rosenberg, *Decoupling Deterrence and Compensation*, *supra* note 41, at 1912 (class-action opt-out on grounds of plaintiff autonomy "is a prescription for making everyone worse off.").

70 *See* McCall et al., *supra* note 59, at 839.

71 Bank of the West v. Superior Court, 833 P.2d 545, 557 (Cal. 1992).

72 CAL. BUS. & PROF. CODE § 17203 (Deering 1992 & Supp. 2003).

73 *See generally* McCall et al., *supra* note 59, at 826-49 (discussing forms of relief and case law).

74 Gail E. Lees, *The Defense of Private and Governmental Unfair Competition Law Claims*, 694 PRACTISING LAW INSTITUTE LITIGATION AND ADMINISTRATIVE PRACTICE COURSE HANDBOOK SERIES, UNFAIR COMPETITION CLAIMS 2003, at 261, 306 (2003).

75 Kasky v. Nike, Inc., 45 P.3d 243, 248 (Cal. 2002).

76 *See id.*

despite Nike's vociferous First Amendment objections, the California Supreme Court permitted the case to go to trial.[77] After an unsuccessful petition to the United States Supreme Court,[78] the case settled for a $1.5 million payment to a corporate watchdog group and Nike promised to mend its ways, both employment-wise and speech-wise.[79]

One can think of *Kasky v. Nike* as the ultimate consumer class action *ex ante*. The case conforms to that model in all essential respects except one: proponents of the *ex ante* model insist on a preclusive, *res judicata* effect on all possible claimants.[80] (Quasi-class actions under the UCL generally lack such effects.)[81] Alternatively, one can think of *Kasky v. Nike* as a kind of consumerist public law action for the production of a more "republican" globalization discourse that ought to proceed regardless of what millions of participants below the Sunsteinian margin may actually want to hear or say.[82] At this point of perfect convergence, consumer law has reached its culmination.

IV. RISKS OF A DUAL REGIME

It would be silly to deny the deterrence and transaction cost problems that afflict the common law model. It may even be true that those problems are particularly pronounced in the context of consumer transactions. All that granted, a wholesale divestiture of legal claims from their common law owners begets other, potentially more vexing difficulties. For example, an *ex ante* regime requires ancillary estoppel and preclusion rules that make good on the promise to get the deterrence level right. What then are those rules? Proponents of an *ex ante* regime, as noted, favor mandatory class actions and wholesale preclusion.[83] That position raises serious due process concerns[84] and numerous practical problems—prominent among them, the specter that corporate defendants will cut themselves cheap, collusive

77 *Id*. at 262-63.

78 Nike v. Kasky, 123 S.Ct. 2554 (2003).

79 Lisa Girion, *Nike Settles Lawsuit Over Labor Claims*, L.A. Times, Sep. 13, 2003, at C1.

80 *See* Rosenberg, *supra* note 69, at 849 n.42.

81 *See* Fellmeth, *supra* note 24, at 1 & 11 n.4; Lees, *supra* note 74, at 449.

82 Professor Cass Sunstein has repeatedly urged the mobilization of "public law" for a "republican discourse." *See* Cass R. SUNSTEIN, DEMOCRACY AND THE PROBLEM OF FREE SPEECH 39–43, 68–92 (1993). Mercifully, Sunstein shrinks from the practical implications of his proposal. *See* Stephen F. Williams, *Background Norms in the Regulatory State*, 58 U. CHI. L. REV. 419, 427–29 (1991) (reviewing CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE (1990)). More practical-minded individuals like Marc Kasky lack such inhibitions.

83 *See* Rosenberg, *supra* note 69, at 840-48.

84 *See* Ortiz v. Fibreboard Corp., 527 U.S. 815, 846-48 (1999).

settlements with a plaintiffs' lawyer of their choice.[85] The problem appears in even sharper relief outside the context of Rule 23 and its formal protections for absent class members.[86] As noted, under California's UCL, verdicts obtained by private litigants on behalf of the public have no preclusive effect (barring a preclusive judgment in a parallel class action).[87] If they did, the statute would be facially unconstitutional since it would create a roving commission to dispose of the rights of absent, unnotified parties.[88] But now, the due process problem appears at the other end—the lack of preclusion raises the very real threat of multiple prosecutions and verdicts over the same violations by the same parties.[89] This dilemma, which even the California courts have recognized,[90] has no easy solution.[91]

Similarly, the estimation of damages, restitution, or benefit-of-the-bargain losses over a disparate class of consumers (outside the context of particularized injuries) poses considerable risks of judicial error. Proponents of an *ex ante* model argue that liability awards are always a matter of statistics.[92] Sophisticated survey and sampling techniques will reduce the room for error, and the elimination of confusing questions of causation or reliance will generate judicial economies of scale.[93] But neither the empirical evidence nor practical considerations provide much support for such comforting assurances.

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85 *See* Issacharoff, *supra* note 32, 381 n.152.

86 FED. R. CIV. P. 23(d)(4).

87 Fellmeth, *supra* note 24, at 1 & 11 n.4.

88 *See* Stop Youth Addiction, Inc. v. Lucky Stores, Inc., 950 P.2d 1086, 1106 (Cal. 1998) (Baxter, J., concurring).

89 *See In re* N. Dist. of Cal. "Dalkon Shield" IUD Prods. Liab. Litig., 526 F. Supp. 887, 899 (N.D. Cal. 1981) ("A defendant has a due process right to be protected against unlimited multiple punishment for the same act."), *vacated on other grounds*, 693 F.2d 847 (9th Cir. 1982). *See* W. Union Tel. Co. v. Pennsylvania, 368 U.S. 71, 75 (1961) (recognizing that court's failure to protect defendants from identical claims in other courts constitutes denial of due process).

90 *See, e.g.*, Bronco Wine Co. v. Frank A. Logoluso Farms, 262 Cal. Rptr. 899, 911 (Cal. Ct. App. 1989) ("One must question the utility of a procedure that results in a judgment that is not binding on the nonparty and has serious and fundamental due process deficiencies for parties and nonparties.").

91 In *dictum* in *Kraus v. Trinity Mgmt. Servs., Inc.*, 999 P.2d 718, 733 (Cal. 2000), the California Supreme Court suggested that courts might tackle the possibility of future suits by "condition[ing] payment of restitution . . . on execution of acknowledgement that the payment is in full settlement of claims against the defendant, thereby avoiding any potential for repetitive suits on behalf of the same persons or dual liability to them." Such an extra-statutory band-aid, however, would do nothing to preclude follow-on suits in cases where the defendant prevailed in the first case. Moreover, it would do nothing to prevent plaintiffs' lawyer (and defendant) from disposing of the claims of members of the public, including actually injured parties, without any of the formal and due process protection of a class action.

92 Rosenberg, *Decoupling Deterrence and Compensation*, *supra* note 41, at 1893.

93 *Id*.

In the *Avery* litigation, the plaintiffs' expert estimated consequential losses (principally the cost of replacing the installed aftermarket parts with the original manufacturers' products) at anywhere between $658 million and $1.2 billion.[94] On cross-examination, he conceded that his high-end estimate might be off by about $1 billion.[95] The benefit-of-the-bargain award in *Price* was, as noted, based on surveys of consumer averments of what they would have paid had they known the true nature of the product.[96] The award is the difference between that hypothetical price and an allegedly promised "safe" cigarette—by plaintiffs' own admission, a non-existent product.[97] We are nonetheless asked to believe that it is possible somehow to estimate a demand curve that slopes from here to there.

The sorts of calculations that go into these awards treat the car buff who owns a vintage Chevy on a par with the owner of a run-of-the-mill vehicle with a previously dented fender.[98] The latter may well be better off, both because the "inferior" replacement part is superior to the dented, pre-loss original and because he benefits as a repeat customer from State Farm's general aftermarket parts policy. Likewise, the class in *Price* includes everyone from health-conscious nicotine addicts, who believed (however fantastically) that they were consuming a "safe" product, to the merely image-conscious who are under no such illusion and smoke Lights because they are socially more acceptable than in-your-face, filterless Camels. In calculating the awards in *Avery* and *Price*, the courts made do with an expert's wild guess about the margin—*and then effectively treated every claimant as a marginal purchaser*.[99] The "mistake" is hardly accidental. First, the lack of direct evidence of the location of the margin or the distribution of claimants along the demand curve invites this kind of shortcut.[100] Second, any serious consideration of the distribution—even if only for purposes of assessing aggregate damages—would tend to

94 Avery v. State Farm Mut. Auto. Ins. Co., 746 N.E.2d 1242, 1260 (Ill. App. Ct. 2001).

95 *Id*. The court nonetheless characterized the expert's testimony as more than "sheer speculation." *Id*. at 1261.

96 Price v. Philip Morris, Inc., No. 00-L-112, 2003 WL 22597608, at *14-16 (Ill. Cir. Ct. Mar. 21, 2003).

97 *Id*. at *15.

98 The vintage Chevy owner has suffered a genuine loss because both he and his potential customers can tell a replacement fender from the real thing.

99 *See Avery*, 746 N.E.2d at 1260; *Price*, 2003 WL 22597608, at *16.

100 Nor can one ascribe the "mistake" of treating customers (yet again and by means of a liability verdict) to the benefits of a bargain that they have already received to the parochial incentives of state trial judges. For a federal appellate decision and opinion along these lines, by a judge who really should know better, see *Desiano v. Warner-Lambert Co.*, 326 F.3d 339 (2d Cir. 2003).

illustrate that the customers have practically nothing in common but the bare fact that they *are* customers. A court that has slighted or sidestepped that reality at the class certification stage is unlikely to emphasize it at a later stage.

Put those considerations aside and assume a world without transaction costs and, importantly, without judicial mistakes. Assume that common law or *ex ante* rules could both yield efficient results: it still does not follow that the conjunction and simultaneous operation of those two regimes *also* yields efficient results. A system that bars recovery for non-injured consumers must offer full recovery for the marginal consumers who did rely to their detriment on the seller's representations. Conversely, an *ex ante* rule must bar additional claims for compensation as a form of *ex post* opportunism. In real life, however, the regimes work in tandem.

To revert to the case examples, the *Williams* class consists of all OxyContin purchasers for whom the product worked as intended but who claimed that the product, contrary to the company's representations, proved addictive for some other consumers.[101] Those others are specifically *excluded* from the class and remain free to sue over their alleged injuries regardless of the outcome of the *Williams* litigation.[102] The *Avery* plaintiffs sued on their contract and under a state consumer-fraud statute.[103] If inferior placement parts caused consequential damages for some class members (for example, by contributing to a second crash) those individuals remain free to bring suit against the manufacturer, installer, and presumably State Farm. The *Price* plaintiffs sued for misrepresentation, not bodily injury; Marlboro Lights smokers in Illinois remain free to bring product liability lawsuits.[104] Under California's Unfair Competition Law, verdicts and settlements in cases brought on behalf of the public do not preclude subsequent lawsuits against the same defendants over the same conduct by parties who are actually injured by the unlawful conduct (as well as those who are not).[105]

While one might say that *ex ante* and *ex post* lawsuits deter different types of conduct (for example, the sale of a substandard product *and* fraudulent representations about it), one cannot easily separate the claims in this fashion. In these cases, misrepresentations count for legal purposes only if they induce social losses and only because they produce them. Why

101 Williams v. Purdue Pharma Co., 297 F. Supp. 2d 171, 172-73 (D.D.C. 2003).
102 *Id.* at 172.
103 *Avery*, 746 N.E.2d at 1247.
104 *Price*, 2003 WL 22597608, at *3.
105 Fellmeth, *supra* note 24, at 1 & 11 n.4.

else deter them? Conversely, the defendant's misrepresentations are typically a crucial element in common law cases, for example, to defeat the ordinary defenses in contract and tort. The plain fact is this: so long as the parties actually injured can sue, any additional deterrence is over the top.[106] In allowing both types of suits (without one foreclosing the other), we do in fact have an *ex ante* rule and a common law rule operating on top of each other, over the same range of transactions.

This dual regime has very nearly become a general norm. For example, voluminous federal and state regulations govern what manufacturers and service providers may and may not say about pharmaceutical drugs,[107] tobacco products,[108] warranties,[109] equity offerings,[110] credit cards,[111] and mortgage loans,[112] among other products. We also have general federal and state prohibitions against "unfair" business practices, which are defined and enforced by the Federal Trade Commission and by state consumer protection agencies.[113] These rules embody rough-and-ready judgments about the socially acceptable (if not exactly optimal) level of activity. They prohibit conduct that would otherwise have to be deterred by means of litigation. In other words, they are *ex ante* rules in legislative or administrative form. However, only rarely do these rules have preclusive and preemptive effect. For example, Marlboro Lights were sold in meticulous compliance with federal laws and regulations, but that fact failed to impress jurors and judges in Madison County, Illinois.[114] Compliance defenses rarely succeed in liability lawsuits over "unsafe" pharmaceutical drugs or automobiles.[115] The risk is not simply confusion or incoherence: it is massive over-deterrence.

106 *In re* Bridgestone/Firestone, Inc., 288 F.3d 1012, 1017 (7th Cir. 2002) ("If tort law fully compensates those who are physically injured, then any recoveries by those whose products function properly mean excess compensation.") (internal footnote omitted).

107 21 C.F.R. § 202.1 (2003).

108 Federal Cigarette Labeling and Advertising Act, 15 U.S.C. § 1331 (1993).

109 Magnuson-Moss Warranty Act, 15 U.S.C. § 2302 (1998).

110 Truth in Lending Act, 15 U.S.C. § 1601 (1998).

111 Truth in Lending Act, 15 U.S.C. § 1637 (1998).

112 Home Mortgage Disclosure Act of 1975, 12 U.S.C. § 2801 (1997).

113 Federal Trade Commission Act, 15 U.S.C. § 45 (1991 & Supp. 2003); California Unfair Practices Act, CAL. BUS. & PROF. CODE § 17200 (Deering 1992 & Supp. 2003).

114 Price v. Philip Morris, Inc., No. 00-L-112, 2003 WL 22597608, at *19 (Ill. Cir. Ct. Mar. 21, 2003) (rejecting defendant's claim under the Federal Cigarette Advertising and Labeling Act, 15 U.S.C. § 1331).

115 *See, e.g.*, Edwards v. Basel Pharm., 933 P.2d 298, 303 (Okla. 1997).

V. COMMON LAW AND CONSUMER LAW: CAN'T WE HAVE ONE WITHOUT THE OTHER?

Confident assertions about the efficiency of the common law often seem to founder on the manifest inefficiencies of what now passes for common law: would Judge Posner and his followers kindly explain the liability explosion?[116] Without wishing to enter that messy and complicated debate, the preceding casual observation suggests that many of the actual or perceived problems stem, not from common law adjudication *per se,* but from its conjunction or interaction with legislative rules and interventions.

It seems quite obviously the case that the common law may *sua sponte* go off the rails. Multi-billion dollar verdicts in some product design defect cases are an example.[117] Common law terms and doctrines, from "nuisance" to "unconscionable" and, for that matter, "injury," are sufficiently nebulous to sustain varying social and economic arrangements under a nominally unchanged doctrine.[118] That openness creates a potential for efficient adaptation and for ideological flights of fancy.[119]

Still, slides into wholesale nominalism are probably bound to be exceptions to the general practice. At the end of the day, the common law embodies reciprocity relations that are real, not some theoretical construct. Not everything can be a nuisance. My averred right to an unobstructed view is a prohibition on my neighbor's right to expand his home, and that consideration will be obvious to the judge because the defendant will press it with some force. Characterize anything but the literal truth as a "misrepresentation" and all advertising will cease; that intuition explains the continued viability of the distinction between actionable misrepresentation and permissible "puffery."[120]

116 *See, e.g.*, Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067, 1094 (1989), *reprinted in* ECONOMIC FOUNDATIONS OF PRIVATE LAW 173, 200 (Richard A. Posner & Francesco Parisi eds., 2002) ("[A] decade of effort by economists to develop theories of tort law succeeded on its own scholarly terms, but economists all too often provided efficiency proofs for institutions that most lawyers now view as inefficient.").

117 *See, e.g.*, Ann W. O'Neill, *1999: The Year in Review*, L.A. TIMES, Dec. 26, 1999, at B2 (discussing a jury award of 4.9 billion in damages against General Motors when a 1979 Chevy Malibu burst into flames after being rear-ended by a drunk driver: the figure was later reduced by three billion dollars).

118 The textbook example is still Judge Skelly Wright's wholesale transformation of "unconscionability" in *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965).

119 *See, e.g*, George L. Priest, *The New Scientism in Legal Scholarship: A Comment on Clark and Posner*, 90 YALE L.J. 1284 (1981).

120 *See, e.g.*, Charter Township of Ypsilanti v. Gen. Motors Corp., 506 N.W.2d 556, 559, 561 (Mich. Ct. App. 1993).

Recognize anything as an "injury" and it will soon transpire that nothing may be left to compensate actually injured victims.[121] Characterize as "unconscionable" any sales practice or contract terms that might scandalize a middle-class consumer with secure credit (such as a federal judge) and it turns out that sales to low-income, riskier customers dry up altogether.[122] At some level, a common law judge must care about activity levels as well as harms; about production values as well as consumption; about over- as well as under-deterrence.

So how does one strike a rough balance between these risks? The much-maligned common law requirements that circumscribe classes of plaintiffs and causes of actions, a starting point for the consumer law critique of the common law, can be understood as a kind of functional corollary or corrective to the inescapable vagueness of central substantive doctrines. A negligent misrepresentation lies somewhere on a spectrum between fraud at one end and an innocent effort to package consumer information at the other, which can be done only by omitting some information that is known to the seller. In cases alleging misrepresentation, there are substantial costs to erring on either side.

The common law must find a rough balance. On the one hand, the legal defenses that sound in tort (which are the third and last line of defense against abuse and exploitation, well behind the competitive discipline of the market and contractual defenses) must be given their proper real-world context to avoid the threat of under-deterrence. On the other hand, the threat of over-deterrence created by inflated loss allegations must be avoided by limiting the universe of cases to those where the losses are concretely visible. In these cases, detrimental reliance ensures that the plaintiff before the court is actually the marginal consumer whose losses are far more ascertainable than the infra-marginal class's estimates of losses to someone else.[123]

Reciprocity-based inhibitions tend to give way when the legislature signals an intention to promote consumer interests and consumption values. Presumably (judges surmise), a legislature that enacts a consumer protection statute wants to do more than to codify pre-existing law. Thus, courts may loosen injury requirements and adopt more relaxed notions of inducement and reliance even where the text of the statute

121 *See* Metro-N. Commuter R.R. Co. v. Buckley, 521 U.S. 424, 435-36 (1997) (asbestos litigation).

122 *See* Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 305 (1975).

123 I owe the point to Richard Epstein.

leaves some doubt about the legislature's intent to prompt that judicial response. Courts, one might say, act on what they take to be the legislature's signals, rather than following its affirmative commands.

This broad-brush description captures the state judiciaries' response to the enactment of "little FTC acts" and analogous consumer protection statutes passed by many states in the late 1950s and 1960s. For the most part, those state enactments sought to strengthen the hand of *public* regulators and prosecutors (foremost, the consumer protection offices of state attorneys general) in enforcing prohibitions against unfair competition, false advertising, and the like.[124] Like the FTC itself, state agencies generally enjoy broad discretion in defining "unfair" or "deceptive" practices.[125] Typically, public agencies are not required to prove all the common law elements of statutory offenses, for example, detrimental reliance by individual consumers.[126] This arrangement makes a good deal of sense: let individual consumers sue over direct harms, and let public prosecutors, whose abuses can be checked by political and budgetary means, direct their attention to "fraud on the market" offenses that are likely to be under-deterred through private litigation.

Over time though, many state courts came to read those statutes as a warrant for more expansive *private* litigation.[127] The train of thought is not hard to follow: the legislators' enhanced authorization of public prosecutors looks to all eyes like an endorsement of consumer interests outside the confines and strictures of the common law.[128] When private plaintiffs subsequently sue on those more expansive theories, they are

124 *See* Sovern, *Reconsidering*, *supra* note 28, at 448 ("The state statutes, like the FTC Act, typically grant enormous power to the public agencies which enforce them . . . .").

125 Jean Braucher, *Delayed Disclosure in Consumer E-Commerce as an Unfair and Deceptive Practice*, 46 WAYNE L. REV. 1805, 1807 (2000).

126 Agencies, both federal and state, need not even allege or show that a "misrepresentation" was false. *See, e.g.*, FTC v. Sterling Drugs, Inc., 317 F.2d 669, 674 (2d Cir. 1963) ("[P]roof of intention to deceive is not requisite to a finding of violation of the statute . . . ."); Bockenstette v. FTC, 134 F.2d 369, 371 (10th Cir. 1943) ("It is not necessary . . . for the Commission to find that actual deception resulted."); FTC v. Balme, 23 F.2d 615, 621 (2d Cir. 1928) ("Nor is it necessary . . . to find . . . that any competitor of the respondent has been damaged."). *See also* Sovern, *Reconsidering*, *supra* note 28, at 444-45, 450-51.

127 *See* Seth William Goren, *A Pothole on the Road to Recovery: Reliance and Private Class Actions Under Pennsylvania's Unfair Trade Practices and Consumer Protection Law*, 107 DICK. L. REV. 1, 13-14 (2002) (collecting cases and commentary).

128 S*ee, e.g.*, Commonwealth v. Monumental Props., Inc., 329 A.2d 812, 822 (Pa. 1974) (We cannot presume that the Legislature when attempting to control unfair and deceptive practices . . . intended to be strictly bound by common-law formalisms. Rather the more natural inference is that the Legislature intended the Consumer Protection Law to be given a pragmatic reading . . . .").

hardly acting contrary to the statutory intent; they are merely assisting resource-strapped public agencies.

In the 1970s (the heyday of the consumer law movement), state legislatures made the next move and provided explicitly for the private enforcement of consumer protection statutes.[129] Most states also provided added incentives for private litigation, typically in the form of attorneys' fees and treble damages for certain violations.[130] While federal courts sought to limit the reach of expansive state statutes (for example, through broad preemption under the Federal Arbitration Act),[131] judicial responses among the states appear to have varied greatly. In some states, courts limited what they viewed as the scope of private consumer litigation, often by means of reading common law requirements of inducement, reliance, and injury into the statutes.[132] However, in most other cases the state judiciary accepted the legislature's invitation to give free rein to private enforcers.[133]

California provides a dramatic illustration of judicial creativity in expanding the reach of the Unfair Competition Act. In particular, the creation of universal standing in *Barquis v. Merchants Collection Association of Oakland, Inc.*[134] was quite plainly neither intended nor anticipated by the legislature.[135] These differences in institutional agenda-setting and legal development would make an interesting study for political scientists. Of greater practical import though, is the near-uniform tendency toward greatly expanded private consumer litigation.

That tendency is readily explained. In the area of consumer law, as in many other venues, legislatures and courts act as competing suppliers of substantially identical goods. Naturally, the demand for consumer law will gravitate towards the more favorable forum. The default outcome is that an expansion of

129 *See* Sovern, *Reconsidering*, *supra* note 28, at 448.

130 *Id*. at 448-49.

131 *See* Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 281 (1995); Southland Corp. v. Keating, 465 U.S. 1, 16 (1984). S*ee also* Williams v. Purdue Pharma Co., 297 F. Supp. 2d 171, 174, 177 (D.D.C. 2003) (dismissing consumer complaint for lack of injury despite statutory language authorizing "any person" to seek redress for illegal trade practices); Bullet Golf, Inc. v. U.S. Golf Ass'n, No. CV-94-4182-ER, 1995 U.S. Dist. LEXIS 6189, at *2 (C.D. Cal. Mar. 20, 1995) (dismissing claim under California FAA without credible allegation of actual deception and injury).

132 *See, e.g.*, Heidt v. Potamkin Chrysler-Plymouth, Inc., 354 S.E.2d 440, 441 (Ga. Ct. App. 1987) (requiring reliance); Goren, *supra* note 127, at 32 (discussing and criticizing Pennsylvania Supreme Court's decision to that effect); Sovern, *supra* note 28, at 457-60.

133 *See* Goren, *supra* note 127, at 13-14.

134 496 P.2d 817, 839 (Cal. 1972).

135 Stop Youth Addiction, Inc. v. Lucky Stores, Inc., 950 P.2d 1086, 1107-09 (Cal. 1998) (Brown, J., dissenting) (discussing statutory text and history).

consumer law occurs so long as both *or either* institution say "yes." It can be avoided only if both say "no," or else the nay-saying institution affirmatively refuses to cooperate and then presumes and exercises the authority to rein in the wayward rival.

Such a scenario is barely thinkable. Theoretically, state courts could, within the limits of their state constitution, refuse to apply statutes in derogation of common law requirements. Theoretically, legislatures could repeal private enforcement provisions or judicial decisions to that effect. Neither courts nor legislatures, however, are any good at this sort of thing. Both confront great institutional obstacles even in reversing their own decisions, let alone the decisions of a coordinate branch of government. Litigation under California's Unfair Competition Law has spawned sufficient abuse and distress to prompt stopgap interventions by the office of the attorney general.[136] It has also prompted reform proposals by a reform commission that included prominent members of the plaintiffs' bar[137] and a legal scholar with impeccable consumer advocacy credentials.[138] Still, the California Supreme Court has emphatically declined opportunities to curtail the scope of the statute.[139] The Sacramento legislature, for its part, has proven a graveyard for reform proposals.[140]

VI. CONCLUSION

As legal doctrines change, so do institutional and interest group arrangements. The loosening of common law requirements in the 1970s had the intended result of facilitating consumer

136 Attorney General Bill Lockyer filed suit against a Beverly Hills law firm under the same Unfair Competition Law that the firm was accused of abusing. Press Release, Office of the Attorney General, Attorney General Lockyer Files "17200" Consumer Protection Lawsuit Against Beverly Hills Law Firm (Feb. 26, 2003), *available at* http://caag.state.ca.us/newsalerts/2003/03-021.htm.

137 *Unfair Competition Litigation*, 26 CAL. L. REVISION COMMISSION REPS. 191 (1996).

138 *See* Fellmeth, *supra* note 24, at 1. Professor Fellmeth has a long and distinguished record as a consumer law advocate.

139 *See, e.g.*, *Stop Youth Addiction*, 950 P.2d at 1115 (Brown, J., dissenting) (observing that "the Courts of Appeal have done an admirable job of reining in the UCL's potential for adverse regulatory effects" and charging the majority with "choos[ing] to speed us along the path to perdition.").

140 In point of fact, the California legislature has repeatedly *expanded* the reach of the UCL, typically in response to limiting judicial rulings. *See, e.g.*, CAL. BUS. & PROF. CODE § 17203 (Deering 1992 & supp. 2004) (reversing Mangini v. Aerojet-General Corp., 230 Cal. App. 3d 1125, 1156 (1991)); State v. Texaco, Inc., 762 P.2d 385, 399 (1988) (holding that the statute only applies to wrongful business practices). In light of the legislature's resistance, business-backed reform advocates now propose reform by means of an initiative and referendum. *See STOP $hakedown Lawsuits*, Californians to Stop $hakedown Lawsuits, http://www.stopshakedownlawsuits.com/ (last visited Mar. 4, 2004).

litigation by public interest organizations and legal aid groups.[141] In retrospect, the dominance of that form of litigation has proven temporary. Consumer law has long since slipped its constituency-oriented moorings. It now responds to the demands of lone rangers and, far more importantly, the class action bar.

Strikingly, the role of consumer protection statutes has attracted very little attention in the public, political, or academic debate over "tort reform." Perhaps this is because billion dollar verdicts in "misrepresentation" cases are of somewhat more recent vintage than older, yet equally spectacular, product liability cases. Perhaps the business community prefers a unifying agenda, such as a campaign against punitive damages (which every corporation opposes) to an agenda that would require a partial surrender of tactical opportunities. Like many unfair competition laws, California's statute permits business firms to sue their competitors, and the state's leading tort reform group has insisted that these opportunities must be preserved in reforming the statute.[142] Also, state legislators quite probably have an incentive to pretend that the "liability crisis" is altogether the fault of an out-of-control judiciary. Scholars continue to teach Torts and Contracts without much attention to peripheral interferences from consumer protection statutes.[143]

The obvious problem is that the periphery has long begun to overwhelm the common law center. I seriously doubt that one could find many contemporary class action cases of any consequence where a conventional fraud or breach of contract claim is *not* accompanied by a statutory claim of unfairness, deception, or misrepresentation.[144] The less obvious and more challenging problem is the conjunction and interaction of disparate theories of enforcement and recovery. A theory of misrepresentation without reliance, inducement, and injury may make a certain amount of sense in the context of a public enforcement monopoly. However, wrenched out of that context,

141 Stewart Macaulay, *Bambi Meets Godzilla: Reflections on Contracts Scholarship and Teaching vs. State Unfair and Deceptive Trade Practices and Consumer Protection Statutes*, 26 HOUS. L. REV. 575, 583 (1989) ("Legal services programs have brought many of the reported cases.").

142 *See* John H. Sullivan, California's Notorious "17200"—Written by Lewis Carroll, Adapted by Stephen King?, Remarks at the Meeting of the Center for Legal Policy at the Manhattan Institute and the Federation of Defense and Corporate Counsel (Oct. 24, 2002), transcript available at http://www.cjac.org/bp17200/.

143 Macaulay, *supra* note 141, at 575-76.

144 In three case examples discussed above, plaintiff sued under state fraud and unfair competition statutes. *See supra*, notes 42, 47 & 51 and accompanying text. Additionally, the *Toshiba* case was brought under the federal Computer Fraud and Abuse Act of 1986, 18 U.S.C. § 1030. Shaw v. Toshiba Am. Info. Sys., Inc., 91 F. Supp. 2d 926 (E.D. Tex. 1999).

it becomes profoundly problematic. Benefit-of-the-bargain redress makes eminent sense in a common law case over a breach of contract, but out of that context, it may turn into a menace. Yet, for perfectly understandable institutional reasons, what we have is a dual, overlapping regime.

I do not profess to know whether it is possible to unscramble this particular omelet. One can think of partial steps in that direction—for example, a sharper distinction between public and private enforcers, or an expansion of affirmative compliance defenses. The former strategy would confine common law and *ex ante* rules to their respective domains; the latter would force a social choice between the two. It may be too late or too early in the day to contemplate such steps. Too late because the privatization of public law norms, unhinged from requirements of injury, is a *fait accompli* sustained by a seamless coalition of consumer advocates and plaintiffs' attorneys. Too early because common law modes of thought continue to exert a powerful pull on our collective imagination.

To their credit, the most articulate proponents of an *ex ante* regime emphatically proffer their scheme as an alternative to common law modes of thought, not as a supplement.[145] They have been at pains to insist that public regulatory schemes are often superior to, and ought to preclude, private litigation.[146] Their clarion call is efficiency, not some boundless ideological conception of "consumer rights."[147] Precisely this convergence of efficiency theorems and consumerist nostrums ought to give pause, and, after a deep breath, call attention to the political economy of the beast. One may dismiss notions of plaintiff autonomy and the individual's right to a day in court as so much sentimental nonsense and *ex post* opportunism.[148] The fact is that the sentimentalists and opportunists will continue to vote, litigate, and agitate in defiance of elegant blackboard schemes. The siren song of consumer law in its modern, disembodied state is precisely that everyone should have a day in court, injured or not. To show that this bastard regime cannot be efficient from any perspective is the easy part. The hard part is to tie ourselves

145 FRIED & ROSENBERG, *supra* note 39, at 14 ("Crucially, ex ante and ex post preferences are mutually exclusive concerning the fundamental purpose of the legal system in managing accident risk.").

146 *Id*. at 66-67; Rosenberg, *Decoupling Deterrence and Compensation*, *supra* note 41, at 1918-19 ("[T]he general, well-documented advantages of these "alternatives" dictate resorting to courts only to the extent of systematic failure of administrative regulation to control risk appropriately and of government and commercial first-party insurers to cover loss adequately.").

147 FRIED & ROSENBERG, *supra* note 39, at 13.

148 Rosenberg, *Decoupling Deterrence and Compensation*, *supra* note 41, at 1911-16.

to one mast or the other.

Consumers' Rights in the Laissez-Faire Economy: How Much *Caveat* for the *Emptor*?

Jan Narveson[*]

I. INTRODUCTION

What are the Consumer's rights in a free enterprise economy? It is tempting to supply a one-word answer: None. After all, the Consumer has the final word: "No!" What more do we need? But to say this would be misleading. To begin with, the right to say No! is itself a major right, more important perhaps than anything else. And it is a right; so the answer "none" is misleading, indeed just false. Further thought suggests that the situation is quite a bit more complicated than that. When the would-be Consumer becomes a customer, she needs to exercise judgment and caution. But the thesis that *all* the responsibility rests on the Consumer's shoulders must be rejected, despite the plausibility of a simple invoking of *caveat emptor ("Let the buyer beware!").* This essay will propose a general criterion as being the basically right one to apply.

II. RIGHTS IN GENERAL

A. What Are They?

To begin with, perhaps we had better make clear what rights are. To have a right is to have a status that somehow imposes *requirements* on others. In the case where these are legal requirements, they would be enforceable either by the institutions of the civil law or even by those of criminal law. A theory about rights is a theory about the "somehow": it would tell us how it is that the people who (so the theorist claims) earn the

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status of rightholder do, in fact, earn it—what are the characteristics of the rightholder and his or her relation to others that leads to the fixing of duties on the part of those against whom these rights are held. All rights entail duties to *refrain* from certain actions, namely those that would render it impossible for the agent to do what he or she is being said to have the right to do. Another sort of right, one that additionally entails positive requirements to act on the institutions of the law to provide protections to the rightholder, is also conceptually definable. The general point, then, is simply that when we talk of someone's rights, we are thereby talking of someone else's duties. In the case of Consumers and Sellers, the Consumer's right is, in some way or another, the Seller's duty.

Let's begin the present inquiry, then, by pointing out that everyone has rights—consumers and producers alike. (And let's not forget that all of us are both.) Whether there are "consumer's rights" is then a question of whether we have, in our *capacity as consumers*, any *special* rights, over and above what we already have generally as people. And the answer to this too, I shall argue, is in the affirmative. However, I shall also argue that we can, given a suitably normal description of the situations of consumers in relation to suppliers, deduce consumer rights from a more general thesis not confined to consumers.

B. Why?

We need to make clear, in a general way, what rights people have, *qua* people. Therefore, we need a deep inquiry, for there is little point in mere proclamations. Such an inquiry would also explain *why* we should even have the rights proposed. But, while we hardly have the space to undertake such an inquiry here, a few general things can be usefully said. The viewpoint of this essay is straightforward and classically liberal: We all have the right to do whatever we wish, with the very substantial exception that we may not, in doing what we wish, *impose* (significant, avoidable) *costs* on others.[1] This is a slightly more precise way, perhaps, of expressing the original Hobbesian Law of Nature: That we are always to "seek peace" and to use force *only* for self-defense, noting that we may also assist in defending from attack whoever voluntarily enlists us to do so.[2]

The same view can be expressed in terms of liberty, a fact that has given rise to the contemporary use of the term

1 THOMAS HOBBES, LEVIATHAN 92-93 (Richard Tuck ed., Cambridge Univ. Press 1991) (1651); JAN NARVESON, THE LIBERTARIAN IDEA 7 (1988).

2 HOBBES, *supra* note 1, at 92.

"libertarianism" to designate that general outlook. The view, so expressed, is that we all have a general right to liberty, which means that we must respect that right on the part of everyone else, just as they must respect it in relation to us.[3] Hobbes expressed this idea in his Second Law of Nature: That we are "*to lay down this right to all things; and be contented with so much liberty against other men, as he would allow other men against himself.*"[4]

Why should we accept this general outlook? I have in various writings defended libertarianism in much the same way as Hobbes and the other classic writers seem to want to defend it: namely, as the *maximally rational arrangement for interpersonally regulating the activities of people in society*.[5] It is the view that commends itself to us on the broadest interpersonal basis. In that sense, this Libertarian Principle may also be claimed as identifying the common good for the general case of human interaction. The common good is, in effect, liberty.

The reasoning begins with people as they are. What are they? First, people are possessed of a very wide range of interests and abilities. Second, they are capable of understanding and exchanging ideas about practical matters and of reacting to the deliberations and decisions of their fellows. Practical thinking addresses the interests and values we have at the time and our resources for advancing these, and allows us to decide what to do in light of this information (including the decision to seek more information). While each of us operates in an environment that includes physical things and situations, such as weather, our environment also includes other people. We know some people in our conscious neighborhood, but we also have the knowledge that there are many more not so much farther on and a very great many more still farther on.

Some of these people will be ones with whom we *interact* more or less. The special feature about interaction with fellow humans is that it can be, and often is, *strategic*—A reacts to B's reaction to A—and how we act toward another person is a function in part of what we think the other person will do. That, in turn, is a function of what we take his reasoning processes to be, including how we expect him to react to our own behavior.

3 *See* J. Charles King, *Moral Theory and the Foundations of Social Order*, *in* THE LIBERTARIAN READER 16, 27 (Tibor R. Machan ed., 1982). *See generally* JAN NARVESON, THE LIBERTARIAN IDEA (Temple Univ. Press 1988).

4 HOBBES, *supra* note 1, at 92.

5 JAN NARVESON, THE LIBERTARIAN IDEA (Temple Univ. Press 1988); Jan Narveson, *Contracting for Liberty*, *in* JUSTICE: ALTERNATIVE POLITICAL PERSPECTIVES 55, 55-65 (James P. Sterba ed., 4th ed. 2003); Jan Narveson, *Libertarianism*, *in* THE BLACKWELL GUIDE TO ETHICAL THEORY 306, 306-24 (Hugh LaFollette ed., 2000).

While that may sound complicated, the very truth of this fact can be made to work in favor of relatively simple principles. All of us, potentially, have much to fear from our fellows who can, at the worst, kill or do other terrible things to us. But we also all have, potentially, much to gain from our fellows, even though their tastes and specific abilities vary so widely. Such wide variation is important, for it means that *helping* our fellows, especially in major respects, is likely to be difficult and to require subtle and detailed knowledge of others that we do not typically have. On the other hand, it is fairly easy to know what would hurt, damage, or kill others.

The stage is set, then, for a sort of "deal"—the "social contract" in its classic form. The main agreement point calls upon all to refrain from harming, injuring, and generally interfering with each other, except only in the case where the other party is actively attempting to hurt or injure us. But with regards to helping others, here we rely on specific arrangements made between interested parties. The principle for those, then, is simply to keep one's agreements once made. Between the two, what we have is a fully cooperative society—a society in which we all cooperate in supporting the conditions in which we can each work or play or interact with others to maximum, mutual advantage. Non-aggression underpins society; cooperative mutually advantageous action via specific negotiation, agreement, and contract propels it forward to the general betterment, in the end, of all. Law has its place in this, providing structure where needed to promote this cooperative state of affairs. Both criminal and civil law work to curb our tendency to bypass cooperation (by larceny, violence, or fraud) for our own personal gain. Civil law especially works to enable us to redress damages in arrangements gone awry.

It is, I think, extremely difficult to improve on this general structure of basic rights. And it is that structure that enables us to focus specifically on the rights of the Consumer in the extremely important area of commercial transactions.

C. Property

Probably the most vexing single question about social matters, and especially about economic matters in society, is whether individual ownership of things—private property—is justifiable. To see why it plausibly is, we need but appreciate that the right to property can be seen as a spin-off from the general libertarian outlook. The right of property, if it is one,

exists antecedently to any acts of any governments—it is not identified, informed, or legislated by governments.[6] If a government passes a piece of legislation about property, our question is: does it act consistently with the *antecedently knowable* right of property? The word of government is not what establishes the property right. Or, to put it in stronger terms, governments have *no authority whatsoever* that they do not have purely by virtue of being formulators and perhaps enforcers of the "natural" law—the moral rules that pass muster with rational agents generally.[7]

So, is there a right to property or not? I side with Locke on the matter in holding that there is, though not quite exactly for his stated reason.[8] Still, his reason is pretty good. Property, in Locke's view, is the result of somebody's efforts, somebody's labor. His right of property is nothing more than his right to *do* the things he has done and wants to continue to do in relation to the items in question.[9] That is what property is: the right to use and to continue using the thing in question as one wants. More generally, it is the right to determine the disposition of the thing owned; others must clear any proposed uses of it with the person said to be the "owner." If our state-of-nature Crusoe, as it were, has plowed up some ground or hacked a table out of a tree, with a view to planting or playing gin rummy or whatever, then if anyone comes along and undertakes some other use of that item, a use incompatible with Crusoe's purposes, then that person is an aggressor. He has, by his actions, intervened to upset the pattern of Crusoe's own activity—the very thing that our general right of liberty forbids. Once initial possession is clear, we proceed by exchange as well as by work. Once anyone owns something and anyone else owns something else, they are morally in a position to make an exchange if they so desire.

The classical liberal tradition has it, in Locke's terminology, that we "own ourselves."[10] Discussants have attached all sorts of exotic meanings to this phrase, but, in fact, its meaning is quite straightforward and yields a result that is simply identical with the Libertarian Principle. To "own" something is to be in a position of authority over its use, so that anyone else who wants to use it in some way must, in principle, obtain the permission of the owner. In short, owners are people with the right to *exclude*.

6 JOHN LOCKE, TWO TREATISES OF GOVERNMENT 287-88 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690).

7 *See generally* Steven J. Eagle, *The Development of Property Rights in America and the Property Rights Movement*, 1 GEO. J.L. & PUB. POL'Y 77 (2002).

8 LOCKE, *supra* note 6, at 287-88.

9 *Id*.

10 *Id*.

And so self-ownership is the right to exclude others from the use of oneself: if they want you to do something, or to do something to you, they must *ask*. That is exactly what the libertarian principle asserts. Ownership of things outside the self is, in effect, an application of the rights termed "self-ownership" to such things by virtue of the agent's self-initiated actions involving those things.

Obviously, any rights identified in this way are subject to the restriction that they are exercised during "good behavior": that is to say, that the exerciser has not done anything that would warrant abridging his right in some way. Thus, the thief does *not* have the right to what he has taken, and others *may* seize it by force if need be (and collect costs of apprehension and perhaps also to provide some extra disincentive for doing such things in the future. Just how to adjust these disincentives is a difficult matter that, fortunately, we will not need to go into here.)

In short, property rights in things outside ourselves are a subset of liberty rights—the general right of liberty being the basic right from which all other legitimate ones are derived, given appropriate descriptions of the relevant circumstances. It may perhaps be unnecessary to add that this basic right is what we nowadays call a "negative" right (a right that others *not* do something to the rightholder), not a "positive" right (a right that the rightholder be in some way *assisted* in doing the things he has this right to do). If I want your help, I have to ask for it, or make an offer for it, and I get the help only if this request or this offer is accepted.

D. Realism

It may certainly be suggested that this program is, in these days of big government, *unreal*. After all, we all live in an environment in which governments, at many levels, have immense powers going far beyond anything that the classical libertarian rights endorse.[11] If we start with the premises of classical liberalism, we appear to be saying that virtually everything done by virtually every government is immoral and should be illegal.[12]

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11 *See generally* ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA ch. 6 (1974); AMERICAN RADICAL THOUGHT: THE LIBERTARIAN TRADITION (Henry J. Silverman ed., 1970); TIBOR R. MACHAN, INDIVIDUALS AND THEIR RIGHTS 100-102 (1989) (discussing the libertarian view of individual rights).

12 *See generally* L. T. HOBHOUSE, LIBERALISM (1964) (discussing the classical traits of liberalism); THEODORE MEYER GREENE, LIBERALISM: ITS THEORY AND PRACTICE (1957) (discussing modern misconceptions of classical liberalism).

There are two very different ways to respond to such an objection. On the purely theoretical front the only acceptable response is to pick up the glove and say to the defenders of big government, "Prove it!" I think we are in a position to guarantee that they will be unable to do this, but perhaps it does not matter for present purposes.

Another, perhaps more pertinent response, is to say that it is still worth finding out what consumer (or other economic) rights are as issuing from the libertarian view *because it is the general view underlying our economic system*. This person we are calling "the consumer" is operating in a market environment. In the free economy no one is required to be a producer. Those who produce typically act with a view to profit, and consumers consume with a relentless eye to their own satisfaction and no sense of obligation to the people who supply their needs. Therefore, the converse is true: We are to presume that a given firm is after our dollars—not our health, education, welfare, or happiness. *We* are out for those things and many more—notably our comfort and our entertainment. We *do not need any other justification whatsoever* for spending our dollars as we do. We "Consumers" are, in this system, *sovereign, king*. The Consumer calls the shots. Nobody may tell him what to buy or why. Nobody may dictate prices to him. He makes his own decisions, and that is the end of the matter.

III. CONSUMER RIGHTS

A. The Basics

Nevertheless, it is useful to spell out a bit more precisely what follows in the way of rights specific to consumers from the thesis that the consumer shares with all the general right to be and do whatever he or she wishes to be and do, subject to the constraint of respecting the same right for all others. For this purpose, we first need to look at a matter of fundamental importance to any theory of rights of this general type: the *baseline of interaction*. For present purposes, that baseline is our *encounter in the marketplace*, an encounter between two free beings. However, we will stipulate here that this encounter is not only between "free" beings, but also *innocent* beings, in the sense that we are presumed not to have done anything previously that would justify curtailment of the standard rights. If we are guilty of some punishable failing in the past, that may impugn our status as free-market participants. But we shall take it that few persons are guilty in that way, and our question is: What is owed to persons in this normal case, where relevant innocence

characterizes the parties?

On this libertarian view, everyone is subject to a general requirement, or obligation, to respect the freedom of all others. There is a more precise way to summarize this general obligation, which has been admirably formulated by David Gauthier in what he calls the "Lockean Proviso."[13] The Gauthier version says: "Don't better by worsening. Do not make yourself better off than you would have been in someone else's absence, by making that person worse off than he would have been in your absence."[14] In short, *do not worsen* the net situation of the person with whom you interact. ('Net" is needed here: the dentist's benefits come at some cost in pain and discomfort, but on the whole she leaves her patient better off.) It will be appreciated that the "Proviso," so conceived, is really another restatement of the Libertarian Principle. I believe we can also see that it provides a fruitful key to the matter of consumer rights.

B. Describing the Goods

Transactions in the business society are *voluntary*. The potential purchaser is under no general obligation to buy, and the seller is under no obligation to sell. (Of course, either may be under such obligations from, say, a spouse or friends or other persons with special involvements, but that lies beyond our purview.) Both agents, then, are in the marketplace because they have interests, wants, desires, and values that they hope to satisfy by their market activities. And that's it. But while this is true and fundamental, we must also appreciate an important basic aspect of any exchange: that the parties proceed on the basis of *descriptions* of whatever is being exchanged. One party, the seller, in effect starts the ball rolling by making an offer. The other party is presumably in search of some or other good or service: she contemplates the offer in question and decides to take it or not. How does she do this? She must have some information prior to purchase or rejection, and this information must, in the nature of the case, come at least in part from the seller. Simply by recognizing that the other party is a seller with something to sell (and the seller recognizing a buyer with intent to buy), a fair amount of information has already been processed,

13 The expression is rather misleading, since it has little to do with the "proviso" urged by Locke to limit our acquisition of property. It is, accordingly, to be understood here as simply Gauthier's coined phrase for the principle he adumbrates, *not* as a reference back to the very disputable and disputed phrase in Locke's writings that stimulated its recent prominence. DAVID GAUTHIER, MORALS BY AGREEMENT 205-11 (1986).

14 David Gauthier, *Uniting Separate Persons*, *in* RATIONALITY, JUSTICE AND THE SOCIAL CONTRACT 176, 182 (David Gauthier & Robert Sugden eds., 1993).

of course. But getting us to the point where the consumer says "Yes" and hands over his money and the seller hands over the goods or performs the contracted-for services requires more. The "more" in question is in effect or (more usually) in fact a description of what is to be sold.

In a sense, there are two other sources of information for this description. First, there is previously acquired information or background information that potential purchasers are free to acquire by doing whatever homework they may like and be able to do. They might read *Consumers' Reports*, talk with acquaintances, and so on. But second, there is what the seller *says* about his product in his sales pitch or in the labeling of that product. (It can even be nonverbal: he can hold up the goods for the potential buyer to see for himself, or feel, or even sample.) What is easily overlooked or underestimated in this process is that information is *conveyed by standard usage of whatever terminology is employed*. When the merchant describes the goods in some way or another, he employs a language, one spoken in common by himself and the buyer.[15] In both cases, then, there is a communicative process, one that can be misused, derailed, or otherwise go wrong.

C. Caveat Emptor?

When there is a description of the goods, even one so simple as applying a familiar single common noun to it, the consumer gets a *message*. Which message? There is the one the consumer infers from that structure of words (or whatever mode of communication is employed), and then there is what the purveyor intended to convey. The first is a potential problem because the consumer may get information from two different sources: the public rules of the language (the "standard meaning" of the terms), and, in addition, from a body of impinging information that may indefinitely modify his interpretations. The second presents a different problem since we must expect that the seller will want to bias the information in such a way as to increase the likelihood of turning the potential buyer into an actual buyer to the seller's profit. A satisfactory theory of consumer-seller relations needs to cope with both sources of "noise."

Here is where a first important entry into what we may consider to be consumer rights takes place. Words are *public*,

15 If their languages are not the same, they must work through interpreters, of course, but this only complicates the same process, for the interpreter attempts to match the vocabulary of the one language with a vocabulary from the other for the purposes at hand.

and for that very reason, they are mostly *standard*. If the seller employs a special word, say a technical term or even one contrived by the seller for the purpose, then the consumer will need to have this explained somehow. The process of doing so will again employ standard language and may again run into noise from the consumer's peripheral sources of information/misinformation.

Still, we can already see that this is where Caveat Emptor breaks down. The idea behind it is that the Consumer bears *all* the risk in an exchange. But for it to be reasonable to hold that he does bear it, Consumer must know what he is getting into. But knowing that requires some kind of language, and language is intrinsically not the sort of thing that the consumer by himself *can* control. Language is not two Humpty Dumptys deciding to use words however they wish. The need to communicate makes that idea a non-starter. It has become commonplace in philosophy nowadays that the idea of a "private language" is impossible,[16] but that need not concern us here. All that matters to us, in this hands-on, arms-length world of business relations, is that for carrying on transactions in the marketplace, a public language is indispensable. In communications, the risks are shared. I decide how to interpret you, you decide how to interpret me. Neither of us can do that unless we have *some* basis for interpretation—and neither of us as individuals supplies that basis. Instead, the public rules of language do that. All speakers must take responsibility for what they mean, and that responsibility is rooted in public meanings.

D. Three Components of Meaning

So, what exactly does "standard language" convey in its designative capacity? Enormous amounts of philosophizing about language could leave one thoroughly confused on that subject, but it had better not be that difficult. We may here distinguish three components likely to enter into the structuring of these messages. First, there will be what we will call "dictionary meanings." True, we can then ask, "Which dictionaries do we go by? What do dictionary compilers think they are doing?" But while those questions are askable, legitimate, and important, it remains that dictionaries do get written and people do make use of them for the very good reason that we do have problems, and we know that solving them requires public rules. It makes sense to try to codify those. Dictionaries are attempts at such codification, articulating the

16 For the classic argument, see Ludwig Wittgenstein, *Philosophical Investigations*.

standard meanings of the day. They help. Second, there are informal accretions to meaning from community experience—but communities vary. One such community may attach a rather different accretion of meaning than another, thus complicating life for the would-be student of commerce. And finally, what can be regarded as a special subset of the previous category, there is the fund of *commonly known information* in the consumer community. This last is not strictly "part of the meaning of the word" and yet, there it is—typically both the consumer and the seller know it.

All of this enables us to make a suggestion. Consumer goods are typically designated by some one or some very few words in a phrase standardly applied to the items in question. The word or label, "F," when it denotes some usable thing, ordinarily conveys the sense that the thing *will serve a certain purpose or purposes*—the one or ones familiarly implied by the name in question via any or all of the three sources of meaning mentioned above. If I say this is a "rake" I am conveying to you the information that it will be useful for raking, say leaves or other such things. If it is a potato peeler, I convey that it will be useful for that. Such functional description is pervasive in Consumerland for the obvious reason that the Consumer is here in the marketplace precisely because he or she is in search of something that will serve some purpose or purposes known especially to her or him. Thus, it is those purposes that need to be known so that they can be catered to by the manufacturer and then by the retailer of those items. The development of a vocabulary that more or less precisely conveys the functions in question is, thus, an essential for efficient market exchange.

E. Criteria and Standards

The relevant criteria for assessing performance of a consumer good are based on the good's purpose(s). But then the question arises, how well will it serve that purpose? Given that the consumer must act on information at hand, that question is, in effect, how well can we *expect* it to serve that purpose given the description under which it is being proffered? Here we get into what could be a delicate issue. But there is a plausible, indeed arguably indispensable, general condition that we can invoke: If Seller doesn't *qualify* the description, then Consumer legitimately assumes that it will perform *at least normally* for the purposes in question. No precise definition of "normal" is intended, or perhaps possible, for this purpose; nevertheless, the point is that if what Consumer gets under the description "F" performs so miserably as to be unrecognizable, then he has a

complaint. Consumer is *entitled* to descriptions employing normal language, in the absence of special cues or qualifications, and normal language carries with it connotations of normalcy in performance *unless* qualifications are explicitly invoked—a process that can easily be initiated given the ready availability of more language. It is easy for Seller to alter his claim, after all. If what he is selling is *substandard* and known to be, he can *say* so. He often does: one can often find a "substandard" rack at much reduced prices. That is as it should be. No wrong is done by Seller in offering low-quality goods so long as he does not describe his offerings in such a way as to lead a normal user of the language to believe they are standard or better. It is when he does not, and yet his goods are indeed below normal performance levels, that the consumer has a beef.

As a rule of thumb, we may suggest that goods found to be substandard when they are not explicitly billed as such may be returned to Seller for a full refund. Should this be a *right*? It is a strong presumption, and any company that does not do this will soon get a reputation for unreliability. It may be best to leave it at that.

We can invoke our third identified source of information as well. In addition to the very meaning of the words we use, there is the fairly closely related matter of what we may call Community Information. It is often reasonable to assume that Consumer "knows" certain things, and it would be a bore—even insulting perhaps—to mention the facts in question. But, of course, in different communities different things will be items of familiar knowledge. So it might be possible to seriously mislead customers in place A with descriptions that would cause no problems at all in place B. Sellers need to be (and almost always are) aware of these disparities in background information-levels and must act accordingly.

How does all this accord with our starting point of general rights of freedom? The answer is found by identifying the *status quo* of Consumer vis-à-vis Seller at the point of exchange, the marketplace. Seller presumes certain general things about Consumer. Specifically, he presumes that Consumer is "in the market for" an item of type "F," and that he has a "normal" level of information about Fs and, for that matter, normal interests in using his F when he gets it. Seller's function in selling is that Consumer's acquisition of an F *leaves Consumer better off than in the status quo*, this being why he is there at all.

F. Making the Consumer Happy?

Now, part of this would get us into Subjectivity Land in a way that no sane code of consumer law could tolerate. Did Consumer make a "good buy?" That's for Consumer to decide. It is certainly not rational to *require* Seller to provide Consumer with something that he will be "happy" with. Seller surely *hopes* to do this and would love it if he succeeded, for to succeed at this is to leave a Consumer who is ready to come back for more. But meanwhile, there is a question of where to set the bottom line: At what point does Consumer actually have a *complaint*? When do we reasonably judge that his *rights* have been infringed or violated? To make such a judgment, we need to know whether the objective facts about the particular sample of F that Consumer acquired on the basis of the description provided *by the Seller* live up to what is *reasonably* understood to have been *conveyed* by that information. And that is something we can find out, albeit at the level of imprecision that it is reasonable to expect in such matters.

"Here: you said this was a 'toy submarine.' But it doesn't submerge! I want my money back!" It is no good, at this point, for Seller to respond, "But I didn't *say* it would submerge." The language used is such that he didn't *need to* say that. On the contrary, the language used is such that he *did* have to say that it would *not* submerge if indeed he knew it would not. What if he didn't know it wouldn't submerge, but nevertheless, the fact remains that it doesn't? Here we get into the question of what degree of epistemic responsibility for product performance do we members of the broader community reasonably expect of our Seller? This is no trifling matter nowadays when sales persons typically sell all manner of immensely complicated things whose inner workings are a complete mystery to the consumer, the seller, and even the defense lawyer. Again, it is the seller's description of the goods that licenses certain general expectations. If the product does not live up to those expectations, then *whether or not* Seller knew *or had reason to know* of its actual performance characteristics, his description *commits him* to a certain standard of performance. If it fails, he must take responsibility for that—again, *unless* he *explicitly qualifies this in advance.* The Consumer needs to know what he's getting into in order for his purchase to be rational. But often he doesn't know, and neither does Seller. So for second best, Consumer *reasonably expects* a certain level of performance, and Seller knows that he has this reasonable expectation—knows it because he knows the meaning of the language in which he describes the product and, in addition, the typical array of

information that any consumer in that market would be expected to have. Given all this, it is reasonable to hold the seller to what his description conveys.

G. How Much Information?

Another basic question that arises here is: How much information about his products does the seller need to *supply* to pass muster, morally speaking? It would be easy to overstate this and to say, "the whole truth." But that is *not* reasonable. We must distinguish between the Whole Truth, on the one hand, and Nothing But the Truth on the other. It is the latter, *not* the former, for which Seller is responsible. If Seller says what is *false*, he is liable. *Not saying all that is true*, however, is quite another matter. Not the least of the reasons why it is unreasonable to make Seller responsible for the *whole truth* is that neither he nor anyone else actually *knows* the whole truth—about *anything*. No doubt there will always be further information turning up about any given thing, product or otherwise. Moreover, some of this information just might turn out to be quite pertinent. Who can know? But whatever Seller *does* say about it, he can be held to account for. If he does not know, all he has to do is confess his ignorance. At some point, of course, his ignorance may be below the minimum required to participate in the sale of the item in question. But above that line, ignorance is not surprising and is forgivable.

However, Seller might know something of importance to a purchase of the particular item in question, and *not* say so. Then there can be an issue whether he had a responsibility to say *that*. Now, the fundamental line is the status quo of our rational consumer at the time of purchase. Will purchase of the item being sold leave the consumer better off than if he'd just stayed home and kept his money? If not, and if the reason was not some change of taste or interest on the part of Consumer but was due instead to the performance of the purchased item in ways known to Seller but not revealed to Consumer, then Seller is at fault. On the other hand, if the item is, say, just mediocre and Seller knew that but did not volunteer the information, then, while it would have been virtuous for Seller to pipe up and volunteer this possibly useful further information, he is not guilty of fraud but merely of sharpish practice. That should not surprise anyone, including Normal Canny Consumer. Seller may live to regret it: the competitor down the street may be more forthright, and Seller's former customers may flock to the competitor's store and desert the tightlipped merchant. Fair enough.

Suppose that Consumer can get the same item down the street at Ziggy's for 40% less: Is Seller responsible for providing this information? Surely not. There needs to be a fair division of labor, as it were, regarding the discovery and supplying of information. And, of course, Consumer, who has many advantages over Seller, has this one in particular: He can put Seller on the spot by simply *asking*. Then the requirement that Seller, whatever else he does, not intentionally produce *false* information covers the Consumer very well. Consumer uses his own judgment in deciding how to interpret *non*-answers, but our principle protects him in the case of *false* answers.

In noting that Consumer "can put Seller on the spot by simply asking," we enter into another of those difficult areas of modern life. For in modern Consumerland, asking is not so easy after all, as anyone with an obscure computer problem who attempts to query the manufacturer can testify. Indeed, there needs to be much thought about just how "simply" the consumer should be able to ask.

Meanwhile, we can differentiate this type of case, of non-culpable ignorance on the part of the Seller, from the preceding one, in which Consumer is deliberately misled, by suggesting that while the consumer may not have a *right* to Seller's acting on the basis of common knowledge, it would nevertheless be a very good idea for the company to take the familiar attitude (or at least, an attitude that once was familiar) that "The customer is always right." This puts the onus on Seller, even though it must be admitted that customers can have rather bizarre ideas about expected performance. Still, good business is one thing and what we may insist on as a matter of right is another. The customer whose expectations are well out of line with standard meanings and normally known information is, in truth, wrong. But a company that extends the benefit even of unreasonable doubt to such customers may well win many more customers.

H. How Fine the Print?

There often are things Seller needs to make clear. As such, how easy must it be for Consumer to get the message in order for us to rule that Seller has done his duty? A small page covered with microscopic print might be good enough if Consumer is most unlikely ever to need the information; not so, however, if it's something he really should be aware of before going further, with significant risk to himself if he is not. Here again, it is difficult to formulate a precise standard that would cover all or even most cases. What we can say is that this is a relevant variable—that the complaint, "but it was practically indiscernible!" is often a

justified complaint. Perhaps we had best settle for the suggestion that Consumer is entitled to have necessary information conveyed in such a way as to be absorbable without major effort, and let it go at that.

I. Health and Safety

One of the most important areas for applying our libertarian non-harm principle is that of health and safety. We want what we buy to do us good, not harm. We want it to leave us in a state of health *no worse than when we began*. If the product is sold *as* a health-*enhancement* product, then we have a right to expect that it will leave us not only no worse off, but actually better off, in the specific ways that the manufacturer claims, while leaving us *no worse off in any other* way. This expectation is, again, *prima facie*: A health-enhancing product might have known negative side effects, and Seller must duly warn Consumer of these facts when known. Our non-harm criterion, however, continues to apply regarding things *not* mentioned on the list of known side effects.

But all these are questions of degree, and what is more, the degree is especially that of *probability*. Simply, few products will *make* you sick or not. Almost all will increase or decrease the *probability* that you will become sick with this, that, or the other. The big question, then, is: What reasonable standard is there for determining merchant liability if things go wrong? *How* wrong must they go before Seller is liable?

J. Liberty and Risk

The first point I would make on this matter of risk is that the consumer should *have his choice* about this. In so saying, I appear to be taking a position radically at odds with current trends in consumer law and the mores of commercial life as I understand them. According to these trends, risk is borne virtually entirely by the Seller. Consumer is protected not only from defects in products, including ones that may have been unpredictable by the Seller, but also from Consumer's own poor judgment. For instance, Consumer might buy a product which he knows is dangerous in some way—the case of cigarette smoking obviously comes to mind. May a consumer sue a cigarette manufacturer when he gets lung cancer from regularly smoking the latter's product, even though fully informed about likely risks of doing so? My answer is a flat negative. *Unless* some manufacturer was so foolish as to assure the purchaser that *no* damage to his health would be forthcoming, the current (and long-standing) climate of information is such that a consumer

voluntarily purchasing a pack of cigarettes may be safely assumed to know what the risks are. There *could* still be places in the world where that is not so, I suppose, and in those few cases, we may agree that the smoker could have a case. And in any case, the manufacturer could (and is now legally required to) issue a clear warning. If Consumer buys nonetheless, then the only reasonable view is that the case is closed. With consumer rights should come consumer responsibilities. If we walk in voluntarily and with our eyes open, then we take responsibility for the consequences of our actions, so long as there is not actual malice on the part of the other party.

One of the most colossal extravagances of the American government today is found in its elaborate requirements for pharmaceuticals. For such things to make it to the market an ordeal awaits; new drugs are subjected to onerous testing procedures that take many years to complete and increase the cost of development by a huge factor. During these many years, many people die because they cannot acquire drugs that would have likely saved their lives. The lives that are saved by the extensive testing must be set against the lives that would have been saved by earlier access to the drugs, and it is widely held that the second set of deaths vastly outnumbers the first.[17] This is a major-league denial of Consumer liberty. It is an implicit assumption that consumers do not know what they are doing. And, insofar as manufacturers are held to the standards of the FDA, it is an assumption of unconcern by manufacturers. All this goes against the environment of freedom to which, I think, we people are entitled.

Were there no FDA, it would be easy enough for private companies to set up in business appraising and testing drugs; those which passed to a very high standard would be rated as such, and the rating company could assume liability for error. Pharmaceutical companies would advertise the ratings earned in this way as a selling point for their products; products that did not pass specific tests would have to be described as such. The consumer wanting more protection could look to this "pharmaceutical Underwriter's Laboratories" and pay the price; others could take greater risks and pay less. Consumers knowingly buying less-tested products would not be able to sue; consumers buying more-tested products that nevertheless fail

17 Daniel B. Klein & Alexander Tabarrok, *Is the FDA Safe and Effective?*, The Independent Institute, *at* http://www.fdareview.org/fda.pdf (last updated Sept. 26, 2001); Sam Kazman, *Deadly Overcaution: FDA's drug Approval Process*, 1 J. REG. & SOC. COSTS 35 (1990), *available at* http://www.cei.org/gencon/019,03887.cfm (last visited Mar. 11, 2004).

could sue. (And companies implicated could sue the Underwriters if the latter were found to have done inadequate or improper testing when proper testing was promised.) You would pay your money and take your choice. As things now stand, you only pay your money, or do without, or try to get it from a foreign source. The consumer deserves better than that.

K. Managing Risk

Two questions arise. First, how much risk should be taken to be "normal?" And second, how thorough and how precise does Seller have to be about what he puts on his labels by way of warning the customer of risks?

Regarding the first: nothing that anyone does is risk-free. To live is to be subject to risk. Some of our activities *elevate* the level of risk we face in some respects: driving a car incurs a risk of having some kind of accident, skiing can be lethal, and so on. Common sense is enough to identify some of these, but assorted products entail risks that common sense would not know about. The unobvious surely needs mentioning. But at what point does the obvious need noting? Parents may need to be warned about toys that might be risky for children. But there's not much point in manufacturers trying to warn the children themselves, and what parent is unaware of the dangers of childhood activities? How risky do things need to be before the user even needs to be warned? It would be nice to be able to say something more interesting than "significantly risky"—but still, that is the right answer. The risk must be more than is obvious to common sense and significantly greater than the normal risks of everyday activity. (The two sets are not quite coextensive.) Further, to be significant, it must be at least discernible. If the probability of breaking your leg or getting killed from using product X is about the same as what it would be if you stayed home and watched TV, it does not need to be mentioned. If it is a thousand times higher, it probably does. But if it's only three times as high? Or seventeen? Seventeen times .00001 is still very small. But a thousand times that is .01, which is not.

When warning is needed, because the risks involved are larger than the background ones just noted, how large does the print have to be? How precise does the information need to be? These are not easy issues, but neither are they imponderable. The print has to be at least *normally* legible and the information can be *quite* approximate in normal cases—but, if you're selling it to scientists, it had better be much more precise. Buying and selling take place in a particular market environment, and the levels of these variables—print-size, size of background risk, and,

hence, need to warn—require adjustment to suit. In the U.S. today, a new factor in our legal environment is the apparent willingness of courts to protect the consumer against himself in tort cases—$2.9 million for a cup of too-hot coffee spilled on an irate lady, for example.[18] The courts now proceed on a principle having virtually nothing to do with the original purpose of torts, namely to compensate victims of injuries that were fairly clearly the fault of some other party. But in so doing, they "protect" people at the expense of all the rest who have to pay the higher prices necessary to sustain the damage suits imposed by some few careless or malicious persons with the aid of the courts.

Just what is the right solution to risk problems? That is a much investigated question, and rightly so. The suggestion here is fairly rudimentary: What Seller basically owes to Buyer is *not to significantly increase his marginal involuntary net risk*. Estimating that is not easy, and the fact that it is not (when it is not) is itself relevant and can be made part of the information package. But it is the right idea.

IV. THE BOTTOM LINE: CONSUMER SOVEREIGNTY

The maxim *Caveat Emptor* has much to be said for it. Provided it is understood how and when the merchant can be in the wrong, there must be a region in which the consumer makes his own decisions and takes responsibility for them. If there is no misdescription of the goods, if there is no reason to expect net damage to health from her purchase, then the consumer's final protection does indeed lie in the fact that she can, as noted at the outset, simply say No. The wise merchant will do his best to see to it that the consumer says Yes—after all, that's how he makes his living. But his "best" after all has to be compatible with making a profit, and this means among other things keeping costs down. Absolute certainty that the customer is going to be happy is not to be had and attempts to achieve it would make all goods prohibitively expensive. That, of course, does no service to the consumer either. A happy medium is needed, and that medium is best understood as an understanding, between seller and buyer, that is rational from both points of view. In that respect, the proposals in this essay have merely been faithful to the idea of the market. And that idea is a good one—the market answering to that idea is by far the best institution we can have for such things.

18 *Big Jury Award for Coffee Burn*, N.Y. TIMES, Aug. 19, 1994, at D5.

Why Amendments to Rule 23 Are Not Enough: A Case for the Federalization of Class Actions

Lisa Litwiller[*]

I. INTRODUCTION

Class action litigation can be a useful tool to protect consumers from corporate misconduct, particularly where the individual claims are too small to be economically viable. However, class actions are subject to abuse by unscrupulous counsel, some of whom use the mechanism to enrich themselves at the expense of the clients they claim to represent. As one commentator has noted, "In many of these cases, the victimized consumers often receive pennies, or nearly-worthless coupons, while plaintiffs' counsel receives millions in legal fees."[1] Moreover, class actions are increasingly being filed over frivolous matters, often without the knowledge or consent of the proposed class members.[2] Indeed, although they were "[o]nce considered a tool of judicial economy . . . class actions are now often considered a means of defendant extortion."[3]

The current procedures governing class actions are plagued by numerous problems and abuses that threaten to undermine the rights of both plaintiffs and defendants. One key reason for these problems is that most class actions, regardless of their nationwide scope, are adjudicated in state courts where the governing rules are applied inconsistently and, frequently, in a manner that contravenes basic fairness. The number of class

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1 American Tort Reform Association, TORT REFORM REC., Dec. 31, 2003, at 44, http://www.atra.org/files.cgi/7668_Record12-03.pdf.

2 For example, a lawsuit was recently filed in the Eastern District of Tennessee on behalf of the entire nation against Viacom International, Inc., CBS Broadcasting, Inc., MTV Network Enterprises, Inc., Janet Jackson, and Justin Timberlake over the incident which occurred during the Super Bowl half-time show broadcast on February 1, 2004. Lisa de Moraes, *Jackson's Flash Has an Afterimage that Won't Fade*, WASH. POST, Feb. 6, 2004, at C1. *See also Pop Notes*, WASH. POST, Feb. 11, 2004, at C5 (noting that the suit had been withdrawn by the plaintiff who had "made her point").

3 American Tort Reform Association, *supra* note 1, at 44.

action suits brought against Fortune 500 companies increased dramatically between 1988 and 1998, and the vast majority of these actions were brought in state courts[4] where there is often inadequate supervision over litigation procedures and proposed settlements.[5]

Furthermore, current law enables lawyers to manipulate procedural rules to bring multi-state class actions in certain state courts whose judges may be inclined to certify improper classes and approve fundamentally unfair settlements. As Congress has noted, "In this environment, consumers are the big losers: in too many cases, judges are readily approving class action settlements that offer little – if any – meaningful recovery to the class members, and simply enrich class counsel."[6] In many of these suits the client-attorney relationship is reversed. The class serves at the pleasure of the attorneys who have the last say as to where, when, and which suits are filed.[7] Plaintiffs' attorneys often manipulate the system—dropping plaintiffs and claims that may defeat the class status.[8]

Class actions have had an economic impact as well. The United States Chamber of Commerce has observed that:

> Businesses spend millions of dollars each year to defend against the filing and even the threat of frivolous class action lawsuits. Those costs, which could otherwise be used to expand business, create jobs, and develop new products, instead are being passed on to consumers in the form of higher prices. In some cases, a company will be forced out of business because of expensive litigation.[9]

Attorneys seek to certify large classes to use as leverage against these corporate defendants, pushing them into settlements that result in relatively little recovery on the part of the plaintiffs.[10] The Chamber of Commerce supports class action reform because it "would move large, multi-state class action lawsuits from state to federal court, preventing widespread

4 Victor E. Schwartz et al., *Fair Federal Forums Should Decide Interstate Class Actions*, 69 U.S. L. WK. 2115, 2115 & n.1 [hereinafter Schwartz, *Fair Federal Forums*] (noting that filings in federal courts grew 338% while filings in state courts grew by more than 1,000%). *See also* DEBORAH HENSLER ET AL., PRELIMINARY RESULTS OF THE RAND STUDY OF CLASS ACTION LITIGATION 15 (1997).

5 Schwartz, *Fair Federal Forums*, *supra* note 4, at 2117-18.

6 S. REP. NO. 108-123, at 6 (2003).

7 Schwartz, *Fair Federal Forums*, *supra* note 4, at 2116.

8 *Id*.

9 *Class Action Reform*, U.S. Chamber of Commerce, http://www.uschamber.com/government/issues/reform/classaction.htm (last updated Dec. 2003) [hereinafter *Class Action Reform*].

10 Schwartz, *Fair Federal Forums, supra* note 4, at 2116.

'venue shopping' by trial lawyers."[11]

However, the federal class action system has not escaped criticism. Federal cases such as *Amchem Products, Inc. v. Windsor*[12] and *Ortiz v. Fibreboard Corp.*,[13] involving the certification of settlement classes which the United States Supreme Court ultimately found to be unfair, have highlighted the need for reform. Attempting to address the problems raised by cases like these, the United States Judicial Council has adopted amendments to Rule 23 of the Federal Rules of Civil Procedure, and Congress is currently considering legislation that would significantly impact class actions. However, despite these changes, plaintiffs' attorneys remain free to venue shop in state courts. In fact, in light of the decisions in *Amchem* and *Fibreboard*, plaintiffs' lawyers "have further incentive to avoid federal court."[14]

This Article suggests that Congress should go further and place multi-state class actions within the exclusive jurisdiction of the federal judiciary. Adopting such a scheme would minimize the risk that corporate defendants would be subjected to multiple, often inconsistent, verdicts. It would likewise eliminate the anomalous result of the application of inconsistent choice-of-law decisions. Moreover, it would allow multiple suits to be consolidated under the auspices of the federal Multi-District Litigation Panel, which would ensure the orderly progression of suits and result in judicial economies. It would also lessen the frequency of improper certification and fundamentally unfair settlements.

Accordingly, Section Two of this Article begins by examining the *Amchem* decision, which led lawmakers to consider reforming class action procedure. Section Three tracks the changes in the newly amended Federal Rule of Civil Procedure 23 which governs class actions. Section Four examines the currently pending legislation that would federalize the majority of class actions, and Section Five concludes that multi-state class actions, like federal securities litigation, should be within the exclusive province of the federal courts.

11 *Class Action Reform*, *supra* note 9.

12 521 U.S. 591 (1997).

13 527 U.S. 815 (1999).

14 John S. Baker, Jr., *Respecting a State's Tort Law, While Confining its Reach to that State*, 31 SETON HALL L. REV. 698, 709 (2001).

II. A LOOK AT *AMCHEM*

Amchem Products, Inc. v. Windsor, the case that highlighted the need for reform in class action litigation, was a controversial case concerning a so-called "settlement class."[15] Settlement class cases are those in which the motion for class certification is brought contemporaneously with a proposed settlement. The issue in *Amchem* was the legitimacy of class settlements under the then applicable Rule 23.[16] At the time *Amchem* was being litigated, asbestos-related litigation had become a crisis. Asbestos cases were clogging both state and federal court dockets and defendants were being sued repeatedly for the same or similar claims, often bankrupting corporations and usually gaining the plaintiff little recovery.[17] Indeed, the Judicial Conference Ad Hoc Committee on Asbestos Litigation observed that the asbestos litigation was

> a tale of danger known in the 1930s, exposure inflicted upon millions of Americans in the 1940s and 1950s, injuries that began to take their toll in the 1960s, and a flood of lawsuits beginning in the 1970s. On the basis of past and current filing data, and because of a latency period that may last as long as 40 years for some asbestos related diseases, a continuing stream of claims can be expected. The final toll of asbestos related injuries is unknown. Predictions have been made of 200,000 asbestos disease deaths before the year 2000 and as many as 265,000 by the year 2015.
>
> The most objectionable aspects of asbestos litigation can be briefly summarized: dockets in both federal and state courts continue to grow; long delays are routine; trials are too long; the same issues are litigated over and over; transaction costs exceed the victims' recovery by nearly two to one; exhaustion of assets threatens and distorts the process; and future claimants may lose altogether.[18]

Ultimately, the Committee recommended that Congress create a national asbestos dispute resolution scheme.[19] However, despite the Committee's report, Congress failed to take any action to control the asbestos litigation. Thus, it fell to the federal courts to try to wrest control. As a result, a group of federal judges familiar with asbestos litigation urged the Judicial Panel on Multidistrict Litigation ("MDL Panel") to consolidate all

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15 521 U.S. 591, 597 (1997).

16 *Id*. at 619.

17 *Id*. at 598.

18 *Id*. at 598-99 (quoting REPORT OF THE JUDICIAL CONF. AD HOC COMM. ON ASBESTOS LITIGATION 2-3 (Mar. 1991)).

19 *Amchem*, 521 U.S. at 598.

then-pending asbestos litigation into a single proceeding to be tried by the U.S. District Court for the Eastern District of Pennsylvania.[20] Once the cases were consolidated, each side formed steering committees and settlement negotiations commenced.[21] The problem, however, was that the MDL Panel only had the authority to consolidate the cases already filed, and any settlement reached in the consolidated cases would not give the beleaguered defendants any repose as to future claims.[22]

The solution devised by the steering committees was to certify a class for settlement purposes only.[23] This class was to have been comprised of "future claimants," as opposed to the plaintiffs already before the court in the consolidated cases.[24] Counsel from the plaintiff's steering committee purported to represent both the currently pending plaintiffs (the "inventory" plaintiffs) as well as future claimants.[25] When it appeared that the administrative scheme for binding future claimants was likely to bear fruit, defendants agreed to settle the cases of the inventory plaintiffs for more than $200 million.[26]

Acting in concert, the inventory plaintiffs and defendants jointly prepared and filed "a complaint, an answer, a proposed settlement agreement, and a joint motion for conditional class certification."[27] Thus, it was clear that this particular class action suit "was not intended to be litigated," but rather was intended to bind absent potential plaintiffs.[28] The proposed class consisted of all people who had not yet filed an asbestos-related lawsuit against one of the participating defendants, but who had either (1) been exposed to asbestos or asbestos-containing products, or (2) had a spouse or family member so exposed.[29] The class was not further delineated into subclasses, but was represented by nine named plaintiffs who represented the class as a whole.[30]

The settlement agreement proposed to settle all claims filed before January 15, 1993, and precluded nearly all class members from litigating against defendant companies after that date.[31] The settlement proposal described four classes of compensable

20 *Id*. at 598-99.
21 *Id*. at 599.
22 *Id*. at 599-600.
23 *Id*. at 601-02.
24 *Amchem*, 521 U.S. at 601.
25 *Id*. at 600-01.
26 *Id*. at 601.
27 *Id*. at 601-02.
28 *Id*. at 601, 603.
29 *Amchem*, 521 U.S. at 602.
30 *Id*. at 602-03.
31 *Id*. at 603.

diseases, along with the range of damages for each category.[32] Certain exceptional medical claims might be separately compensated, but the number and dollar amounts of such claims were limited.[33] Furthermore, the scheduled payments were not adjusted for inflation.[34] The settlement agreement also discussed methods of determining compensation, dispute review procedures, and other claims limitations.[35] Class members were forever bound to the settlement, but defendants could "choose to withdraw from the settlement after ten years."[36]

The District Court conditionally certified the class despite objections. The objectors claimed the settlement was unfair as it applied to those who did not yet have compensable claims. Objections also arose as to the lack of compensation for certain types of claims, as well as to the perceived conflict of interest plaintiffs' counsel would have in representing the various unnamed subclasses.[37] The Third Circuit Court of Appeals vacated the certification, holding that the requirements of Rule 23 had not been met.[38]

The Supreme Court affirmed the appellate court decision.[39] It noted that "since the 1966 revision of Rule 23, class-action practice [had] become ever more 'adventuresome' as a means of coping with claims too numerous to secure their 'just, speedy, and inexpensive determination'" if litigated separately.[40] The Court further held that in a settlement-only class certification request, the court must protect absentees by giving heightened attention to the Rule specifications and by blocking overbroad class definitions.[41] "Such attention is of vital importance, for a court asked to certify a settlement class will lack the opportunity, present when a case is litigated, to adjust the class, informed by the proceedings as they unfold."[42]

The Court closed with a quote that is as applicable to this discussion as it was to the *Amchem* case: "[T]he rulemakers' prescriptions for class actions may be endangered by 'those who embrace Rule 23 too enthusiastically just as they are by those who approach the Rule with distaste.'"[43] Thus, although the

32 *Id*. at 603-04.
33 *Id*. at 604.
34 *Amchem*, 521 U.S. at 604.
35 *Id*.
36 *Id*. at 604-05.
37 *Id*. at 605, 607-08.
38 *Id*. at 608.
39 *Amchem*, 521 U.S. at 629.
40 *Id*. at 617-18 (quoting FED. R. CIV. P. 1).
41 *Id*. at 620.
42 *Id*.
43 *Id*. at 629 (quoting C. WRIGHT, LAW OF FEDERAL COURTS 508 (5th ed. 1994))

Amchem settlement was a creative way to potentially solve what seemed an intractable problem, ultimately the wisdom of certifying a class of absent members, represented by counsel that had a conflict – and whom they had never met – proved to be a use of Rule 23 that was just too enthusiastic.[44] In response, Congress finally decided to act. It has approved changes to Rule 23[45] and is still considering the Class Action Fairness Act,[46] both of which are discussed in more detail below.

III. CHANGES TO RULE 23

Certain changes to Rule 23 of the Federal Rules of Civil Procedure and class action procedure became effective on December 1, 2003.[47] Primarily in response to the *Amchem* case discussed above, the changes to Rule 23 are a step towards curbing what has become a system highly susceptible to abuse. The following is a look at those changes and an explanation as to why these changes effectuate a system that can better serve the judiciary and the litigant alike. By clarifying class action procedure, the rulemakers attempted to improve what many have thought to be an unmanageable system.[48]

In August 2001, the Advisory Committee on Civil Rules submitted its proposed Rule 23 amendments to the Judicial Conference.[49] After circulation to the bench and bar and two public hearings where over forty witnesses testified, the rules were recommended for approval.[50] Focusing "on class-action procedures rather than on substantive certification standards," the amendments were a "balanced and neutral attempt to protect individual class members, enhance judicial oversight and discretion, and further the overall goals of the class-action device."[51] Focusing on the "rapid changes" modern complex litigation had imposed on Rule 23 and the problems arising from such litigation, the Judicial Conference approved the rules with the hope of streamlining class action procedures.[52] In doing so, the amendments focus on four areas of class action procedure: when certification decisions and notice must be made; how judges are to oversee class action settlements; the appointment of class

(internal bracketing omitted).

44 *Amchem*, 521 U.S. at 629.

45 *See infra* Appendix A.

46 *See infra* Appendix B.

47 FED. R. CIV. P. 23.

48 REPORT OF THE JUDICIAL CONF. COMM. ON RULES OF PRACTICE AND PROCEDURE 13 (Sep. 2002), *available at* http://www.uscourts.gov/rules/jc09-2002/Report.pdf.

49 *Id*. at 8.

50 *Id*.

51 *Id*. at 8-9.

52 *Id*. at 8.

action counsel; and how counsel is to be compensated.[53]

A. Certification Under the New Rule

One of the most significant changes to Rule 23 is the new criteria clarifying when and how class certification is to occur.[54] Before the new amendments, certification under Rule 23(c)(1) was to occur "as soon as practicable."[55] Under the new amendments, certification is to take place "at an early practicable time."[56] While the language has not been altered drastically, in changing its certification procedure, the advisory committee indicated that its purpose was to allow some deferment in certification in order that some discovery into the "merits" of the case may be conducted.[57] The purpose of this deferment and discovery is to allow both the parties and the presiding judge a chance to better understand the issues presented in the case and make certification decisions with as much pertinent information as possible.[58] The advisory committee acknowledges that some discovery will be necessary to aid the court in making its certification decision.[59] It makes clear that "certification discovery" is to be treated differently than the usual "merits discovery," which normally takes place after certification has been resolved.[60] Because of this, the presiding judicial officer should closely supervise the certification discovery.[61] The advisory committee also makes clear that, while some delay in the certification procedure may be necessary, the judge should "ensure that the certification decision is not unjustifiably delayed."[62]

The addition of Rule 23(c)(1)(B) provides clear guidance for what the judge must include in a certification order. A class action certification order "must define the class and the class claims, issues, or defenses, and must appoint class counsel under Rule 23(g)."[63] After a certification order is entered, however, Rule 23(c)(1)(C) sets out new criteria for amending the original certification order. Prior to the December 2003 amendment, Rule 23(c)(1) allowed for the granting of conditional class certification and the amendment or alteration of any class certification order

53 FED. R. CIV. P. 23(c),(e),(g),(h).
54 FED. R. CIV. P. 23(c).
55 FED. R. CIV. P. 23(c)(1) (repealed 2003).
56 FED. R. CIV. P. 23(c)(1)(A).
57 FED. R. CIV. P. 23(c)(1)(A) advisory committee's note.
58 *Id*.
59 *Id*.
60 *Id*.
61 *Id*.
62 FED. R. CIV. P. 23(c)(1)(A) advisory committee's note.
63 FED. R. CIV. P. 23(c)(1)(B).

until a decision on the merits was rendered.[64] Under the new rule, the court cannot conditionally grant its certification order but can alter or amend it any time before final judgment.[65] By eliminating the potential for conditional class certification, the advisory committee maintains that class certification should be refused until the necessary requirements have been met.[66]

The advisory committee also attempted to shore up any ambiguity as to when amendment or alteration can take place. In particular, the advisory committee was concerned with bifurcated trials.[67] In that instance, a decision on the merits is rendered at the time of the liability verdict, but amendment or alteration of the class certification may be necessary in order to effectuate a smoother determination of damages.[68] The new amendment now allows for this type of alteration or amendment where the jury verdict makes it necessary.[69]

In summary, the amendments discussed above clarify the certification process and provide for more judicial supervision and involvement. The amendments attempt to resolve some of the conflict seen throughout U.S. courts in terms of when and how to certify a class. Of particular interest is that courts can no longer grant conditional certification but must refuse certification until Rule 23's requirements are met.[70] While courts are still free to amend should issues or party positions change, the certification decision must now be one of the first conclusive decisions of the litigation. These new amendments allow for more flexibility by permitting some discovery prior to the certification decision but deny a court's ability to grant certification on a tentative basis.

B. Judicial Oversight of Class Action Settlements

Perhaps the most significant changes to Rule 23 are the amendments governing judicial review of class action settlements.[71] The goal in amending the class action settlement rule was to "assure adequate representation of class members

64 FED. R. CIV. P. 23(c)(1) (repealed 2003).

65 FED. R. CIV. P. 23(c)(1)(C).

66 FED. R. CIV. P. 23(c)(1)(C) advisory committee's note.

67 *Id*.

68 *Id*.

69 FED. R. CIV. P. 23(c)(1)(C). An additional amendment to FED. R. CIV. P. 23(c)(2) gives the presiding court the authority to direct notice of certification or amendments in the certification order to 23(b)(1) and 23(b)(2) classes should it deem it necessary. FED. R. CIV. P. 23(c)(2)(A). The Committee cautions that the ordering of notice should be "exercised with care." FED. R. CIV. P. 23(c)(2)(A) advisory committee's note. Notice is already required for (b)(3) classes. FED. R. CIV. P. 23(c)(2)(B).

70 *See* FED. R. CIV. P. 23(c)(1)(A).

71 FED. R. CIV. P. 23(e).

who have not participated in shaping the settlement."[72] Pursuant to the newly amended Rule 23(e)(1)(A), approval of the settlement of class actions or potential class action claims is only required if "the claims, issues, or defenses of a certified class are resolved by a settlement, voluntary dismissal, or compromise."[73] In other words, court approval of settlements is only necessary in cases where a class has been certified. In addition to resolving the ambiguity as to when settlement approval is required, amendments to Rule 23(e)(1)(B) now require notice of the settlement to those class members who would be bound by the settlement.[74] If the settlement is to bind more than the class representatives through either issue or claim preclusion, each of the class members affected must be notified.[75] If the settlement is only to bind class representatives individually, no notice is necessary.[76]

Rule 23(e)(1)(C) requires that, when the settlement would bind class members, the court conduct a hearing and make specific findings as to whether the settlement is "fair, reasonable, and adequate."[77] The "fair, reasonable and adequate" standard is a familiar standard that courts have consistently applied in the majority of class action settlements and which the advisory committee adopted for application to all settlement approval processes.[78] The court's findings upon review are to "be set out in sufficient detail to explain to class members and the appellate court the factors that bear on applying the standard."[79] In other words, the new settlement amendments are intended to not only protect the individual class member but to allow for a more accurate and understandable review process.

The new Rule 23 also addresses what parties must disclose to the court regarding their settlement agreements. Rule 23(e)(2) reinforces the basic requirement that the parties disclose all terms of settlement or compromise that need approval.[80] In addition, Rule 23(e)(2) requires the parties to disclose any other agreements made in connection with the settlement.[81] According to the advisory committee notes, this amendment "aims instead at related undertakings that, although seemingly separate, may

72 FED. R. CIV. P. 23(e) advisory committee's note.
73 FED. R. CIV. P. 23(e)(1)(A) advisory committee's note.
74 FED. R. CIV. P. 23(e)(1)(B).
75 FED. R. CIV. P. 23(e)(1)(B) advisory committee's note.
76 *Id*.
77 FED. R. CIV. P. 23(e)(1)(C).
78 JUDICIAL CONF. REPORT, *supra* note 48, at 13.
79 FED. R. CIV. P. 23(e)(1)(C) advisory committee's note.
80 FED. R. CIV. P. 23(e)(2). *See also* FED. R. CIV. P. 23(e)(2) advisory committee's note.
81 FED. R. CIV. P. 23(e)(2).

have influenced the terms of the settlement by trading away possible advantages for the class in return for advantages for others."[82] Now, not only do the courts have the right to review all terms of the settlement agreement before them, they also have the right to require that any side agreements made in connection with the settlement be disclosed.

Perhaps one of the most discussed amendments to Rule 23, 23(e)(3) provides that the court has the discretion to order a second opt out opportunity if it deems necessary.[83] In its provision, the advisory committee explains that a second opt out opportunity can be ordered by the court in those instances when the class has already been certified and the class members' first choice to opt out expired before notice of the settlement was received.[84] By allowing individual class members a choice whether to be bound by the settlement, the amendment provides "added assurance to the supervising court that a settlement is fair, reasonable, and adequate. It is just the sort of 'structural assurance of fairness,' mentioned in *Amchem Products Inc.*, that permits class actions in the first place."[85] When combined with the individual class members' right to object to a proposed settlement, the Rules have expanded protection of the individual class members, particularly in instances where he or she will be bound by the settlement.[86]

By expanding the role of the judiciary in the settlement process, the revised Rule 23 now creates a more accurate and class member friendly process. Courts now play a prominent role in each step of the settlement process and are given the ability to better effectuate the process. Ambiguities that once thwarted the settlement process have been clarified. Most importantly, the role of the court, the expanded method of review, and the ability for class members to opt out in particular situations, allow a court to better ascertain if the settlement before it is truly "fair, reasonable, and adequate."[87]

C. A Brief Look at the Changes of Class Counsel Appointment and Compensation

Two other major amendments to Rule 23 deserve mention. Rule 23(g) codifies the common practices of courts in scrutinizing class action counsel. The rule builds on what courts have already

82 FED. R. CIV. P. 23(e)(2) advisory committee's note.
83 FED. R. CIV. P. 23(e)(3).
84 FED. R. CIV. P. 23(e)(3) advisory committee's note.
85 JUDICIAL CONF. REPORT, *supra* note 48, at 15.
86 *See* FED. R. CIV. P. 23(e)(4).
87 FED. R. CIV. P. 23(e)(1)(C).

done and "fill[s] the gap by articulating the responsibility of class counsel and providing an appointment procedure."[88] The new amendments provide courts with guidelines in appointing class counsel for both the certification and litigation stages of the class action.[89] In addition, the rule sets forth specific criteria for class counsel and even gives the court the power, should it feel necessary, to order disclosure of the proposed terms of an attorney fee award.[90] As with the two areas above, the Rule's definition of how class counsel should be appointed provides better protection for all class members and contributes to the smooth progression of a class action suit.

In addition to new limitations on the appointment of counsel, Rule 23(h) provides new criteria regarding review of attorney fees. "[D]esigned to work in tandem with new subdivision (g)," this new subsection applies to civil actions where a class has already been certified.[91] If the Court is authorized by law or party agreement to award attorney fees, this new subsection provides a format for how those awards are to be calculated and mandates that such awards be deemed reasonable by the court.[92] By allowing the court to monitor the award of attorney fees, requiring class members be notified, and ordering a hearing on any objections to the award, this new amendment combines with its counterpart to protect the rights of class members and curb potential abuses of the class action process.

IV. THE CLASS ACTION FAIRNESS ACT

Despite the protections afforded by the new Rule 23, the current class action system is still susceptible to abuses by state and local courts, particularly in multi-state class action cases. Congress has found that "[o]ver the past decade, there have been abuses of the class action device that have (A) harmed class members with legitimate claims and defendants that have acted responsibly; (B) adversely affected interstate commerce; and (C) undermined public respect for our judicial system."[93] Abuses by state and local courts have kept "cases of national importance out of federal court," sometimes demonstrated "bias against out-of-State defendants," made judgments that imposed one state's law on other States, and bound "the rights of the residents of those

88 JUDICIAL CONF. REPORT, *supra* note 48, at 17.

89 *See* FED. R. CIV. P. 23(g)(1)(A), (B).

90 FED. R. CIV. P. 23(g)(1)(C).

91 FED. R. CIV. P. 23(h) advisory committee's note.

92 *Id*.

93 150 CONG. REC. S57 (daily ed. Jan. 20, 2004) (reporting S.A. 2232, amendments to S. 274).

States."[94]

In response, Congress drafted The Class Action Fairness Act of 2003.[95] The Act is intended to:

> (1) assure fair and prompt recoveries for class members with legitimate claims; (2) restore the intent of the framers of the United States Constitution by providing for Federal court consideration of interstate cases of national importance under diversity jurisdiction; and (3) benefit society by encouraging innovation and lowering consumer prices.[96]

Although some might argue that class actions should be abolished altogether, Congress found that they "are an important and valuable part of the legal system when they permit the fair and efficient resolution of legitimate claims of numerous parties" aggregated into a single action.[97] Therefore, Congress has concluded that federal reform is the preferred solution over outright abolishment.

Although the fate of the proposed Act is uncertain at the time of this Article's publication, recent actions indicate that the proposed legislation will probably pass.[98] The House version was introduced and passed as H.R. 1115,[99] and the Senate version was introduced as S. 274 and 1751.[100] S. 274 passed the Senate judiciary committee, but was stalled by filibuster when brought to the floor for a vote.[101] A vote for cloture was taken October 22, 2003, but defeated 59-39, and the delay continued.[102] However, on January 20, 2004, Senator Grassley (R-IA), the Bill's original sponsor, proposed amendments designed to garner the votes necessary to end the debate and allow for a final vote.[103] Then,

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94 *Id*.

95 *See infra* Appendix B.

96 150 CONG. REC. S57 (daily ed. Jan. 20, 2004) (reporting S.A. 2232, amendments to S. 274).

97 *Id*.

98 However, the proposed Act has been subject to heated debate. *Compare* 149 CONG. REC. S12,987 (daily ed. Oct. 22, 2003) (statement of Sen. Kennedy) (arguing that the Class Action Fairness Act is "a radical shift in Federal law" to support corporate interests), *with* 149 CONG. REC. S12,994 (daily ed. Oct. 22, 2003) (statement of Sen. Chambliss) (arguing that the Act promotes federalism by limiting state control over national policies).

99 It passed on June 12, 2003 by a vote of 253-170. *Final Vote Results for Roll Call 272*, http://clerk.house.gov/EVS/2003/roll272.xml (June 12, 2003).

100 Senate Bill 274 is the version that went forward, while Senate Bill 1751 died before it went to Committee. *See* 150 CONG. REC. S57 (daily ed. Jan. 20, 2004); 149 CONG. REC. S13,004 (daily ed. Oct. 22, 2003).

101 Ameet Sachdev, *Coupon Awards Reward Whom?*, CHI. TRIB., Feb. 29, 2004, Business, at 1.

102 *U.S. Senate Roll Call Votes 108th Congress - 1st Session*, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=108&session=1&vote=00403 (Oct. 22,. 2003).

103 *See* 150 CONG. REC. S57 (daily ed. Jan. 20, 2004) (reporting SA 2232, amendments to S. 274).

on February 10, 2004, Senator Grassley reintroduced the bill as S. 2062, which was placed on the legislative calendar February 11, 2004.[104] After three attempts to pass this important legislation in the last five years, Congress may finally succeed in giving our class action system a much-needed overhaul.[105]

One of the major concerns addressed by the Act is finding the right balance between respect for state autonomy, the plaintiff's right to choose the forum, and national desires for efficiency, consistency, and fairness.[106] Congress is concerned that by hearing certain class actions in state courts, cases of national importance are kept out of federal court. This allows for bias against out-of-state defendants and imposes one state's view of the law on other states and their residents. This contradicts the intent of the framers of the Constitution with respect to diversity jurisdiction.[107]

Congress addressed these federalism concerns by redefining diversity jurisdiction and the parties' ability to remove to federal court, while maintaining reasonable limits on when they may do so. Under the proposed legislation, where the aggregated amount in controversy for all plaintiffs exceeds $5,000,000,[108] most civil cases may be removed to federal court when (1) "any member of a class of plaintiffs is a citizen of a [state] different from any defendant," or (2) any plaintiff or defendant is from a foreign state and parties on the other side are citizens of a U.S. state.[109] Class actions that are excluded from this provision include those where (1) a primary defendant is a state, state official, or "other governmental entit[y] against whom the district court may be foreclosed from ordering relief," or (2) there are fewer than 100 plaintiffs.[110] Claims involving securities or corporate governance are also excluded.[111] However, the Senate and House versions of the Bill differ on who may remove to federal court. Both agree that any defendant may remove,[112] but only the House version permits any plaintiff class member to

104 *See* 150 CONG. REC. S953 (daily ed. Feb. 11, 2004); 150 CONG. REC. S1191 (daily ed. Feb. 11, 2004).

105 *See* Victor E. Schwartz et al., *Federal Courts Should Decide Interstate Class Actions: A Call for Federal Class Action Diversity Jurisdiction Reform*, 37 HARV. J. ON LEGIS. 483, 510 (2000) [hereinafter Schwartz, *Federal Courts*].

106 *See* 150 CONG. REC. S57 (daily ed. Jan. 20, 2004) (reporting S.A. 2232, proposed amendments to S. 274).

107 *Id*.

108 Excluding interest and costs.

109 150 CONG. REC. S58 (daily ed. Jan. 20, 2004).

110 *Id*.

111 *Id*. at S59.

112 *Id*.; H.R. 1115, 108th Cong. § 5 (2003).

remove, even without the consent of all class members.[113]

Once a motion for removal is made, the district court *may* decline to exercise diversity jurisdiction if it finds that, based on the totality of the circumstances, it should do so in the interests of justice.[114] The court may refuse to exercise jurisdiction when "greater than one-third but less than two-thirds of the members of all proposed plaintiff classes in the aggregate and the primary defendants are citizens of the State in which the action was originally filed."[115] The court should also consider if: (1) "the claims asserted involve matters of national or interstate interest;" (2) "the claims asserted will be governed by laws of the State in which the action was originally filed or by the laws of other States;" (3) the case was pleaded specifically to avoid federal jurisdiction; (4) the selected forum has a special connection between "the class members, the alleged harm, or the defendants;" (5) there are substantially more plaintiffs from the forum state compared to the number of plaintiffs from other states; and (6) other class actions asserting the same or similar claims have been filed in the three years preceding the action in question.[116]

Furthermore, a district court *must* decline jurisdiction in two instances: first, when more than two-thirds of all plaintiffs and the primary defendants "are citizens of the State in which the action was originally filed;" second, when more than two-thirds of all proposed plaintiffs are citizens of the state in which the action is filed and at least one primary defendant (one "from whom significant relief is sought . . . [and] whose alleged conduct forms a significant basis for the claims asserted") is a citizen of the state in which the action was filed.[117] In addition, "the principal injuries resulting from the alleged conduct or any related conduct of each defendant" must have occurred within the state where the action was filed, and no other class action asserting the same claim may have been filed against the defendant within the previous three years.[118]

These changes to diversity jurisdiction will result in a more efficient judicial system, both at the state and federal levels, benefiting consumers, defendants, and the public as a whole. It will ensure that plaintiffs with similar claims against national entities, regardless of where they live, will be treated fairly and

113 H.R. 1115, 108th Cong. § 5 (2003).
114 150 CONG. REC. S58 (daily ed. Jan. 20, 2004).
115 *Id.*
116 *Id.*
117 *Id.*
118 *Id.*

consistently. It also permits defendants to address class action claims once—saving them time and money and allowing them to get back to the business of stimulating the economy. The autonomy of each state and its citizens is respected by limiting the ability of other states to impose their laws in these areas.

Consumers are further protected by the Consumer Class Action Bill of Rights contained in Section 3 of this Act, which provides for judicial scrutiny of settlements involving coupons, develops an attorney fee structure designed to ensure real awards for plaintiffs, and requires notification to appropriate state and federal officials.[119] Specifically, in any proposed settlement that involves awarding coupons to class members, the court may approve the settlement only after a hearing and only if it finds that the settlement is fair, reasonable, and adequate for class members.[120] The court also has the option of requiring that a portion of the value of any unclaimed coupons be donated to one or more charities chosen by the parties.[121] Courts may only approve of settlements that require class members to pay attorney fees that result in a net loss "if the court makes a written finding that non-monetary benefits to the class member substantially outweigh the monetary loss."[122] The court may not approve a settlement that provides for greater payments to some class members solely because they are located closer to the court.[123]

The Act also spells out how plaintiffs' attorney fees are to be calculated. First, if the proposed settlement involves payment to class members by coupon, the portion of the attorney fees related to the coupon award will be based on the value of the redeemed coupons.[124] The court has the discretion to grant a motion for expert testimony to determine the value of the coupons to the class members.[125] Second, if any portion of the recovery of the coupons is not used to determine the attorney fees, the fees will be awarded "based upon the amount of time class counsel reasonably expended working on the action."[126] This second method is also used for determining the fees for obtaining equitable relief, including an injunction, and requires approval by the court.[127] The statute permits the combination of the two

119 150 CONG. REC. S57-58 (daily ed. Jan. 20, 2004).
120 *Id*. at S57.
121 *Id*.
122 *Id*.
123 *Id*.
124 150 CONG. REC. S57 (daily ed. Jan. 20, 2004).
125 *Id*.
126 *Id*.
127 *Id*.

methods.[128]

Within ten days of filing a proposed settlement, each participating defendant must provide notice to the appropriate state and federal officials.[129] The notice must include: (1) a copy of the complaint, materials filed with the complaint (except those available on the Internet), and any amended complaints; (2) "notice of any scheduled judicial hearing in the class action;" (3) any proposed or final notification to class members of their right to opt out or, if no such right exists, a statement that no right exists, and a proposed settlement; (4) "any proposed or final class action settlement;" (5) any contemporaneous settlement or agreement between the parties' attorneys; (6) "any final judgment or notice of dismissal;" (7) the names and proportionate shares (or a reasonable estimate) of that State's residents; and (8) any related judicial opinions.[130] A court may not give final approval of a settlement until at least 90 days after the last required notification.[131] A class member may refuse to comply with or be bound by the settlement agreement if the class member can demonstrate that the defendants failed to notify the appropriate state and federal officials.[132]

The sponsors designed the Act to protect consumers who they believed were "being taken for a ride by a renegade legal practice that often compensates them nominally—for example, with coupons—while their lawyers take home millions of dollars in fees."[133] Indeed, "[t]he U.S. Chamber of Commerce Institute for Legal Reform has reported that every American consumer pays an annual 'litigation tax,' totaling in the hundreds of dollars, which comes in the form of higher prices for consumer products in order to offset the cost of 'a litany of litigation.'"[134] Part of this cost is the result of some maneuvering by plaintiffs' attorneys in naming defendants in such a way as to destroy diversity and ensure that the case is heard in the state court of their choice. Specifically, class action counsel will:

> name local parties, such as retailers, wholesalers, and distributors, as co-defendants. The lawyers rarely intend to obtain a judgment against these local employers, who are dragged into the case simply to destroy diversity. This practice

128 *Id*.
129 150 CONG. REC. S58 (daily ed. Jan. 20, 2004).
130 *Id*.
131 *Id*.
132 *Id*.
133 Schwartz, *Federal Courts, supra* note 105, at 483.
134 Cher Gonzalez, *'Plaintiff's Bill of Rights' Wouldn't Just Help Businesses*, E. BAY BUS. TIMES, Nov. 15, 2002, *available at* http://www.bizjournals.com/eastbay/stories/2002/11/18/editorial2.html.

> imposes legal costs on sellers. Ultimately, these costs are passed on to consumers in the form of tort taxes on the products and services they purchase.[135]

Assuming that this legislation becomes law, such attempts at "gaming the system" will no longer hamper the federal courts' ability to resolve meritorious, national class actions in a fair and just manner.

V. CONCLUSION

Taken together, the Rule changes now in effect and the Class Action Fairness Act, if passed, will work together to improve the way in which federal class actions will be litigated. For example, many class actions that have multi-state or national consequences are currently brought in state courts, where state rules may give trial judges substantial discretion with respect to whether to certify the class or approve the settlement. Moreover, it may be the case that local judges tend to engage in favoritism or are known to be "plaintiff – friendly." The net result is that defendants' due process rights may be violated when plaintiffs are permitted to litigate in a friendly forum. In addition, allowing class actions with national implications to be heard in state court sometimes permits state judges to set national policy in a manner that is essentially beyond review. Federal courts are better equipped to handle cases with national implications, and generally are more competent in certifying and managing these cases. Accordingly, allowing defendants (or unnamed plaintiffs) to remove seems sensible, and the above-described rule changes go far toward accomplishing that goal.

However, Congress should go a step further and bring multi-state class actions within the *exclusive* jurisdiction of the federal courts. Congress has the authority—it has already created areas of exclusive federal jurisdiction.[136] Federalizing class actions would ensure that proposed class actions would undergo sufficient scrutiny prior to certification.[137] It would also permit cases to be consolidated before a single court, thereby reducing the number of duplicative lawsuits. Lastly, federal courts are in a superior position to deal with complex class actions.[138]

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135 Schwartz, *Federal Courts, supra* note 105, at 486.

136 For example, federal courts have exclusive jurisdiction over matters sounding in bankruptcy, tax, maritime or admiralty law, securities litigation and copyright. 28 U.S.C. §§ 1333-34, 1338, 1346 (2003); 15 U.S.C. § 78aa (1999).

137 State courts have, in the past, certified cases when class certification is inappropriate. *See, e.g.*, Liggett Group, Inc. v. Engle, 853 So. 2d 434, 441-42 (Fla. Dist. Ct. App. 2003) (reversing the trial court's certification of a class of smokers and their survivors).

138 *See* John H. Beisner & Jessica Davidson Miller, *They're Making a Federal Case*

More importantly, however, federalizing class actions would reduce the federalism concerns that arise when a state purports to render a decision in a multi-state class action.[139] As the Supreme Court noted in *Phillips Petroleum Co. v. Shutts,*[140] there are Constitutional limitations regarding the choice of the substantive law to be applied because the Full Faith and Credit Clause requires other states to recognize the judgment of the particular court.[141] Federal courts will be less likely to automatically apply the forum state's law in cases in which some other choice of law would be more appropriate.

As a safeguard, in cases that are entirely local in character and the entire plaintiff class are residents of the forum state, state court would remain an option. However, in all other class actions that have, or purport to have, a national scope, the federal court should be the only alternative.

Out Of It . . . In State Court, 25 HARV. J.L. & PUB. POL'Y 143, 151-54 (2001).

139 *Id*. at 153 (noting that "matters of interstate comity are more appropriately handled by federal judges appointed by the President and confirmed by the Senate"). *See also* 149 CONG. REC. S12,994 (daily ed. Oct. 22, 2003) (statement of Sen. Chambliss).

140 Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985).

141 *Id*. at 822-23.

APPENDIX A

Rule 23. Class Actions (current version)

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) Determining by Order Whether to Certify a Class Action; Appointing Class Counsel; Notice and Membership

in Class; Judgment; Multiple Classes and Subclasses.

(1)(A) When a person sues or is sued as a representative of a class, the court must—at an early practicable time—determine by order whether to certify the action as a class action.

(B) An order certifying a class action must define the class and the class claims, issues, or defenses, and must appoint class counsel under Rule 23(g).

(C) An order under Rule 23(c)(1) may be altered or amended before final judgment.

(2)(A) For any class certified under Rule 23(b)(1) or (2), the court may direct appropriate notice to the class.

(B) For any class certified under Rule 23(b)(3), the court must direct to class members the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice must concisely and clearly state in plain, easily understood language:

• the nature of the action,

• the definition of the class certified,

• the class claims, issues, or defenses,

• that a class member may enter an appearance through counsel if the member so desires,

• that the court will exclude from the class any member who requests exclusion, stating when and how members may elect to be excluded, and

• the binding effect of a class judgment on class members under Rule 23(c)(3).

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) Orders in Conduct of Actions. In the conduct of

actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) Settlement, Voluntary Dismissal, or Compromise.

(1)(A) The court must approve any settlement, voluntary dismissal, or compromise of the claims, issues, or defenses of a certified class.

(B) The court must direct notice in a reasonable manner to all class members who would be bound by a proposed settlement, voluntary dismissal, or compromise.

(C) The court may approve a settlement, voluntary dismissal, or compromise that would bind class members only after a hearing and on finding that the settlement, voluntary dismissal, or compromise is fair, reasonable, and adequate.

(2) The parties seeking approval of a settlement, voluntary dismissal, or compromise under Rule 23(e)(1) must file a statement identifying any agreement made in connection with the proposed settlement, voluntary dismissal, or compromise.

(3) In an action previously certified as a class action under Rule 23(b)(3), the court may refuse to approve a settlement unless it affords a new opportunity to request exclusion to individual class members who had an earlier opportunity to request exclusion but did not do so.

(4)(A) Any class member may object to a proposed settlement, voluntary dismissal, or compromise that requires court approval under Rule 23(e)(1)(A).

(B) An objection made under Rule 23(e)(4)(A) may be withdrawn only with the court's approval.

(f) Appeals. A court of appeals may in its discretion permit an appeal from an order of a district court granting or denying class action certification under this rule if application is made to it within ten days after entry of the order. An appeal does not stay proceedings in the district court unless the district judge or the court of appeals so orders.

(g) Class Counsel.

(1) Appointing Class Counsel.

(A) Unless a statute provides otherwise, a court that certifies a class must appoint class counsel.

(B) An attorney appointed to serve as class counsel must fairly and adequately represent the interests of the class.

(C) In appointing class counsel, the court

(i) must consider:

• the work counsel has done in identifying or investigating potential claims in the action,

• counsel's experience in handling class actions, other complex litigation, and claims of the type asserted in the action,

• counsel's knowledge of the applicable law, and

• the resources counsel will commit to representing the class;

(ii) may consider any other matter pertinent to counsel's ability to fairly and adequately represent the interests of the class;

(iii) may direct potential class counsel to provide information on any subject pertinent to the appointment and to propose terms for attorney fees and nontaxable costs; and

(iv) may make further orders in connection with the appointment.

(2) Appointment Procedure.

(A) The court may designate interim counsel to act on behalf of the putative class before determining whether to certify the action as a class action.

(B) When there is one applicant for appointment as class counsel, the court may appoint that applicant only if the applicant is adequate under Rule 23(g)(1)(B) and (C). If more than one adequate applicant seeks appointment as class counsel, the court must appoint the applicant best able to represent the interests of the class.

(C) The order appointing class counsel may include provisions about the award of attorney fees or nontaxable costs

under Rule 23(h).

(h) Attorney Fees Award. In an action certified as a class action, the court may award reasonable attorney fees and nontaxable costs authorized by law or by agreement of the parties as follows:

(1) Motion for Award of Attorney Fees. A claim for an award of attorney fees and nontaxable costs must be made by motion under Rule 54(d)(2), subject to the provisions of this subdivision, at a time set by the court. Notice of the motion must be served on all parties and, for motions by class counsel, directed to class members in a reasonable manner.

(2) Objections to Motion. A class member, or a party from whom payment is sought, may object to the motion.

(3) Hearing and Findings. The court may hold a hearing and must find the facts and state its conclusions of law on the motion under Rule 52(a).

(4) Reference to Special Master or Magistrate Judge. The court may refer issues related to the amount of the award to a special master or to a magistrate judge as provided in Rule 54(d)(2)(D).

APPENDIX B

The full text of the bill is as follows: **A BILL**

To amend the procedures that apply to consideration of interstate class actions to assure fairer outcomes for class members and defendants, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; REFERENCE; TABLE OF CONTENTS.

(a) SHORT TITLE- This Act may be cited as the 'Class Action Fairness Act of 2003'.

(b) REFERENCE- Whenever in this Act reference is made to an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of title 28, United States Code.

(c) TABLE OF CONTENTS- The table of contents for this Act is as follows:

Sec. 1. Short title; reference; table of contents.

Sec. 2. Findings and purposes.

Sec. 3. Consumer class action bill of rights and improved procedures for interstate class actions.

Sec. 4. Federal district court jurisdiction for interstate class actions.

Sec. 5. Removal of interstate class actions to Federal district court.

Sec. 6. Report on class action settlements.

Sec. 7. Effective date.

SEC. 2. FINDINGS AND PURPOSES.

(a) FINDINGS- Congress finds the following:

(1) Class action lawsuits are an important and valuable part of the legal system when they permit the fair and efficient resolution of legitimate claims of numerous parties by allowing the claims to be aggregated into a single action against a defendant that has allegedly caused harm.

(2) Over the past decade, there have been abuses of the class action device that have—

(A) harmed class members with legitimate claims and defendants that have acted responsibly;

(B) adversely affected interstate commerce; and

(C) undermined public respect for our judicial system.

(3) Class members often receive little or no benefit from class actions, and are sometimes harmed, such as where—

(A) counsel are awarded large fees, while leaving class members with coupons or other awards of little or no value;

(B) unjustified awards are made to certain plaintiffs at the expense of other class members; and

(C) confusing notices are published that prevent class members from being able to fully understand and effectively exercise their rights.

(4) Abuses in class actions undermine the national judicial system, the free flow of interstate commerce, and the concept of diversity jurisdiction as intended by the framers of the United States Constitution, in that State and local courts are—

(A) keeping cases of national importance out of Federal court;

(B) sometimes acting in ways that demonstrate bias against out-of-State defendants; and

(C) making judgments that impose their view of the law on other States and bind the rights of the residents of those States.

(b) PURPOSES- The purposes of this Act are to—

(1) assure fair and prompt recoveries for class members with legitimate claims;

(2) restore the intent of the framers of the United States Constitution by providing for Federal court consideration of interstate cases of national importance under diversity jurisdiction; and

(3) benefit society by encouraging innovation and lowering consumer prices.

SEC. 3. CONSUMER CLASS ACTION BILL OF RIGHTS AND IMPROVED PROCEDURES FOR INTERSTATE CLASS ACTIONS.

(a) IN GENERAL- Part V is amended by inserting after chapter 113 the following:

CHAPTER 114—CLASS ACTIONS

Sec.

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Sec. 1711. Definitions

In this chapter:

(1) CLASS- The term 'class' means all of the class members in a class action.

(2) CLASS ACTION- The term 'class action' means any civil action filed in a district court of the United States under rule 23 of the Federal Rules of Civil Procedure or any civil action that is removed to a district court of the United States that was originally filed under a State statute or rule of judicial procedure authorizing an action to be brought by 1 or more representatives as a class action.

(3) CLASS COUNSEL- The term 'class counsel' means the persons who serve as the attorneys for the class members in a proposed or certified class action.

(4) CLASS MEMBERS- The term 'class members' means the persons (named or unnamed) who fall within the definition of the proposed or certified class in a class action.

(5) PLAINTIFF CLASS ACTION- The term 'plaintiff class action' means a class action in which class members are plaintiffs.

(6) PROPOSED SETTLEMENT- The term 'proposed settlement' means an agreement regarding a class action that is subject to court approval and that, if approved, would be binding on some or all class members.

Sec. 1712. Judicial scrutiny of coupon and other noncash settlements

The court may approve a proposed settlement under which the class members would receive noncash benefits or would otherwise be required to expend funds in order to obtain part or all of the proposed benefits only after a hearing to determine whether, and making a written finding that, the settlement is fair, reasonable, and adequate for class members.

Sec. 1713. Protection against loss by class members

The court may approve a proposed settlement under which any class member is obligated to pay sums to class counsel that

would result in a net loss to the class member only if the court makes a written finding that nonmonetary benefits to the class member substantially outweigh the monetary loss.

Sec. 1714. Protection against discrimination based on geographic location

The court may not approve a proposed settlement that provides for the payment of greater sums to some class members than to others solely on the basis that the class members to whom the greater sums are to be paid are located in closer geographic proximity to the court.

Sec. 1715. Prohibition on the payment of bounties

(a) IN GENERAL- The court may not approve a proposed settlement that provides for the payment of a greater share of the award to a class representative serving on behalf of a class, on the basis of the formula for distribution to all other class members, than that awarded to the other class members.

(b) RULE OF CONSTRUCTION- The limitation in subsection (a) shall not be construed to prohibit a payment approved by the court for reasonable time or costs that a person was required to expend in fulfilling the obligations of that person as a class representative.

Sec. 1716. Clearer and simpler settlement information

(a) PLAIN ENGLISH REQUIREMENTS- Any court with jurisdiction over a plaintiff class action shall require that any written notice concerning a proposed settlement of the class action provided to the class through the mail or publication in printed media contain—

(1) at the beginning of such notice, a statement in 18-point or greater bold type, stating 'LEGAL NOTICE: YOU ARE A PLAINTIFF IN A CLASS ACTION LAWSUIT AND YOUR LEGAL RIGHTS ARE AFFECTED BY THE SETTLEMENT DESCRIBED IN THIS NOTICE.';

(2) a short summary written in plain, easily understood language, describing—

(A) the subject matter of the class action;

(B) the members of the class;

(C) the legal consequences of being a member of the class action;

(D) if the notice is informing class members of a proposed settlement agreement—

(i) the benefits that will accrue to the class due to the

settlement;

(ii) the rights that class members will lose or waive through the settlement;

(iii) obligations that will be imposed on the defendants by the settlement;

(iv) the dollar amount of any attorney's fee class counsel will be seeking, or if not possible, a good faith estimate of the dollar amount of any attorney's fee class counsel will be seeking; and

(v) an explanation of how any attorney's fee will be calculated and funded; and

(E) any other material matter.

(b) TABULAR FORMAT- Any court with jurisdiction over a plaintiff class action shall require that the information described in subsection (a)—

(1) be placed in a conspicuous and prominent location on the notice;

(2) contain clear and concise headings for each item of information; and

(3) provide a clear and concise form for stating each item of information required to be disclosed under each heading.

(c) TELEVISION OR RADIO NOTICE- Any notice provided through television or radio (including transmissions by cable or satellite) to inform the class members in a class action of the right of each member to be excluded from a class action or a proposed settlement, if such right exists, shall, in plain, easily understood language—

(1) describe the persons who may potentially become class members in the class action; and

(2) explain that the failure of a class member to exercise his or her right to be excluded from a class action will result in the person's inclusion in the class action.

Sec. 1717. Notifications to appropriate Federal and State officials

(a) DEFINITIONS-

(1) APPROPRIATE FEDERAL OFFICIAL- In this section, the term 'appropriate Federal official' means—

(A) the Attorney General of the United States; or

(B) in any case in which the defendant is a Federal depository institution, a State depository institution, a depository institution holding company, a foreign bank, or a nondepository

institution subsidiary of the foregoing (as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), the person who has the primary Federal regulatory or supervisory responsibility with respect to the defendant, if some or all of the matters alleged in the class action are subject to regulation or supervision by that person.

(2) APPROPRIATE STATE OFFICIAL- In this section, the term 'appropriate State official' means the person in the State who has the primary regulatory or supervisory responsibility with respect to the defendant, or who licenses or otherwise authorizes the defendant to conduct business in the State, if some or all of the matters alleged in the class action are subject to regulation by that person. If there is no primary regulator, supervisor, or licensing authority, or the matters alleged in the class action are not subject to regulation or supervision

by that person, then the appropriate State official shall be the State attorney general.

(b) IN GENERAL- Not later than 10 days after a proposed settlement of a class action is filed in court, each defendant that is participating in the proposed settlement shall serve upon the appropriate State official of each State in which a class member resides and the appropriate Federal official, a notice of the proposed settlement consisting of—

(1) a copy of the complaint and any materials filed with the complaint and any amended complaints (except such materials shall not be required to be served if such materials are made electronically available through the Internet and such service includes notice of how to electronically access such material);

(2) notice of any scheduled judicial hearing in the class action;

(3) any proposed or final notification to class members of—

(A)(i) the members' rights to request exclusion from the class action; or

(ii) if no right to request exclusion exists, a statement that no such right exists; and

(B) a proposed settlement of a class action;

(4) any proposed or final class action settlement;

(5) any settlement or other agreement contemporaneously made between class counsel and counsel for the defendants;

(6) any final judgment or notice of dismissal;

(7)(A) if feasible, the names of class members who reside in each State and the estimated proportionate share of the claims of such members to the entire settlement to that State's appropriate State official; or

(B) if the provision of information under subparagraph (A) is not feasible, a reasonable estimate of the number of class members residing in each State and the estimated proportionate share of the claims of such members to the entire settlement; and

(8) any written judicial opinion relating to the materials described under subparagraphs (3) through (6).

(c) DEPOSITORY INSTITUTIONS NOTIFICATION-

(1) FEDERAL AND OTHER DEPOSITORY INSTITUTIONS- In any case in which the defendant is a Federal depository institution, a depository institution holding company, a foreign bank, or a non-depository institution subsidiary of the foregoing, the notice requirements of this section are satisfied by serving the notice required under subsection (b) upon the person who has the primary Federal regulatory or supervisory responsibility with respect to the defendant, if some or all of the matters alleged in the class action are subject to regulation or supervision by that person.

(2) STATE DEPOSITORY INSTITUTIONS- In any case in which the defendant is a State depository institution (as that term is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), the notice requirements of this section are satisfied by serving the notice required under subsection (b) upon the State bank supervisor (as that term is defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) of the State in which the defendant is incorporated or chartered, if some or all of the matters alleged in the class action are subject to regulation or supervision by that person, and upon the appropriate Federal official.

(d) FINAL APPROVAL- An order giving final approval of a proposed settlement may not be issued earlier than 90 days after the later of the dates on which the appropriate Federal official and the appropriate State official are served with the notice required under subsection (b).

(e) NONCOMPLIANCE IF NOTICE NOT PROVIDED-

(1) IN GENERAL- A class member may refuse to comply with and may choose not to be bound by a settlement agreement or consent decree in a class action if the class member demonstrates that the notice required under subsection (b) has not been provided.

(2) LIMITATION- A class member may not refuse to comply with or to be bound by a settlement agreement or consent decree under paragraph (1) if the notice required under subsection (b) was directed to the appropriate Federal official and to either the State attorney general or the person that has primary regulatory, supervisory, or licensing authority over the defendant.

(3) APPLICATION OF RIGHTS- The rights created by this subsection shall apply only to class members or any person acting on a class member's behalf, and shall not be construed to limit any other rights affecting a class member's participation in the settlement.

(f) RULE OF CONSTRUCTION- Nothing in this section shall be construed to expand the authority of, or impose any obligations, duties, or responsibilities upon, Federal or State officials.'.

(b) TECHNICAL AND CONFORMING AMENDMENT- The table of chapters for part V is amended by inserting after the item relating to chapter 113 the following:

1711.

SEC. 4. FEDERAL DISTRICT COURT JURISDICTION FOR INTERSTATE CLASS ACTIONS.

(a) APPLICATION OF FEDERAL DIVERSITY JURISDICTION- Section 1332 is amended—

(1) by redesignating subsection (d) as subsection (e); and

(2) by inserting after subsection (c) the following:

(d)(1) In this subsection—

(A) the term 'class' means all of the class members in a class action;

(B) the term 'class action' means any civil action filed under rule 23 of the Federal Rules of Civil Procedure or similar State statute or rule of judicial procedure authorizing an action to be brought by 1 or more representative persons as a class action;

(C) the term 'class certification order' means an order issued by a court approving the treatment

of some or all aspects of a civil action as a class action; and

(D) the term 'class members' means the persons (named or unnamed) who fall within the definition of the proposed or certified class in a class action.

(2) The district courts shall have original jurisdiction of any civil action in which the matter in controversy exceeds the sum or value of $2,000,000, exclusive of interest and costs, and is a

class action in which—

(A) any member of a class of plaintiffs is a citizen of a State different from any defendant;

(B) any member of a class of plaintiffs is a foreign state or a citizen or subject of a foreign state and any defendant is a citizen of a State; or

(C) any member of a class of plaintiffs is a citizen of a State and any defendant is a foreign state or a citizen or subject of a foreign state.

(3) Paragraph (2) shall not apply to any civil action in which—

(A)(i) the substantial majority of the members of the proposed plaintiff class and the primary defendants are citizens of the State in which the action was originally filed; and

(ii) the claims asserted therein will be governed primarily by the laws of the State in which the action was originally filed;

(B) the primary defendants are States, State officials, or other governmental entities against whom the district court may be foreclosed from ordering relief; or

(C) the number of members of all proposed plaintiff classes in the aggregate is less than 100.

(4) In any class action, the claims of the individual class members shall be aggregated to determine whether the matter in controversy exceeds the sum or value of $2,000,000, exclusive of interest and costs.

(5) This subsection shall apply to any class action before or after the entry of a class certification order by the court with respect to that action.

(6)(A) A district court shall dismiss any civil action that is subject to the jurisdiction of the court solely under this subsection if the court determines the action may not proceed as a class action based on a failure to satisfy the prerequisites of rule 23 of the Federal Rules of Civil Procedure.

(B) Nothing in subparagraph (A) shall prohibit plaintiffs from filing an amended class action in Federal court or filing an action in State court, except that any such action filed in State court may be removed to the appropriate district court if it is an action of which the district courts of the United States have original jurisdiction.

(C) In any action that is dismissed under this paragraph and is filed by any of the original named plaintiffs therein in the same State court venue in which the dismissed action was

originally filed, the limitations periods on all reasserted claims shall be deemed tolled for the period during which the dismissed class action was pending. The limitations periods on any claims that were asserted in a class action dismissed under this paragraph that are subsequently asserted in an individual action shall be deemed tolled for the period during which the dismissed action was pending.

(7) Paragraph (2) shall not apply to any class action that solely involves a claim—

(A) concerning a covered security as defined under 16(f)(3) of the Securities Act of 1933 and section 28(f)(5)(E) of the Securities Exchange Act of 1934;

(B) that relates to the internal affairs or governance of a corporation or other form of business enterprise and that arises under or by virtue of the laws of the State in which such corporation or business enterprise is incorporated or organized; or

(C) that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security (as defined under section 2(a)(1) of the Securities Act of 1933 and the regulations issued thereunder).

(8) For purposes of this subsection and section 1453 of this title, an unincorporated association shall be deemed to be a citizen of the State where it has its principal place of business and the State under whose laws it is organized.

(9)(A) For purposes of this section and section 1453 of this title, a civil action that is not otherwise a class action as defined in paragraph (1)(B) shall nevertheless be deemed a class action if—

(i) the named plaintiff purports to act for the interests of its members (who are not named parties to the action) or for the interests of the general public, seeks a remedy of damages, restitution, disgorgement, or any other form of monetary relief, and is not a State attorney general; or

(ii) monetary relief claims in the action are proposed to be tried jointly in any respect with the claims of 100 or more other persons on the ground that the claims involve common questions of law or fact.

(B)(i) In any civil action described under subparagraph (A)(ii), the persons who allegedly were injured shall be treated as members of a proposed plaintiff class and the monetary relief that is sought shall be treated as the claims of individual class members.

(ii) Paragraphs (3) and (6) of this subsection and subsections (b)(2) and (d) of section 1453 shall not apply to any civil action described under subparagraph (A)(i).

(iii) Paragraph (6) of this subsection, and subsections (b)(2) and (d) of section 1453 shall not apply to any civil action described under subparagraph (A)(ii).'.

(b) CONFORMING AMENDMENTS-

(1) Section 1335(a)(1) is amended by inserting '(a) or (d)' after '1332'.

(2) Section 1603(b)(3) is amended by striking '(d)' and inserting '(e)'.

SEC. 5. REMOVAL OF INTERSTATE CLASS ACTIONS TO FEDERAL DISTRICT COURT.

(a) IN GENERAL- Chapter 89 is amended by adding after section 1452 the following:

'Sec. 1453. Removal of class actions

(a) DEFINITIONS- In this section, the terms 'class', 'class action', 'class certification order', and 'class member' shall have the meanings given such terms under section 1332(d)(1).

(b) IN GENERAL- A class action may be removed to a district court of the United States in accordance with this chapter, without regard to whether any defendant is a citizen of the State in which the action is brought, except that such action may be removed—

(1) by any defendant without the consent of all defendants; or

(2) by any plaintiff class member who is not a named or representative class member without the consent of all members of such class.

(c) WHEN REMOVABLE- This section shall apply to any class action before or after the entry of a class certification order in the action.

(d) PROCEDURE FOR REMOVAL- Section 1446 relating to a defendant removing a case shall apply to a plaintiff removing a case under this section, except that in the application of subsection (b) of such section the requirement relating to the 30-day filing period shall be met if a plaintiff class member files notice of removal within 30 days after receipt by such class member, through service or otherwise, of the initial written notice of the class action.

(e) REVIEW OF ORDERS REMANDING CLASS ACTIONS

TO STATE COURTS- Section 1447 shall apply to any removal of a case under this section, except that notwithstanding section 1447(d), an order remanding a class action to the State court from which it was removed shall be reviewable by appeal or otherwise.

(f) EXCEPTION- This section shall not apply to any class action that solely involves—

(1) a claim concerning a covered security as defined under section 16(f)(3) of the Securities Act of 1933 and section 28(f)(5)(E) of the Securities Exchange Act of 1934;

(2) a claim that relates to the internal affairs or governance of a corporation or other form of business enterprise and arises under or by virtue of the laws of the State in which such corporation or business enterprise is incorporated or organized; or

(3) a claim that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security (as defined under section 2(a)(1) of the Securities Act of 1933 and the regulations issued thereunder).'.

(b) REMOVAL LIMITATION- Section 1446(b) is amended in the second sentence by inserting '(a)' after 'section 1332'.

(c) TECHNICAL AND CONFORMING AMENDMENTS- The table of sections for chapter 89 is amended by adding after the item relating to section 1452 the following:

'1453. Removal of class actions.'.

SEC. 6. REPORT ON CLASS ACTION SETTLEMENTS.

(a) IN GENERAL- Not later than 12 months after the date of enactment of this Act, the Judicial Conference of the United States, with the assistance of the Director of the Federal Judicial Center and the Director of the Administrative Office of the United States Courts, shall prepare and transmit to the Committees on the Judiciary of the Senate and the House of Representatives a report on class action settlements.

(b) CONTENT- The report under subsection (a) shall contain—

(1) recommendations on the best practices that courts can use to ensure that proposed class action settlements are fair to the class members that the settlements are supposed to benefit;

(2) recommendations on the best practices that courts can use to ensure that—

(A) the fees and expenses awarded to counsel in connection with a class action settlement appropriately reflect the extent to which counsel succeeded in obtaining full redress for the injuries alleged and the time, expense, and risk that counsel devoted to the litigation; and

(B) the class members on whose behalf the settlement is proposed are the primary beneficiaries of the settlement; and

(3) the actions that the Judicial Conference of the United States has taken and intends to take toward having the Federal judiciary implement any or all of the recommendations contained in the report.

(c) AUTHORITY OF FEDERAL COURTS- Nothing in this section shall be construed to alter the authority of the Federal courts to supervise attorneys' fees.

SEC. 7. EFFECTIVE DATE.

The amendments made by this Act shall apply to any civil action commenced on or after the date of enactment of this Act.

Obesity Liability: A Super-Sized Problem or a Small Fry in the Inevitable Development of Product Liability?

Samuel J. Romero[*]

"It would be safer if they told their children, 'Go out and play in traffic.'"[1]

I. INTRODUCTION

For most of us, food is the ultimate temptation. It has been since Biblical times, when Adam and Eve succumbed to the temptation of a forbidden fruit. According to Christian tradition, man remains personally responsible for Adam's act of eating forbidden fruit with the knowledge that it was forbidden.[2] In the past few years, several federal and state courts have been asked to adjudicate who should be held responsible—fast-food restaurants or their consumers—for the health problems that result from restaurants' success in tempting consumers to eat their products.[3] The fast-food restaurants insist they should not be held responsible when their customers choose to consume these food products knowing the products could contribute to obesity.[4] Nevertheless, some consumer advocates believe that

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1 Irvin Molotsky, *Risk Seen in Saturated Fats Used in Fast Foods*, N.Y. TIMES, Nov. 15, 1985, at A20 (quoting Dr. Tazewell Banks, director of a heart program at D.C. General Hospital, on the subject of parents who allow their children to eat foods rich in unsaturated fats at fast-food restaurants).

2 *Romans* 5:12-21.

3 *See, e.g.,* Pelman v. McDonald's Corp., 237 F. Supp. 2d 512 (S.D.N.Y. 2003); Nathan K. Bierma, *Food Industry Cooks up Ways to Stymie Suits*, CHI. TRIB., Aug. 15, 2003, § 5, at 1 (discussing the food industry's response to seven obesity suits); Geraldine Sealey, *Whopper of a Lawsuit: Fast-Food Chains Blamed for Obesity, Illnesses* (describing a lawsuit brought by a 270-pound man against McDonald's and three other fast-food restaurant chains), http://abcnews.go.com/sections/us/DailyNews/fatsuit020725.html (July 26, 2002).

4 Press Release, National Restaurant Association, National Restaurant Association Supports Prevention of Abusive Lawsuits Against Food Industry (Jan. 28, 2003) ("Experts

these restaurants should be held responsible for the negative health effects these products create, especially when the negative effects impact children.[5]

Plaintiffs suing the fast-food industry for causing consumer obesity have been unsuccessful in the courts.[6] For example, on January 22, 2003, a New York federal district court dismissed "obesity" claims against McDonald's by the guardians of two obese children, stating:

> [L]egal consequences should not attach to the consumption of hamburgers and other fast-food fare unless consumers are unaware of the dangers of eating such food . . . . If consumers know (or reasonably should know) the potential ill health effects of eating at McDonalds, they cannot blame McDonalds if they, nonetheless, choose to satiate their appetite with a surfeit of supersized McDonalds products.[7]

The court dismissed the complaint with leave to amend.[8] Nine months later, after the plaintiffs had amended their complaint, the court determined that there was again insufficient evidence to resist McDonald's motion to dismiss.[9] The district court's final dismissal without leave to amend constituted the first substantive defeat of the nascent campaign against the fast-food industry's promotion of obesity.

Obesity is a costly reality of American life.[10] In 2001, the Surgeon General described obesity as having "reached epidemic

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agree that all food can be part of a healthy diet and maintaining a healthy lifestyle is more about balancing energy in and energy out, not chastising some of America's favorite foods. Restaurants should not and will not be blamed for issues of personal responsibility and freedom of choice."), http://www.restaurant.org/pressroom/print/index.cfm?ID=549.

5 Bierma, *supra* note 3. San Francisco attorney Stephen Joseph, who sued Kraft successfully for failing to disclose the danger of trans fats in Oreos, discussed the potential for litigation involving child plaintiffs. Mr. Joseph stated, "'Should adults be suing because of obesity? No. In cases regarding children? There are certainly good arguments of liability in some situations.'" *Id*. Even 2004 Democratic Presidential candidate Senator Joe Lieberman has supported the idea that children should be protected from the marketing practices of the fast-food companies. Ira Teinowitz, *Lieberman on Attack Against Fast-Food Ads*, ADVERTISING AGE, Dec. 8, 2003, at 4.

6 Bierma, *supra* note 3. "[N]one of the estimated seven obesity lawsuits nationwide has gained a major victory for plaintiffs . . . ." *Id*. On the other hand, success is not always measured by wins and losses in the court. Consumer advocates also claim success if they can point to changed behavior in the food industry. *See id*. (positing that the threat of litigation may change behavior).

7 *Pelman*, 237 F. Supp. 2d at 517-18, 543.

8 *Id*. at 543.

9 Pelman v. McDonald's Corp., No. 02 Civ. 7821, 2003 WL 22052778, at *14-15 (S.D.N.Y. Sept. 3, 2003).

10 *See* Marion Nestle & Michael F. Jacobson, *Halting the Obesity Epidemic: A Public Health Policy Approach*, 115 PUB. HEALTH REP. 12 (2000) (discussing the effects of obesity and arguing for increased attention to preventative measures); Anne M. Wolf, *The Health Economics of Obesity and Weight Loss*, *in* EATING DISORDERS AND OBESITY: A COMPREHENSIVE HANDBOOK 453 (Christopher G. Fairburn & Kelly D. Brownell eds., 2d ed. 2002) (comparing the economic impact of obesity to that of smoking).

proportions in the United States."[11] He associated 300,000 deaths a year to obesity and warned that if "[l]eft unabated, . . . obesity may soon cause as much preventable disease and death as cigarette smoking."[12] In 2004, his estimates were validated by a study published in the Journal of the American Medical Association on the causes of death in the year 2000. The study found that 400,000 deaths were attributable to obesity and 435,000 were attributable to smoking.[13] The study also estimated that, absent a sudden reversal in the overweight trend, obesity will soon overtake tobacco as the leading cause of death in the United States.[14] Death, however, is not the only cost of obesity. The Surgeon General estimated direct and indirect costs of obesity at approximately $117 billion a year.[15] Thus, most experts agree that the expenses and consequences linked to obesity are significant.

Therefore, the crux of the current debate on obesity is how to assign responsibility for the great harm it causes. Consumer advocates argue that individuals should not be assigned responsibility when their outside environment may be the determining factor that caused their obesity.[16] The argument is set out by Yale psychology professor Dr. Kelly Brownell, who boldly asserted that "[i]n the absence of a 'toxic' food and physical activity environment, there would be virtually no obesity."[17] Dr. Brownell claims that genetic predisposition to obesity is not the cause of obesity. "[I]t is clear that genetics may *permit* obesity to occur but a 'toxic' environment *causes* it to occur."[18] Dr. Brownell cites a report as authoritative from the Institute of Medicine which concludes:

11 David Satcher, *Foreword* to OFF. OF THE SURGEON GEN., U.S. DEP'T OF HEALTH AND HUMAN SERVS., THE SURGEON GENERAL'S CALL TO ACTION TO PREVENT AND DECREASE OVERWEIGHT AND OBESITY 2001, at XIII (2001). *But see* Jerome P. Kassirer & Marcia Angell, *Losing Weight—An Ill-Fated New Year's Resolution*, 338 NEW ENG. J. MED. 52, 52 (1998) (arguing that the estimate of 300,000 deaths per year in the United States caused by obesity is not well established and that it may be "called into question by methodologic difficulties").

12 Satcher, *supra* note 11, at XIII.

13 Ali H. Mokdad et al., *Actual Causes of Death in the United States, 2000*, 291 JAMA 1238, 1238-40 (2004).

14 *Id*. at 1242.

15 OFFICE OF THE SURGEON GEN., U.S. DEP'T OF HEALTH AND HUMAN SERVS., THE SURGEON GENERAL'S CALL TO ACTION TO PREVENT AND DECREASE OVERWEIGHT AND OBESITY 2001, at 10 (2001).

16 For example, Ralph Nader likened cheeseburgers to weapons of mass destruction. David Wallis, *Questions for Ralph Nader: Give Them the Business*, N.Y. TIMES, June 16, 2002, § 6 (Magazine), at 13.

17 Kelly D. Brownell, *The Environment and Obesity*, *in* EATING DISORDERS AND OBESITY: A COMPREHENSIVE HANDBOOK 433, 433 (Christopher G. Fairburn & Kelly D. Brownell eds., 2d ed. 2002).

18 *Id*. at 434 (emphasis added).

> Although it is clear that genetics has a modest influence on obesity on a population basis, by far the largest amount of variance in body weight is due to environmental influences . . . . The root of the problem, therefore, must lie in the powerful social and cultural forces that promote an energy-rich diet and a sedentary lifestyle.[19]

Ultimately, Dr. Brownell identifies two aspects of the American "toxic" environment that cause obesity. First, he faults the food industry for promoting over-consumption of inexpensive, unhealthful food.[20] Second, he cites American environmental factors that cause declining physical activity.[21] The former cause is the issue that has recently been litigated in the courts.

The criticism of the American food industry's contribution to an environment that promotes obesity is multifaceted. Nutritional experts have criticized the industry for influencing dietary and nutritional guidelines.[22] Powerful lobbies have resisted efforts to clarify nutritional messages sent to the public that encourage them to limit sugars and fatty foods.[23] The food industry has "use[d] every means at their disposal—legal, regulatory, and societal—to create and protect an environment that is conducive to selling their products in a competitive marketplace."[24] This influence has resulted in an environment in which food advertising disproportionately promotes unhealthful products.[25] Finally, the food industry has aggressively marketed fast-food products to children, the most vulnerable segment of society.[26]

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19 *Id.*; COMM. TO DEVELOP CRITERIA FOR EVALUATING THE OUTCOMES OF APPROACHES TO PREVENT & TREAT OBESITY, INST. OF MED., WEIGHING THE OPTIONS: CRITERIA FOR EVALUATING WEIGHT-MANAGEMENT PROGRAMS 53, 152 (Paul R. Thomas ed., 1995).

20 Brownell, *supra* note 17, at 434, 436.

21 *Id.* at 436-37.

22 *E.g.*, MARION NESTLE, FOOD POLITICS: HOW THE FOOD INDUSTRY INFLUENCES NUTRITION AND HEALTH 67-92 (2002).

23 *Id.*

24 *Id.* at 93.

25 *See* Brownell, *supra* note 17, at 434.

> The yearly marketing budget of McDonald's is $1.1 billion, and of Coca-Cola, $866 million, and these are just two companies. The budget of the National Cancer Institute to promote healthy eating is $1 million. Advertising for healthy [sic] foods versus that for fast foods, soft drinks, and so on, is a drop against a tidal wave. It is not a fair contest, and the outcome, a world with diets growing rapidly worse, cannot be considered surprising.

Id.

26 *Id.* at 436; NESTLE, *supra* note 22, at 173-218. The fast-food industry has overtly targeted children. Justice Clarence Thomas took notice of this tactic as recently as three years ago by noting that the fast-food inudstry targeted children openly with success.

> Although the growth of obesity over the last few decades has had many causes, a significant factor has been the increased availability of large quantities of high-calorie, high-fat foods. . . . Such foods, of course, have been aggressively

For the past few years, legal commentators have suggested that the many similarities between the tobacco and the fast-food industry would eventually expose the fast-food industry to liability.[27] They have identified several product liability theories that could be available to hold the fast-food industry responsible for causing obesity.[28] Meanwhile, in 2003 and 2004, Congress debated whether the fast-food industry should be protected from liability and proposed bills limiting the food industry's liability for causing obesity.[29] One of these bills, the Personal Responsibility in Food Consumption Act, has passed the House and awaits action by the Senate.[30] So, the question remains, can obesity lawsuits be successful, and, if so, should the fast-food industry be protected from liability? Given the bills' current status in Congress, the question of liability remains viable, but the potential causes of action are undetermined.

This comment explores the doctrinal basis for product liability for food that causes obesity. Part II provides a brief history of product liability. Part III discusses the recent litigation with McDonald's. Part IV explores the causes of action that may be brought against the fast-food industry and the individual potential for success of each. It also considers the barriers consumer advocates must overcome to hold the fast-food industry liable for causing obesity using any of these causes of action. Part V discusses the potential public policy implications of a law like that proposed by the Personal Responsibility in Food Consumption Act. Finally, this comment concludes that the food industry should not be exempted from liability by further Congressional action. An exemption will not benefit the industry, while the threat of liability benefits both the industry (by maintaining an environment with sufficient flexibility for the success of the fast-food industry) and society (by providing the impetus to fashion a remedy for this serious health problem).

> marketed and promoted by fast food companies. . . . Moreover, there is considerable evidence that they have been successful in changing children's eating behavior.

Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 587-88 (2001)(Thomas, J. concurring).

27 John Alan Cohan, *Obesity, Public Policy, and Tort Claims Against Fast-Food Companies*, 12 WIDENER L.J. 103, 110-16 (2003); Franklin E. Crawford, *Fit for Its Ordinary Purpose? Tobacco, Fast Food, and the Implied Warranty of Merchantability*, 63 OHIO ST. L.J. 1165, 1217-23 (2002).

28 *See* Cohan, *supra* note 27, at 126-28; Crawford, *supra* note 27, at 1223.

29 Commonsense Consumption Act of 2003, S. 1428, 108th Cong. (2003); Personal Responsibility in Food Consumption Act, H.R. 339, 108th Cong. (2003); Small Business Liability Reform Act of 2003, H.R. 2813, 108th Cong. (2003).

30 The Personal Responsibility in Food Consumption Act was passed on March 10, 2003 by a vote of 276 to 139. *Final Vote Results for Roll Call 54*, http://clerk.house.gov/evs/2004/roll054.xml (last visited Apr. 5, 2004).

II. A BRIEF HISTORY OF PRODUCT LIABILITY

Product liability law is of relatively recent origin. One hundred years ago, consumers suing to recover damages caused by a defective product could recover only if they could prove the manufacturer was negligent and that they were in privity (i.e., they had personally purchased the product). In the landmark case of *MacPherson v. Buick Motor Co.*, then Judge Benjamin Cardozo of the New York Court of Appeals revolutionized product liability by substantially abolishing the privity rule when danger was foreseeable.[31] *MacPherson* established that privity was not determinative of liability when there was negligence. According to Judge Cardozo, "If [the manufacturer] is negligent, where danger is to be foreseen, a liability will follow."[32] In addition, Judge Cardozo expanded product liability beyond the limitations imposed by contracts and based it on public policy.[33]

Over the next forty years, courts further dissolved the contract limitations placed on product liability. No longer relying on express warranties, the courts allowed non-privity plaintiffs to recover on implied warranty claims. In the case of *Henningsen v. Bloomfield Motors, Inc.*, the court held manufacturers strictly liable under an "implied warranty that [the product] is reasonably suitable for use as such accompanies it into the hands of the ultimate purchaser."[34] Under this theory, consumers were protected from defective products that did not meet their expectations.

Subsequently, many courts began interpreting product liability in terms of strict liability in tort rather than in the contract theory of implied warranty.[35] Dean William L. Prosser had a significant role in effecting this change by drafting section

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31 111 N.E. 1050, 1053 (N.Y. 1916). *MacPherson* involved a lawsuit against Buick for negligence in purchasing defective wheels which caused the plaintiff's accident. The plaintiff was not in privity because he purchased his Buick from a dealer rather than from a manufacturer. *Id.*; CARL T. BOGUS, WHY LAWSUITS ARE GOOD FOR AMERICA: DISCIPLINED DEMOCRACY, BIG BUSINESS, AND THE COMMON LAW 173-84 (2001) (giving a brief but insightful description of the *MacPherson* case).

32 *MacPherson*, 111 N.E. at 1053.

33 *Id.* "We have put aside the notion that the duty to safeguard life and limb . . . grows out of contract and nothing else. We have put the source of the obligation where it ought to be. We have put its source in the law." *Id.* *See also* BOGUS, *supra* note 31, at 184.

34 161 A.2d 69, 84 (N.J. 1960). *Henningsen* involves the sale of a new Plymouth sedan that was driven for less than 500 miles before it inexplicably veered into a wall after an apparent failure of the steering mechanism. Although the contract contained warranty disclaimers and clauses indicating that the contract was the entire agreement, the court found the defendant liable under an implied warranty theory rather than negligence because the car had been so badly damaged that it was impossible to determine if the manufacturer had been negligent. *Id.* at 73-75, 84.

35 BOGUS, *supra* note 31, at 185.

402A of the Restatement (Second) of Torts.[36] Section 402A stated in part: "One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused . . . ."[37] In essence, section 402A abolished privity and made manufacturers liable for physical injuries caused by their defective products regardless of fault.[38] Courts rationalized this change by emphasizing three theories—manufacturers could be held liable because they were enterprises that could: spread costs of liability, be encouraged to make safer products, and be held responsible because they had represented their products as safe.[39]

As section 402A became accepted, courts assigned manufacturer liability for three types of defects: "(1) manufacturing defects or production flaws, (2) design defects, and (3) information or warning defects."[40] The first type of defect, manufacturing, is the result of "flaws or irregularities in products arising from errors in production."[41] The seller is subject to liability if the "product's condition is dangerous in a manner not intended by the seller nor expected by the consumer."[42] An example of a manufacturing defect is the Bridgestone/Firestone tire failures on Ford Explorers that "probably resulted in part from various irregularities in the production process."[43] The second type of defect, design, "occurs when the intended design of the product line itself is inadequate and needlessly dangerous."[44] The seller is liable for products with design defects because there is "an unreasonably dangerous aspect or feature of the product."[45] The quintessential example of a design flaw is Ford's infamous exploding Pintos with

36 *Id*. at 186. "This *Restatement* section was to be cited in more than three thousand court opinions and, in one fashion or another, to become accepted by every American jurisdiction." *Id*. at 185.

37 RESTATEMENT (SECOND) OF TORTS § 402A (1965).

38 DAN B. DOBBS, THE LAW OF TORTS § 353, at 974-75 (2000).

39 *Id*. at 975-76.

40 *Id*. § 354, at 979.

41 David G. Owen, *Manufacturing Defects*, 53 S.C. L. REV. 851, 852 (2002).

42 *Id*. at 893.

43 *Id*. at 852-53 & n.6. *See also In re* Bridgestone/Firestone, Inc., 288 F.3d 1012, 1018 (7th Cir. 2002) (holding that a tire products liability action was not manageable as a nationwide class action); *In re* Bridgeston/Firestone, Inc., 190 F. Supp. 2d 1125, 1156 (S.D. Ind. 2002) (refusing to dismiss a product liability suit on forum non conveniens grounds brough by victims of vehicular accidents in Venezuela and Columbia). *See generally* Public Citizen and Safetyforum.com, *Spinning Their Wheels: How Ford and Firestone Fail to Justify the Limited Tire Recall* (providing background information on the dispute), http://www.citizen.org/documents/ACF266.pdf (last visited May 29, 2004).

44 DOBBS, *supra* note 38, § 355, at 980.

45 Bogus, *supra* note 31, at 193.

unprotected rear gas tanks.[46] Liability is extended to protect society from the harmful effects of the unsafe features of these products. Finally, warning defects occur when products become unreasonably dangerous because "no information explains their use or warns of their dangers."[47] Liability is extended to manufacturers because these products could be reasonably safe if accompanied by adequate information or warnings.[48] For example, a company may not manufacture full strength glucose in a bottle without a warning to parents to dilute the product because it is dangerous to babies without dilution.[49]

In 1998, the American Law Institute promulgated the Products Liabilities section of the Restatement (Third) of Torts, which clearly defined these three types of defects.[50] In addition, it rejected the use of a "consumer expectation" test as the standard for determining design defectiveness except in cases involving food products.[51] Instead, the risk-utility test was adopted,[52] which requires courts to "attempt to balance the risks of the product as designed against the costs of making the product safer."[53] When applying this test, courts often refer to the following seven factors listed by Dean John Wade:

> (1) The usefulness and desirability of the product . . . . (2) The safety aspects of the product – the likelihood that it will cause injury, and the probable seriousness of the injury. (3) The availability of a substitute product . . . . (4) The manufacturer's ability to eliminate the unsafe character of the product . . . . (5) The user's ability to avoid danger by the exercise of care . . . . (6) The user's anticipated awareness of the dangers inherent in the product and their avoidability . . . . (7) The feasibility, on the part of the manufacturer, of spreading the loss . . . .[54]

Because these factors so closely resemble negligence, product liability for design defects is often considered to be equivalent to liability for negligence.[55]

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46 *Id*. at 190-93; Grimshaw v. Ford Motor Co. 174 Cal. Rptr. 348 (Cal. Ct. App. 1981).

47 DOBBS, *supra* note 38, § 355, at 981.

48 *Id*.

49 *Id*.; Ross Labs. v. Thies, 725 P.2d 1076 (Alaska 1986).

50 RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 2.

51 *Id*. § 2 cmt. g. "With regard to two special product categories [food products and used products] consumer expectations play a special role in determining product defect." *Id*. § 2 cmt. h.

52 RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 2 cmt. a.

53 DOBBS, *supra* note 38, § 357, at 985.

54 John W. Wade, *On the Nature of Strict Tort Liability for Products*, 44 MISS. L. REV. 825, 837 (1973).

55 DOBBS, *supra* note 38, § 357, at 986-87.

Finally, one commentator argues that we are now reaching a new level of product liability called *generic liability* or *product category liability*.[56] *Generic product liability* results "[w]hen a product remains unreasonably dangerous despite the best possible design, construction, and warnings."[57] Because the product "generically fail[s] a risk-utility test," the manufacturer is made liable because the product's risks outweigh its benefits.[58] The commentator asserts that liability imposed on gun and tobacco manufacturers falls under this concept.[59]

This brief history demonstrates the breadth of perspectives that must be brought to a discussion of product liability for fast food. As noted above, product liability involves elements of contract, intentional torts, negligence, strict tort liability, and public policy. The following analysis of fast-food litigation explores the McDonald's litigation within this context and then extends that analysis to future cases.

III. MCDONALD'S LITIGATION

In August 2002, McDonald's Corporation was sued in the Supreme Court of New York, Bronx County, by the parents of two overweight children.[60] The parents claimed their children were "consumers who [had] purchased and consumed [McDonald's] products and, as a result thereof, [had] become overweight and [had] developed diabetes, coronary heart disease, . . . and/or other detrimental and adverse health effects as a result of the [McDonald's] conduct and business practices."[61] McDonald's removed the action to federal court and then filed a motion to dismiss the complaint for failure to state a claim.[62]

A. First Motion to Dismiss Complaint

The individual counts against McDonald's were a mixture of both intentional and negligent torts. The first two counts were for intentionally violating the New York Consumer Protection Act (New York Gen. Bus. Law sections 349 and 350) among other statutes.[63] Count one alleged that McDonald's misled its customers in marketing campaigns by representing their products as nutritious and by not disclosing both their

56 BOGUS, *supra* note 31, at 193-96.
57 *Id*. at 195.
58 *Id*.
59 *Id*. at 195-96.
60 Pelman v. McDonald's Corp., 237 F. Supp. 2d. 512, 519 (S.D.N.Y. 2003).
61 *Id*.
62 *Id*.
63 *Id*. at 520.

ingredients (products high in cholesterol, fat, salt and sugar) and the detrimental effects of these ingredients.[64] Count two alleged that McDonald's also used these same deceptive marketing techniques to target children.[65] The third and fifth counts were based on negligence. Count three alleged negligence for selling products causing obesity, and count five alleged McDonald's negligently marketed addictive food products.[66] Finally, count four was based on an allegation that McDonald's failed to warn of the addictive properties of its foods.[67]

As to the first two counts, McDonald's argued that, because the Nutrition Labeling and Education Act of 1990 ("NLEA") exempts the restaurant industry from federal labeling requirements, McDonald's could not be held liable under New York state law for their failure to provide nutritional information.[68] Under the NLEA, most packaged foods must be labeled with nutritional information.[69] Thus, most food manufacturing industries are protected against claims that a food product caused their obesity because consumers had an explicit warning of the content of the food they ate. Restaurants, on the other hand, are specifically exempt from such labeling requirements.[70] Therefore, McDonald's argument runs, federal

64 *Id*.

65 *Pelman*, 237 F. Supp. 2d at 520.

66 *Id*.

67 *Id*.

68 *Id*. at 525-26. *See also* 21 U.S.C. § 343(q) (2003).

69 21 U.S.C. § 343(q)(1).

70 21 U.S.C. § 343(q)(5)(A)(i). The pre-exemption statute, 21 U.S.C. 343-1(a)(4), requires that the states not interfere directly or indirectly with the federal laws and regulations dealing with nutritional labeling of packaged food. Yet, the statute also allows the states to establish whatever nutritional labeling requirements they wish for those foods exempt under the act; in our case, restaurant food. The preemption section also applies to nutrient and health claims made by restaurants. Any cause of action based on a nutrient or health claim should have been preempted. According to the Code of Federal Regulations:

> [t]he following foods are exempt from this section . . . (2) Food products which are: (i) served in restaurants, *Provided*, That the food bears no nutrition claims or other nutrition information in any context on the label or in labeling or advertising. Claims or other nutrition subject the food to the provisions of this section.

Nutrition Labeling of Food, 21 C.F.R. § 101.9(j) (2003). The court later addresses a potential claim that customers could maintain a well-balanced diet eating at McDonald's everyday. If interpreted as a health claim, this claim *should have been preempted.* The court's citation to the Federal Register indicating states were allowed to regulate "under their own consumer protection laws . . . menus [from] provid[ing] false or misleading information" was true but slightly misleading. *Pelman*, at 526 (citing Food Labeling; General Requirements for Health Claims for Food, 58 Fed. Reg. 2478, 2517 (Jan. 6, 1993)). Just three years after the court's citation, the court would have found a clearer exposition of the preemptive provisions in the Federal Register.

> The provision on nutrition labeling . . . includes an exemption for foods that are served or sold in restaurants . . . (section 403(q)(5)(A)(i)). This exemption, however, is contingent on there being no claims or other nutrition information

law preempts any state law regulating the labeling of food products. The court did not agree. The NLEA permits states to impose labeling requirements for certain food industries that are exempt under the act, including the restaurant industry. [71] In fact, the Food and Drug Administration has interpreted the NLEA as permitting the states to enact laws protecting consumers from menus with "false or misleading information."[72] Consequently, the court held that the federal labeling laws did not protect McDonald's from plaintiffs' New York state law claims.[73]

The court, therefore, addressed the first two counts of misleading advertisements by following the interpretive requirements for New York statutes.[74] The New York Consumer Protection Act[75] requires the plaintiff plead with specificity any "deceptive acts or practices that form the basis of a claim."[76] The court cited as examples of deceptive acts or practices public statements made by the tobacco industry in which they denied: that there is a causal link between disease and tobacco, that cigarettes are addictive, and that they manipulated nicotine to regulate cigarette addictiveness.[77] Ultimately, the plaintiffs were not successful because they did not provide equivalent examples of such practices by McDonald's. Their complaint did not identify one single deceptive act toward consumers or their children.[78] The complaint also failed to show that McDonald's decision not to post its nutritional information was a deceptive omission.[79] Accordingly, these plaintiffs failed to provide any evidence of deception to the court.[80]

The court then considered whether additional advertisements and McDonald's statements on their website were deceptive.[81] These advertisements either encouraged the

> on the label or labeling, or in the advertising, for the food. The use of nutrient content claims, health claims, or other nutrition information on the label or labeling of a food sold in a restaurant or other establishment in which food is served for immediate consumption will subject that food to the nutrition labeling provisions of the act (see sections 403(q) and (r) of the act and §101.9(j)(2)(i) through (j)(2)(iii) (21 CFR 101.9 (j)(2)(i) through (j)(2)(iii))).

Food Labeling; Nutrient Content Claims and Health Claims; Restaurant Foods, 62 Fed. Reg. 40320 (1996).

71 21 U.S.C. § 343-1(a)(4).

72 *Pelman*, 237 F. Supp. 2d at 526.

73 *Id*.

74 *Id*.

75 N.Y. GEN. BUS. LAW §§ 349-50 (2004).

76 *Pelman*, 237 F. Supp. 2d at 526.

77 *Id*. at 526-27.

78 *Id.* at 527, 530.

79 *Id*. at 529.

80 *Id*. at 527, 530.

81 *Pelman*, 237 F. Supp. 2d at 527-28.

public to eat at McDonald's every day or asked the public to make McDonald's meals part of a balanced diet.[82] Although claims based on these statements could have survived the motion to dismiss for lack of specificity, the court noted that the statements were likely not deceptive.[83] According to the court, a reasonable consumer would not have been misled by McDonald's conduct.[84] Furthermore, the statements were not made in conjunction, so McDonald's never asserted that eating their products every day would constitute a well-balanced diet.[85] The court contrasts this practice with that of Subway, which has made some implied health claims.[86] McDonald's advertisements "encouraging consumers to eat its products 'everyday' is mere puffery . . . in the absence of a claim that to do so will result in a specific effect on health."[87] As a result, the court concluded that these statements were not misleading.[88]

Conversely, the court did characterize some older McDonald's advertising as deceptive.[89] This, however, was not helpful to the plaintiffs because the court was careful to note that these advertisements would likely be barred by statutes of limitations.[90] For instance, one advertisement claimed that "sodium is down *across* the menu," when it was not.[91] Another advertisement did not disclose the presence of preservatives when it discussed the ingredients in its shakes. The advertisement finished by saying "that's all," implying there were no additional ingredients.[92] Each of these ads is deceptive on its face. Nonetheless, the court considered them only to assist the

82 *Id*. at 527.

83 *Id*.

84 *See id*. at 525, 528.

85 *Id*. at 527-28.

86 *Pelman*, 237 F. Supp. 2d at 528 n.15 (describing Subway's advertising campaign claiming that its product is a "healthier alternative to fatty fast food" and highlighting the dietary accomplishments of Jared Fogle, who lost 235 pounds on a diet of two daily meals at Subway for a year and has been featured in Subway commercials). Yet Subway's press releases do not specifically endorse Jared's diet nor do they explicitly claim that a Subway diet is a healthy diet. For example, one press release indicated that "Subway Corporate Dietician Lanette Roulier stresses that the chain does not endorse the 'Jared Diet'." Press Release, Subway, (December 2000), http://www.subway.com/Publishing/PubRelations/PressRelease/pr-011101j.pdf (last visited Mar. 27, 2004). Furthermore, Subway's website contains a disclaimer that Jared's weight loss program included exercise and that his results are not typical. Subway website, Jared's Statistics, http://subway.com/subwayroot/MenuNutrition/Jared/jaredStats.aspx (last visited Mar. 27, 2004) ("Individuals lost weight by exercising and eating a balanced, reduced-calorie diet that included SUBWAY® sandwiches with 6 grams of fat or less. Their results are not typical.").

87 *Pelman*, 237 F. Supp. 2d at 528.

88 *Id*.

89 *Id*.

90 *Id*.

91 *Id*.

92 *Pelman*, 237 F. Supp. 2d at 529.

plaintiffs in shaping any future claim.[93]

The court emphasized that McDonald's could only be held liable for failing to post nutritional labeling on its products if that omission was deceptive.[94] According to the court, businesses do not have a duty to inform each individual customer of information relevant to that consumer's use of the product unless the business alone possesses "material information."[95] The plaintiffs had never alleged that nutritional content "was solely within McDonalds' [sic] possession or that a consumer could not reasonably obtain such information."[96] Absent a claim that McDonald's held nutritional information the public could not access, McDonald's failure to post nutritional information was not deceptive.[97]

B. Common Law Claims

In count three, the plaintiffs claimed that McDonald's negligently manufactured and sold products causing obesity and failed to warn its consumers of the inherent danger of their products. The court dismissed the claim holding that the plaintiffs had neither established a duty of the defendants nor shown that the defendant's actions were the proximate cause of their children's obesity.[98]

The court first addressed plaintiffs' failure to show a duty. The plaintiffs alleged that McDonald's products were inherently dangerous as formulated, with "high levels of cholesterol, fat, salt and sugar," and that McDonald's, therefore, had a duty to warn its consumers of these dangers.[99] McDonald's countered—framing the issue as one of misuse through over-consumption rather than inherent danger—claiming that it had no duty to protect consumers from dangers caused by the over-consumption of its food when the public is well aware of such dangers.[100] McDonald's based its claims on a comment to section 402A of the Restatement (Second) of Torts:

> Many products cannot possibly be made entirely safe for all consumption, and any food or drug necessarily involves some risk of harm, if only from over-consumption. Ordinary sugar is a deadly poison to diabetics, and castor oil found use under Mussolini as an instrument of torture. That is not what is

93 *Id*. at 528.
94 *Id*. at 529.
95 *Id*.
96 *Pelman*, 237 F. Supp. 2d at 529.
97 *See id*.
98 *Id*. at 530-40.
99 *Id*. at 531.
100 *Id*. at 531-32.

> meant by "unreasonably dangerous" in this Section. The article sold must be dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics. . . . Good tobacco is not unreasonably dangerous merely because the effects of smoking may be harmful; but tobacco containing something like marijuana may be unreasonably dangerous. Good butter is not unreasonably dangerous merely because, if such be the case, it deposits cholesterol in the arteries and leads to heart attacks; but bad butter, contaminated with poisonous fish oil, is unreasonably dangerous.[101]

The court agreed with McDonald's over-consumption analysis and concluded that any product liability "based on over-consumption is doomed if the consequences of such over-consumption are common knowledge."[102] On the other hand, he noted that tobacco was also mentioned in the comment as a product with well-known dangers and this did not bar tobacco liability because tobacco companies had intentionally altered nicotine levels to induce addiction.[103] Thus, McDonald's could be liable only if its products were "so extraordinarily unhealthy that they are outside the reasonable contemplation of the consuming public or that the products are so extraordinarily unhealthy as to be dangerous in their intended use."[104] The plaintiffs' claims could not pass this bar.

The court then turned to the question of proximate cause. The court reasoned that based on the complaint, a jury would be required to engage in "wild speculation" to find that McDonald's caused the obesity.[105] The complaint did not specify how often the child plaintiffs ate at McDonald's.[106] McDonald's products would cause the plaintiffs' obesity only if the plaintiffs ate at McDonald's frequently enough to establish a "significant role in the plaintiffs' health problems."[107] In addition, the complaint included articles that identified other factors that contributed to plaintiffs' obesity.[108] To successfully prove proximate cause, the plaintiffs would have to address or eliminate these factors.[109] Since the plaintiffs did not address these deficiencies, the court

101 RESTATEMENT (SECOND) OF TORTS § 402A cmt. i (1965).

102 *Pelman*, 237 F. Supp. 2d at 532.

103 *Id*.

104 *Id*.

105 *Id*. at 538.

106 *Pelman*, 237 F. Supp. 2d. at 538. However, in a footnote the court noted that the plaintiffs later attached affidavits stating how often the plaintiffs ate at McDonald's. *Id*. at 538 n.28.

107 *Id*. at 538-39.

108 *Id*. at 539.

109 *Id*.

held proximate cause was a barrier that prevented negligence liability.[110]

According to the court, its decision to dismiss the claims based on negligence was consistent with some basic policy principles. Primarily, "it is not the place of the law to protect [the consumers] from their own excesses."[111] Furthermore, it is not the court's role to interfere when the "consumer exercises free choice with appropriate knowledge" as long as the manufacturer does not intentionally "mask[] . . . information necessary to make the choice."[112]

The court also addressed four additional common law arguments raised outside the complaint to assess whether the plaintiffs could make an adequate argument for duty in an amended complaint, and identified two that could have potential.[113] First, the plaintiffs had argued that McDonald's processed their products to the point that they were more dangerous than what a reasonable consumer could expect from an unprocessed product.[114] This argument had potential because any additional danger would be latent rather than patent unless the public was also aware of the danger of this additional processing.[115] Second, a modified argument based on McDonald's knowledge of consumers' potential misuse could have merit.[116] The modified argument would have merit if McDonald's should have been aware that its consumers intended to eat at McDonald's "for every meal of every day" and if McDonald's was also aware that this frequency of consumption was unreasonably dangerous.[117] On the other hand, a claim based on over-consumption rather than exclusive consumption at McDonald's would likely fail due to the court's prior analysis.

Counts four and five were based on McDonald's failure to warn its consumers. Count four alleged that McDonald's failed to warn of the unhealthy attributes of its products and failed on the same principles as count three. To prove McDonald's failed to warn, the plaintiffs had to prove the defendant had a duty to warn. However, the plaintiffs neglected to establish such a duty

110 *Id*. at 539-40.
111 *Pelman*, 237 F. Supp. 2d at 533.
112 *Id*.
113 *Id*. at 533.
114 *Id*. at 534-35. "For instance, Chicken McNuggets, rather than being merely chicken fried in a pan, are a McFrankenstein creation of various elements not utilized by the home cook." *Id*. at 535.
115 *Id*. at 534.
116 *Id*. at 537.
117 *Id*.

in the complaint.[118] The court cited a number of factors involved in assessing whether there was a duty to warn including: the "feasibility and difficulty of issuing a warning . . . ;" the "obviousness of the risk from actual use of the product;" the "knowledge of the . . . user; and proximate cause."[119] The court also recognized that proximate cause would be precluded if a danger was obvious.[120] Therefore, the court dismissed this count because the complaint failed to allege "McDonald's products . . . were dangerous in any way other than that which was open and obvious to a reasonable consumer."[121]

Finally, the court addressed count five, which alleged that McDonald's failed to warn of the addictive properties of its products. The court noted that the complaint did not specify that the plaintiffs themselves were addicted nor did it explain how McDonald's products were involved in causing this addiction.[122] As it stood, the complaint was "overly vague."[123] The court dismissed this count for its failure to allege the "addictive nature of McDonald's foods" and its failure to allege that their food was the proximate cause of the plaintiffs' obesity.[124]

In summary, the plaintiffs' initial complaint was dismissed for lack of specificity. In the first counts, the plaintiffs' failed to allege specific acts of deception toward consumers or toward child plaintiffs. In the subsequent claims, the plaintiffs were unable to specify why the defendants owed a duty to the plaintiffs to not make products that were dangerous if over-consumed, or why the defendant owed a duty to warn of obvious dangers.

The decision in this case was guided by the principle that McDonald's should be held liable only if its "products involve a danger that is not within the common knowledge of consumers."[125] However, the court also recognized that government has a responsibility to protect individuals "in those situations where individuals are somehow unable to protect themselves and where society needs to provide a buffer between the individual and some other entity—whether herself, another individual or a behemoth corporation that spans the globe."[126] Ultimately, the court determined that these principles "require the complaint to be dismissed for lack of specificity," with leave to

118 *Id*. at 540-41.
119 *Pelman*, 237 F. Supp 2d. at 540.
120 *Id*.
121 *Id*. at 541.
122 *Id*. at 542.
123 *Id*.
124 *Pelman*, 237 F. Supp 2d. at 542-43.
125 *Id*. at 518.
126 *Id*. at 516.

amend,[127] which was essentially a public policy decision based on personal responsibility.

C. Amended Complaint

After the first complaint was dismissed, the plaintiffs re-filed an amended complaint with claims dealing exclusively with the New York Consumer Protection Act.[128] The three counts were constructed to conform to the dicta in the prior dismissal. For example, count one alleged that the plaintiffs were misled into believing McDonald's products "were nutritious . . . and/or easily part of a healthy lifestyle if consumed on a daily basis."[129] Count two alleged that McDonald's failed to disclose that their foods were substantially less healthy than they appeared because of additives and further processing.[130] Count three alleged that McDonald's claimed that it provided nutritional information adequately, which in reality it did not.[131] Ultimately, this amended complaint was likewise dismissed because the plaintiffs' allegations still did not demonstrate that the defendant's actions or deception caused them injury.[132]

Unfortunately, much of the plaintiffs' case for deception rested on old advertisements; thus, the claims were barred by the statute of limitations.[133] The plaintiffs attempted to argue a variety of theories to toll the statute of limitations, including the "continuing practice exception,"[134] the "separate accrual rule,"[135] the "diligence-discovery accrual rule,"[136] and infancy tolling.[137] However, the court discarded the first three of these theories, leaving only infancy tolling.[138] This presented its own difficulty

127 *Id*. at 519.

128 Pelman v. McDonald's Corp., No. 02 Civ. 7821, 2003 WL 22052778, at *3 (S.D.N.Y. Sept. 3, 2003).

129 *Id*.

130 *Id*.

131 *Id*.

132 *Id*. at *14.

133 *Pelman*, 2003 WL 22052778, at *4-6.

134 The continuing practice exception requires a tolling after "each successive deceptive statement in furtherance of [an] overall scheme." *Id*. at *5.

135 The separate accrual rule creates a limitation period every time "a plaintiff discovers, or should have discovered a new injury caused by the . . . violations." *Id*. (citation omitted).

136 Under the diligence-discovery accrual rule, "accrual may be postponed until the plaintiff has or with reasonable diligence should have discovered the critical facts of both his injury and its cause." *Id*. at *5 (citation omitted).

137 *Id*. at *6. Under infancy tolling, a cause of action is tolled while a person is "under a disability because of infancy." *Id*. (citation omitted).

138 *Pelman*, 2003 WL 22052778, at *5-6. The court discarded the first of these theories as disfavored; found the second theory did not apply because no new injuries were alleged which did not result from the initial injury; and found the third theory did not apply because the facts about McDonald's products were "well known" such that the plaintiffs should have known the "critical facts of their injury." *Id*.

since the court refused to consider advertisements observed only by the parents, allowing only those actually seen by the children.[139]

This led to the second difficulty faced by the plaintiffs. Because the child plaintiffs had not seen many of the advertisements, they could not prove they relied on the advertisements.[140] As a result, the plaintiffs failed to "allege in general terms that plaintiffs were aware of the false advertisement, and that they relied to their detriment on the advertisement."[141] The only "deceptive act" of which the infant plaintiffs were even aware was McDonald's statement that they were switching to 100% vegetable oil to fry their potatoes and hash browns and that these products would contain zero milligrams of cholesterol.[142] After an analysis of this advertisement, the court found the complaint sufficient to allege reliance on this alleged misrepresentation.[143]

The court then addressed causation, the more difficult obstacle to the plaintiffs' case. Although the plaintiffs did not need to prove proximate cause as they would in a negligence case, they did have to prove that the deceptive act caused their injuries.[144] Although the plaintiffs had, "albeit just barely," established a causal connection between the "deceptive acts" and the decision to eat at McDonald's, the court held that they did not establish an "adequate causal connection between their consumption of McDonald's food and their alleged injuries."[145] Unfortunately, yet again, the plaintiffs had failed to eliminate other factors that could have caused their obesity.[146] For example, they did not address such questions as, "What else did the [minors] eat? How much did they exercise? Is there a family history of the diseases?"[147] Therefore, the court concluded that there was insufficient information to determine whether McDonald's alleged deception caused the plaintiffs' injuries or if it was only a contributing factor.[148]

In the final analysis, from the court's opening statement focusing on plaintiffs' knowledge, it was clear that *Pelman* would be decided in McDonald's favor. Ultimately, the plaintiffs' case

139 *Id*. at *6.
140 *Id*. at *8.
141 *Id*.
142 *Id*. at *9.
143 *Pelman*, 2003 WL 22052778, at *9.
144 *Id*.
145 *Id*. at *11.
146 *Id*.
147 *Id*.
148 *Pelman*, 2003 WL 22052778, at *11.

unraveled because they were unable to produce specific incidences of recent deception and because the dangers of over consumption were obvious. Beyond even these difficulties, they provided no evidence that McDonald's actions caused their injury.

IV. THE FUTURE OF FAST-FOOD LITIGATION

Proponents of liability for the fast-food industry will not give up so easily. Professor John Banzhaf III, one of the leading proponents, has expressed a willingness to continue to litigate against the fast-food industry even after *Pelman*.[149] In June of 2003, Professor Banzhaf chided Congress for considering a bill restricting fast-food liability.[150] He boldly asserted that fast-food companies should be found liable under "a wide variety of different legal theories, different pieces of evidence, many of which you have not seen."[151] Professor Banzhaf joins others who believe the fast-food industry will one day be held liable under a currently non-existent theory.[152] While this may be true, traditional theories should not be abandoned yet. The next section focuses on known theories and policy implications. Specifically, it explores product liability causes of action currently used to hold manufacturers liable for harm caused by their products. It details the barriers common to most of these theories and discusses how those barriers might be problematic in the context of fast-food litigation. Finally, it suggests some new theories that may be used in the future to hold the food industry liable for its actions.

A. Potential Causes of Action: Product Liability

Modern plaintiffs can sue under a number of product liability

149 *See* John F. Banzhaf III, *Dismissal of McDonald's Obesity Law Suit was Expected: Four Wins, One Loss, and Several Legal Theories Yet to Go*, *at* http://banzhaf.net/docs/mcd2no.html (last visited Mar. 8, 2004). *See generally* John F. Banzhaf III, *Using Legal Action to Help Fight Obesity*, *at* http://banzhaf.net/obesitylinks (last visited Mar. 8, 2004). For example, one of the lead headlines at this website is "Flash: McDonald's Case Dismissed, But Anti-Fat Lawyers Aren't Discouraged."

150 "With all due respect, shame on you. If it ain't broke, don't fix it, especially until Congress is prepared to step in and adopt comprehensive legislation and save taxpayers some 50 billion annually in obesity costs." *Personal Responsibility in Food Consumption Act: Hearing Before the Subcomm. on Commercial and Admin. Law of the Comm. on the Judiciary*, 108th Cong. 9 (2003), *available at* http://www.house.gov/judiciary (statement of Professor John Banzhaf, George Washington University School of Law).

151 *Id*. at 10.

152 "And the public, according to recent surveys, is about willing to hold them liable. There is liability now. Juries are about to hold them liable as they are in tobacco suits." *Id*. *See also*, Cohan, *supra* note 27, at 131 ("The fate of obesity litigation may rest at least in part upon the ability of judges to fashion new tort doctrines, a phenomenon that has progressed steadily throughout the past century.").

theories.[153] The basis for the suit may be intentional torts, contract, strict liability, or negligence. Intentional torts cover product liability for misrepresentation, while the rules of contract liability cover claims based on express or implied warranty. Tort liability for unreasonably defective products falls under strict liability. Negligence encompasses defects in manufacturing, negligent marketing and selling, and failing to warn of dangers. While the theories are similar in some aspects, each presents its own obstacles to plaintiffs.

1. Intentional Tort: Misrepresentation

Pelman was essentially decided under a theory of misrepresentation based on the New York Consumer Protection Act. Misrepresentation is usually a fact-intensive inquiry and requires that the plaintiff allege reliance upon the misrepresentation.[154] In *Pelman*, the plaintiffs failed to show personal reliance, and this difficulty is likely to recur in future fast-food litigation based on misrepresentation, given the relatively slow onset of obesity[155] and the difficulty of pinpointing the specific advertisements that caused plaintiffs to eat particular products. The slow onset of obesity further presents problems with statutes of limitations. Therefore, the success of such cases, may—as proponents have suggested—be dependent on finding a theory approved by the court that will toll the statute of limitations.

These obstacles are significant. However, plaintiffs should not wholly abandon the theory of misrepresentation. It is possible in some cases to allege misrepresentation based upon intentional omissions, although the original complaint in *Pelman* shows the hazards of such an approach. In *Pelman*, the court dismissed misrepresentation claims because the public had access to the same nutritional information as McDonald's.[156] An allegation based on failing to disclose a substance that consumers do not expect is likely to find more success in courts. For example, in California, fast-food companies were sued for failing to disclose the presence of acrylamide, a substance linked to

153 *See* Denny v. Ford Motor Co., 662 N.E.2d 730, 731 (N.Y. 1995) (holding it was possible to find a plaintiff liable for a breach of an implied warranty when a claim of strict products liability was not satisfied); Hyundai Motor Co. v. Rodriguez, 995 S.W.2d 661, 668 (Tex. 1999) (holding that "[p]laintiffs are generally entitled to obtain findings that will support alternative theories of recovery" in strict product liability and implied warranty claims).

154 *See* Dobbs, *supra* note 38, § 352, at 971.

155 Scott M. Grundy, *Multifactorial Causation of Obesity: Implications for Prevention,* 67 AM. J. CLIN. NUTR. 563S, 565S (1998).

156 Pelman v. McDonald's Corp., 237 F. Supp. 2d. 512, 529 (S.D.N.Y. 2003).

cancer.[157] Courts recognize a distinction between obvious natural components of food and those that the consumers would not reasonably expect to find in their food.[158] Yet, absent a conclusive showing that fast-food companies added a "secret" ingredient that causes obesity, an obesity claim based on misrepresentation by a deceptive omission will most likely fail.

2. Contract: Express Warranty

Under the law of contracts, plaintiffs may claim that a merchant breached an express or implied warranty.[159] Liability for a breach of warranty on the sale of goods is governed by Article 2 of the Uniform Commercial Code.[160] Claims for breach of an express warranty would be similar to claims of misrepresentation and would arise where the fast-food producer made claims that the food had specific health benefits. For example, as described in *Pelman*, an advertisement that represented that patrons could lose weight or receive certain health benefits by eating at certain restaurants every day would be an express warranty.[161] However, success under this theory is questionable because fast-food companies rarely represent that eating their food would not cause obesity or would provide such benefits (and they are certainly less likely to do so after *Pelman*). Furthermore, the federal government regulates health and nutrient claims made by restaurants.[162] A consumer who sues a

157 Cohan, *supra* note 27, at 122-23. Acrylamide is relevant to obesity liability because it was initially shown to be present in high levels in fast foods such as fried potatoes. However, recent research has found acrylamide present not only in fast foods but also in other nutritious foods. Thus, it is probably impossible at this time to avoid acrylamide. In a meeting convened to discuss acrylamide, Deputy FDA Commissioner, Dr. Lester Crawford noted that fast foods are not the only foods to contain acrylamide. "The exposure assessment has found that many foods contribute to acrylamide exposure. No single food accounts for the majority of acrylamide exposure for the U.S. population." Lester Crawford, Transcript of Proceedings Food Advisory Committee, February 24-25, 2003 Meeting Acrylamide, http://www.cfsan.fda.gov/~dms/acrytra2.html (last visited Mar. 8, 2004). Further data for acrylamide in food can be found at either the World Health Organization web site, http://www.who.int/foodsafety /chem/chemicals/acrylamide/en/, or its infonet on acrylamide, http://www.acrylamide-food.org/. *See also* Center for Food Safety and Applied Nutrition, U.S. Food and Drug Administration, *Pesticides, Metals, Chemical Contaminants & Natural Toxins*, *at* http://www.cfsan.fda.gov/~lrd/pestadd.html (last visited Mar. 8, 2004).

158 Owen, *supra* note 41, at 897-98.

159 Dobbs, *supra* note 38, § 352, at 971.

160 U.C.C. §§ 2- 313,-314,-315 (2003) (providing for an express warranty, implied warranty of merchantability, and implied warranty of fitness for a particular purpose for both merchants and consumers in particular circumstances).

161 In *Pelman*, the plaintiffs contended that McDonald's encouraged its customers to eat everyday as part of a balanced diet. Apparently, this claim did not rise to the level of a warranty. *See supra* notes 90-97 and accompanying text.

162 Food and Drugs, 21 C.F.R. § 101.10 (2003) ("Nutrition labeling in accordance with § 101.9 shall be provided upon request for any restaurant food or meal for which a nutrient content claim . . . or a health claim . . . is made . . . ."). *See also* Food and Drugs,

restaurant for an unsupported health or nutrient claim must show that the restaurant did not comply with the NLEA.[163] Therefore, many, if not all, express warranty claims based on restaurant nutrient or health claims would be preempted by the NLEA. Given these difficulties, it is unlikely that consumers seeking to hold fast-food restaurants liable based on breach of an express warranty would be successful unless the restaurant failed to comply with the NLEA.

3. Contract: Implied Warranty

Fast-food companies could also be held liable for breaching the implied warranty of merchantability. Essentially, the implied warranty of merchantability defined in U.C.C. section 2-314 is "the seller's implied promise that the goods sold in a contract of sale will work."[164] Claims based on the breach of the implied warranty depend heavily on a court's interpretation of merchantability because the U.C.C. provides only a list of "minimum qualities goods must possess in order to be merchantable."[165]

The recent tobacco litigation provides an instructive analogy. In the tobacco cases, courts defined merchantability in two manners. Some courts found cigarettes unmerchantable if plaintiff could prove cigarettes were "commercially unfit or unsuitable for smoking."[166] Other courts held that cigarettes were unmerchantable simply because their use could result in great personal injury.[167] In *American Tobacco Co. v. Grinnell*, the Supreme Court of Texas went further.[168] There the court held that the product would only be unmerchantable if it contained a health danger that was not in the common knowledge.[169] The court held that the danger of nicotine addiction was not in the common knowledge of most consumers in 1952 when the plaintiff began smoking.[170] However, that danger was within the knowledge of the tobacco industry and, therefore, was sufficient to prove the unmerchantability of the product and the subsequent liability of the industry.[171]

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21 C.F.R. §§ 101.13-.14 (2003).

163 Food and Drugs, 21 C.F.R. § 101.9 (j) (2003).

164 Crawford, *supra* note 27, at 1170.

165 *Id*. at 1173.

166 *Id*. at 1199-1200 (quoting Spain v. Brown & Williamson Tobacco Corp., 230 F. Supp. 2d 70, 94 (N.D.N.Y. 2000) (internal quotation marks omitted)).

167 *Id*. at 1200.

168 951 S.W.2d 420 (Tex. 1997).

169 *Id*. at 435. Crawford, *supra* note 27, at 1201.

170 951 S.W.2d at 435.

171 *Id*. at 429- 31 ("Addiction is a danger apart from the direct physical dangers of smoking because the addictive nature of cigarettes multiplies the likelihood of and

In light of these theories of merchantability, assignment of liability to the fast-food industry under an implied warranty theory will only apply if: (1) courts use a definition of merchantability that focuses only on the danger of obesity from fast foods; (2) plaintiffs are able to show present research showing that fast food is addictive;[172] and (3) the court's interpretation of merchantability is broader than the seller's promise that the goods will function as expected by an ordinary consumer.[173] Therefore, only an interpretation of warranty that "merely requires goods to fulfill the basic functional purpose for which such goods are used" will prevent liability from following.[174] In today's present environment, in which regardless of all the hype about fitness and weight loss, the nation appears to be unwilling to effectively address the dangers of obesity,[175] and with no *conclusive* showing that fast food is addictive, it is highly unlikely that a suit based on an implied warranty of merchantability will be successful.

4. Strict Liability: Strict Product Liability

Under a strict product liability theory, the fast-food industry might be strictly liable for the harm caused by any defective product sold. However, according to the Restatement (Second) of Torts, the plaintiffs would be successful only if the product was in a "defective condition *unreasonably dangerous*."[176] As noted in *Pelman*, comment i to section 402A of Restatement (Second) of Torts clearly addresses and negates the argument that the danger from over-consumption of high fat food was so unreasonably dangerous that fast food was defective.[177] The Restatement (Third) of Torts defines food defects in terms of a

contributes to the smoker's ultimate injury, in Grinnell's case, lung cancer.").

172 In an article discussing the implied warranty of merchantability, one author suggests that if fast food is shown to be addictive and if the public perception of the addictive nature of fast food changes, it will enable plaintiffs to "analogize their U.C.C. section 2-314 claims to those of plaintiffs injured by cigarettes." Crawford, *supra* note 27, at 1220. Evidence of fast food's addictive qualities is not far-fetched. First, fast food is generally high-fat and served in larger portions. Researchers have also identified hormonal changes that "remove some element of free will" and have shown similarities between drug addiction and sugar addiction. Diane Martindale, *Burgers on the Brain*, NEW SCIENTIST, Feb. 1, 2003, at 27-29. "However, the idea that food is addictive is far from mainstream." *Id*. at 29. *See also* Jiali Wang et. al., *Overfeeding Rapidly Induces Leptin and Insulin Resistance*, 50 DIABETES 2786 (2001); Carlo Colantuoni et. al., *Evidence that Intermittent, Excessive Sugar Intake Causes Endogenous Opioid Dependence*, 10 OBESITY RESEARCH 478 (2002), http://www.obesityresearch.org/cgi/content/abstract/10/6/478.

173 *See* Crawford, *supra* note 27 at 1223-24.

174 *Id*. at 1224.

175 This is my own opinion based on evidence that obesity and its effects are growing rather than retreating.

176 RESTATEMENT (SECOND) OF TORTS § 402A (1965) (emphasis added).

177 *Id*. § 402A cmt. i.

consumer expectation test.[178] Under this test, manufacturers would not be liable for causing obesity if consumers were aware of fast food's dangerous qualities. In simple terms, consumers know that if they eat too much high fat food they get fat. Therefore, under these definitions of defectiveness, no liability would likely follow.

On the other hand, courts could use a risk-utility test for defectiveness. Under that test, "courts attempt to balance the risks of the product as designed against the costs of making the product safer."[179] The problem with this test is that food is essential for life, and the risk comes largely from over-consumption. Therefore, any attempt to make food safer is counter-productive if the food continues to be over-consumed. The only way to skirt this argument is to claim that "a product is simply so dangerous that it should not have been made available at all."[180] This difficulty was highlighted in *Pelman* when plaintiffs were unable to meet the burden of proving that fast food is "so extraordinarily unhealthy that they are outside the reasonable contemplation of the consuming public or that the products are so extraordinarily unhealthy as to be dangerous in their intended use."[181] Obviously, this is a heavy burden to prove, and, therefore, the risk-benefit test becomes mostly a policy choice on whether dangerous products should be sold at all.

5. Strict Liability: Product Liability, Duty to warn

Under strict product liability in tort, the plaintiff may also argue that the fast-food industry has a duty to warn of the unhealthy attributes of their products. But as noted in *Pelman*, the duty to warn depends on a variety of factors such as: the feasibility and difficulty of issuing a warning, the obviousness of a risk, the knowledge of the users, and proximate cause.[182] Again, although a warning may be both feasible and easy to issue, the risk from eating fast foods is obvious and in the common knowledge of most consumers relieving the producer of the duty to warn. On the other hand, a plaintiff may complain that portions are super-sized at fast-food restaurants, thus the danger of over-consumption is concealed. The difficulty with this argument is that portion size is also obvious and within the common knowledge of the consumer. Consumers are usually

178 RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 7 (1997).
179 Dobbs, *supra* note 38, § 357, at 985.
180 Banks v. ICI Ams., Inc., 450 S.E.2d 671, 674 (Ga. 1994).
181 Pelman v. McDonald's Corp., 237 F. Supp. 2d 512, 532 (S.D.N.Y. 2003).
182 *Id*. at 540.

provided with a range of sizes, and they will make the choice to continue eating or not.[183] For these reasons it seems unlikely that allegations based in a strict liability duty to warn will be successful.

6. Negligence

Finally, plaintiffs may argue that the fast-food industry is negligent. Negligence is "unreasonable conduct, as measured against the conduct of a reasonable prudent manufacturer in the same or similar circumstances."[184] Modern courts hold food manufacturers to a duty of reasonable care for manufacturing and design defects.[185] However, in the obesity context, plaintiffs may find it difficult to identify the duty manufacturers have to consumers to make healthier products. In cases involving gun manufacturers, courts used a multiple-factor balancing test to determine whether the defendant owed a duty to consumers injured by their products.[186] These factors were enumerated in *Rowland v. Christian* and are: the foreseeability of the plaintiffs' harm, the certainty of the plaintiffs' injury, the closeness of the connection between the defendant's actions and the plaintiffs' injury, the culpability of the defendant's conduct, the desirability of preventing future harm, and the burdens and benefits of imposing such a duty.[187] It is interesting to note that the *Pelman* decision held that no duty existed without resorting to these factors because it determined that over-consumption was out of the control of the manufacturer.[188] However, an analysis of the factors is instructive.

For example, the foreseeability of harm to an individual plaintiff is attenuated. All people eat, but not all become fat. Only a certain proportion of the population is susceptible to obesity.[189] The closeness of the connection between fast-food restaurants and obesity for a majority of its customers is limited by the frequency of their visits to fast-food restaurants. Also,

183 Some research has shown that non-obese children will stop their total percentage of calorie input at lower levels than obese children when provided with larger portion sizes. Obese people continue to eat. This research suggests that the size of the portions does not cause obesity; what the obese children lack is control. *Pediatric Obesity; Fast Food is Lure to Overweight Children*, OBESITY, FITNESS & WELLNESS, Nov. 8, 2003, at 30.

184 Owen, *supra* note 41, at 861.

185 *Id.* at 889.

186 Richard C. Ausness, *Tort Liability for the Sale of Non-defective Products: An Analysis and Critique of the Concept of Negligent Marketing*, 53 S.C. L. REV. 907, 952-54 (2002).

187 443 P.2d 561, 564 (Cal. 1968).

188 *See supra* note 111 and accompanying text.

189 James O. Hill, *An Overview of the Etiology of Obesity*, *in* EATING DISORDERS AND OBESITY, A COMPREHENSIVE HANDBOOK 460, 463 (Christopher G. Fairburn & Kelley D. Brownell eds., 2002).

unless fast-food restaurants deceive consumers, feeding hungry people is not a culpable act. Furthermore, although there are certainly many desirable benefits to preventing unhealthy eating habits, placing the burden of improving the nation's eating habits on the fast-food industry by making them liable for obesity would not necessarily accomplish that aim. Most likely, the fast-food industry would react by either providing warnings or by providing healthier alternatives. In that case, the public would most likely just turn to the abundance of unhealthy alternatives in the grocery stores or disregard the warnings and continue their unhealthy diets. Such a reaction is likely, however, when one observes that the addition of nutritional information on food products has hardly seemed to change people's eating habits. Thus, these factors do not clearly indicate that the burden in creating a duty and imposing liability on the fast-food industry would necessarily benefit society.

Even if plaintiffs established a duty, to prove negligence the plaintiffs must also prove that the fast-food industry breached that duty and that that breach caused the plaintiffs' damages.[190] In *Pelman*, the court found that the plaintiffs could not establish a prima-facie case for causation.[191] A further analysis of causation in the obesity context will be continued below. However, unless the plaintiffs can establish this causation, negligence will likely fail.

B. Barriers to Fast-food Liability

To find fast-food corporations liable for their contribution to the nation's obesity, plaintiffs must overcome three significant obstacles under any theory of product liability. They must prove that: the product was defective and unreasonably dangerous as sold; the defendant had a duty to prevent the danger from the product even when the plaintiff was aware of its harmful properties; and the product caused them injury.

To put it simply, eating high fat, carbohydrate rich fast foods can be extraordinarily unhealthy and dangerous. Does that make this food defective? The Restatement (Third) of Torts suggests that courts consider a "harm-causing ingredient of the food product . . . a defect if a reasonable consumer would not expect the food product to contain that ingredient."[192] Under this standard, fast foods are not defective because the public generally expects them to be high fat and carbohydrate rich.

190 Dobbs, *supra* note 38, § 114, at 269.
191 *See supra* notes 98-117 and accompanying text.
192 RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 7 (1997).

This barrier, however, can be overcome if courts adopt a risk-benefit test. Fast foods generally fail this test because these foods have significant negative health effects and are of suspect nutritional value. Unfortunately, the difficulty with the risk-benefit test is in articulating a universal standard to measure the nutritional benefits of specific food products against their negative health effects. Given the constantly changing information as to appropriate nutritional choices, it is doubtful that such a standard would be accepted by the public.[193]

It is even more difficult to establish that the fast-food industry has a duty to its customers when there is an extensive legal history suggesting that plaintiffs are personally responsible for the harm caused by products they purchase with knowledge of their dangerous qualities. The Restatement (Second) of Torts, the Restatement (Third) of Torts, Products Liability section, and an overwhelming majority of jurisdictions have indicated that plaintiffs must take responsibility for their actions. As noted in *Pelman*, the Restatement (Second) of Torts exempted the food industry from taking responsibility for over-consumption of food.[194] The Restatement (Third) of Torts: Products Liability, comment j also adopts the position of section 402A of the Restatement (Second) of Torts on over-consumption.[195] Finally, an overwhelming number of jurisdictions have held that there is no duty to warn consumers of obvious risks.[196]

The most difficult barrier to ascribing liability to the fast-food industry is causation. Plainly, obesity is caused by many factors. For example, one study identified the following short lists of factors that cause weight gain with aging: a decline in resting metabolic rate; a decline in physical activity; an increase in food intake; high fat diets; family, social, and cultural attitudes toward weight; and genetic factors.[197] Furthermore, Dr. Brownell, Yale psychology professor and director of the Yale Center for Eating and Weight Disorders, also blamed the rise in obesity on a toxic environment for physical exercise.[198] Any successful claim against the fast-food industry must provide a

193 *See e.g.* NESTLE, *supra* note 22, at 67-110.

194 *See supra* notes 101-102 and accompanying text.

195 *See* RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 2 cmt. j ("In general, a product seller is not subject to liability for failing to warn or instruct regarding risks and risk-avoidance measures that should be obvious to, or generally known by, foreseeable product users.").

196 When the Products Liability restatement was issued in 1997, an "overwhelming majority of jurisdictions" supported the rule that there was no duty to warn of obvious and generally known dangers. *Id.* Annotations of the restatement do not reflect a significant shift from that position.

197 Grundy, *supra* note 155, at 566S-67S.

198 Brownell, *supra* note 17, at 436-37.

causation theory to overcome these other factors in order to show that the fast-food industry is the sole or primary cause of the plaintiff's obesity.

As in the gun manufacturing context, courts would have to allow plaintiffs to use easier tests for causation to prove their case in order for cases against the fast-food industry to be successful.[199] The usual test for causation is the "but for" or "sine qua non" test that requires plaintiffs prove that they would not be injured if the defendant's act had not occurred.[200] In the obesity cases based on negligent marketing, the plaintiff would have to comply with this test by showing that the defendant's advertising induced their consumption and the consumption caused their obesity.[201] In *Pelman*, this was an insurmountable barrier.[202] In some states a solution to this obstacle may be the use of a "substantial factor" test.[203] This theory is used when two factors join and either could have independently caused an injury.[204] Because the decision whether a cause is substantial is given to the jury, this theory could potentially allow plaintiffs to establish causation if the fast-food industry became unpopular.[205] However, the burden to prove that the fast-food industry caused obesity would be on the plaintiffs, and it still would not relieve the plaintiffs from detailing how the other factors interacted with the fast-food industry actions to cause obesity.

Even if plaintiffs were able to establish that fast foods caused their obesity, they would have the additional problem of establishing which restaurants were specifically responsible. Again, in the case of gun manufacturing, some courts allowed plaintiffs to solve this problem by using enterprise or market share liability.[206] In the fast foods context, the use of either of these theories will have important implications and specific difficulties in application.

Enterprise liability imposes "strict liability [on] business enterprises for harms perceived to be recurrently associated with their operation."[207] This would allow plaintiffs to sue a trade association "on the theory that promulgating standards, or some other action by the association, contributed to his injuries."[208]

199 *See* Ausness, *supra* note 186, at 946.
200 Dobbs, *supra* note 38, § 168, at 409.
201 *See* Ausness, *supra* note 186, at 946-47.
202 *See supra* notes 140-45 and accompanying text.
203 Ausness, *supra* note 186, at 947.
204 *Id*.
205 *See id*. at 948.
206 *Id*. at 948-49.
207 Dobbs, *supra* note 38, at 908.
208 Ausness, *supra* note 186, at 948.

The rationale behind this theory is that the members of the industry "cooperate[d], tacitly or expressly, in particular conduct . . . [and] are said to be acting in concert. Each of those acting in concert is liable jointly and severally for all the intended or foreseeable resulting harm."[209] In the fast food context, this theory would be justified either if members of the industry had worked together, intentionally or unintentionally, to deceive consumers[210] or if juries accepted the argument that the costs of obesity could be passed on by the industry through insurance and higher prices.[211]

Market-share liability is a theory created to assign responsibility when there is delay in the onset of damages and when it is difficult to identify the original manufacturer of a product. It "enables plaintiffs to recover from each member of an entire industry based on its market share of the products sold."[212] This theory reached notoriety in diethylstilbesterol "DES" cases, in which the plaintiffs faced the insurmountable barrier of finding which manufacturer among 300 provided their parents a fungible drug that caused their birth defects.[213] There are some parallels and differences between DES and fast-food liability. Like DES, food is a fungible product, but unlike DES, it is not difficult to establish where plaintiffs ate when there is a pattern of consumer choices. In this respect, liability for the fast-food industry is more analogous to liability in gun manufacturing. In *Hamilton v. Beretta,*[214] a main case on gun manufacturer liability, the New York Court of Appeals decided that market share was inappropriate because it was possible to identify the manufacturer and because different guns had different levels of risk.[215] Fast food plaintiffs may face the same obstacle because different foods have different inherent risks based on their preparation and because it is much easier to identify where the plaintiffs have eaten.

An additional obstacle to the use of these causation theories may be other industries that contribute to obesity. The decline in physical exercise due to an increase in the popularity of sedentary activities is a "substantial factor" causing obesity that

209 Dobbs, *supra* note 38, at 936.

210 *See* Hall v. E. I. Du Pont De Nemours & Co., 345 F. Supp. 353 (E.D.N.Y. 1972) (holding a whole industry liable because they jointly controlled the risk created by inadequate standards for dynamite caps).

211 Dobbs, *supra* note 38, § 353, at 975. *See also*, Gregory C. Keating, *The Idea of Fairness in the Law of Enterprise Liability*, 95 MICH. L. REV. 1266 (1997).

212 Ausness, *supra* note 186, at 949.

213 Frank J. Giliberti, *Emerging Trends for Products Liability: Market Share Liability, Its History and Future*, 15 TOURO L. REV. 719, 723-25 (1999).

214 750 N.E.2d 1055 (N.Y. 2001).

215 *Id*. at 1066-67; Ausness, *supra* note 186, at 949.

makes these theories less workable. If, as Dr. Kelley Brownell notes, "[t]he computer, television, and video games have made sedentary behavior very appealing and engaging, especially for children," these industries should also be included in the formula that assigns responsibility for obesity.[216] Ultimately, the share of responsibility becomes excessively large and unworkable.

C. Surmounting Barriers to Fast-food Liability; Negligent Marketing and Advertising

Some courts may not find these barriers to fast-food liability insurmountable. They may apply the theories developed to hold gun manufacturers liable for how they marketed and promoted guns. In that context, plaintiffs have alleged that the manufacturer's "marketing practices . . . affirmatively created a risk of harm to others."[217] In a series of cases, courts found that gun manufacturers' "special ability to detect and to guard against the risks associated with [their] products gave rise to a 'protective relationship' with those who might be injured."[218] This was especially true when there was a relationship "between a defendant and a third party, such as a parent and child," and when the "defendant affirmatively enhanced an inherent risk."[219] Furthermore, the duty arose because the risk from the defendant's conduct was foreseeable and therefore, the defendant's conduct was "morally blameworthy."[220]

Fast-food liability fits neatly into this theory, generally called negligent marketing or advertising. Under this theory, plaintiffs would claim that the risk of childhood obesity is affirmatively enhanced by the marketing and advertising campaigns of the fast-food industry. Additionally, plaintiffs would claim that fast-food companies target children and induce them to eat dangerous foods. This conduct is foreseeable and intentionally increases the risk children will become obese.

However, cases espousing this theory have been overturned by higher courts in the past few years.[221] This led one commentator to cast doubt as to the future viability of this theory.[222] Nonetheless, the theory has recently risen from ashes

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216 Brownell, *supra* note 17, at 437.

217 Ausness, *supra* note 186, at 952.

218 *Id*. at 925 (discussing the following case using this theory: Hamilton v. Accu-Tek, 62 F. Supp. 2d 802 (E.D.N.Y. 1999); Merrill v. Navegar, Inc., 89 Cal. Rptr. 2d 146 (Cal. Ct. App. 1999) *rev'd*, 28 P.3d 116 (Cal. 2001).

219 Ausness, *supra* note 186, at 925-26, 932.

220 *Id*. at 932-33.

221 *See* Hamilton v. Beretta U.S.A. Corp., 750 N.E.2d 1055 (N.Y. 2001); Merrill v. Navegar, Inc., 28 P.3d 116 (Cal. 2001).

222 Ausness, *supra* note 186, at 965. "However, two cases decided last year, *Hamilton*

in the Ninth Circuit Court of Appeals. In *Ileto v. Glock*, a Ninth Circuit panel based liability on a claim that a gun manufacturer's "affirmative actions in distributing their products [created] an illegal secondary market for guns that targets illegal purchasers."[223] The *Ileto* court did *not* characterize the issue as one of product liability.[224] Instead, the court held that the defendant's possible negligence in allowing its products to produce a nuisance could survive the defendant's Rule 12(b)(6) motion. This case rests on an interpretation of California nuisance law that suggests that certain occupations can become a nuisance "when . . . business is performed in a manner that unreasonably infringes on a public right."[225] This allows plaintiffs to avoid the difficult proof issues for defectiveness in product liability by focusing solely on the effect of negligent marketing on the ability of the product to create a nuisance. Under this reasoning in *Ileto*, fast-food liability becomes more viable.

By approaching the issue from the angle of negligent marketing, the *Ileto* court was able to find a duty on the part of the defendants and breach of that duty. The court found a duty because Glock purposefully targeted and oversupplied states with less restrictive gun laws, increasing the probability that their guns would fall into the hands of illegal purchasers.[226] An analogy to the fast-food industry's excessive targeting of children may be just as persuasive. It is just as foreseeable that, by targeting children, the fast-food industry has affirmatively increased the risk of obesity. Furthermore, in *Ileto*, the court found a breach of duty because "[t]he social value of manufacturing and distributing guns without taking basic steps to prevent these guns from reaching illegal purchasers and possessors cannot outweigh the public interest in keeping guns out of the hands of illegal purchasers and possessors who in turn use them in crimes."[227] It is but a short step to make the argument that the social value of selling high fat, carbohydrate rich foods without taking the basic steps to inform parents of the unhealthy characteristics of this food cannot outweigh the public interest from keeping dangerously unhealthy food from vulnerable children.

Only time will tell if the *Ileto* decision will stand or if its

v. Beretta U.S.A. Corp. and *Merrill v. Navegar, Inc.*, cast serious doubt about the future of negligent marketing as a viable legal theory." *Id.* (internal citations omitted).

223 349 F.3d 1191, 1201 (9th Cir. 2003).

224 *Id.* at 1201-02.

225 *Id.* at 1214.

226 *Id.* at 1204-05.

227 *Id.* at 1205.

reasoning will ever be extended to claims against the fast-food industry. *Ileto* relies on a substantial factor test to prove causation, and its extension of nuisance beyond real property was controversial in California.[228] As noted earlier, the substantial factor test raises its own difficulties in the fast food context. Furthermore, the *Ileto* dissent took issue with the majority's characterizations that it was not a product liability action and that nuisance created by a product could be extended in California beyond real property.[229] It is difficult to predict whether this extension of nuisance law will be beneficial to fast-food litigation plaintiffs.[230] In spite of these difficulties, it is possible that some courts may find the fast-food industry liable for causing obesity by using the reasoning of *Ileto* and other lawsuits against gun manufacturers.[231]

V. PUBLIC POLICY IMPLICATIONS FOR OBESITY LIABILITY

A. The Root of the Public Policy Debate

The McDonald's litigation was about choices made by plaintiffs in response to an environment in which they were encouraged to consume fast foods by major corporations. The reason plaintiffs seek to find these corporations liable is obvious—the fast-food industry has a powerful role in controlling what we eat. According to the United States Department of Agriculture, in 2000 the nation's 844,000 food service eating establishments sold over $358 billion worth of meals and snacks.[232] Fast-food sales accounted for $125 billion of these sales.[233] Food service sales are projected to account for 49% of total food sales by the year 2010.[234] The fast-food industry

228 *Id*. at 1206, 1213-14.

229 *Id*. at 1220, 1223-24 (Hall, J. dissenting). "But to assert that this action is not about products borders on the absurd. . . . The nature of appellees' conduct cannot be analyzed apart from the *product* they are selling." *Id*. at 1220.

230 Presently, there is a substantial split of authority nationally over whether a public nuisance theory should be allowed in the gun context. *See* City of Gary *ex rel*. King v. Smith & Wesson, Corp., 801 N.E.2d 1222, 1232 & n.8 (Ind. 2003) (citing recent decisions either dismissing or allowing public nuisance action to proceed against gun manufacturers). Therefore, it is even more difficult to predict whether the courts would find such a theory persuasive for claims based on obesity.

231 City of Cincinnati v. Beretta U.S.A. Corp., 768 N.E. 2d 1136, 1143 (Ohio 2002) (holding gun manufacturer can be "held liable for creating [a] nuisance."); White v. Smith & Wesson, 97 F. Supp. 2d 816, 828-29 (N.D. Ohio 2000) (finding a duty of care for gun manufacturers to children and other unauthorized users of handguns as well as municipalities who suffer both physical and economic injury through unauthorized gun use).

232 Charlene Price, *Food Service*, *in* ECON. RESEARCH SERV., U.S. DEP'T AGRIC., THE U.S. FOOD MARKETING SYSTEM, 2002, at 34, http:\\www.ers.usda.gov.

233 *Id*. at 35.

234 *Id*. at 34.

heavily advertises to maintain its proportion of the food dollar.[235] For example, McDonald's is the largest fast-food advertiser at $1.3 billion in 2002, ranking 15th among the top 100 national advertisers.[236] Therefore, plaintiffs could have a significant impact on the nation's health if they are successful in changing the practices of these corporations.

The power of the food industry to influence eating behaviors especially impacts children's health. One recent report commissioned by the Henry J. Kaiser Family Foundation summarized many of the current studies on the role of the media in influencing childhood obesity. Based on these studies, it concluded that:

> [I]t appears likely that the main mechanism by which media use contributes to childhood obesity may well be through children's exposure to billions of dollars of food advertising and cross-promotional marketing year after year, starting at the very youngest ages, with children's favorite media characters often enlisted in the sales pitch. Research indicates children's food choices—and parents' food purchases—are significantly impacted by the advertising they see. The number of ads children see on TV has doubled from 20,000 to 40,000 since the 1970s, and the majority of ads targeted to kids are for candy, cereal, and fast food.[237]

From this perspective, the importance of the public policy debate becomes clearer. In our society, children are born into this obesity-conducive environment encouraged by these powerful corporations. However, it does not necessarily follow that these corporations should be held liable for the resulting obesity and its effects. Aside from the fact that eating is an individual act of free choice, Congress's attempt to create a federal exemption for fast-food liability has both positive and negative consequences to the fast-food industry and to our ability to address the causes of obesity.

B. The Rationale for an Exemption for Fast-food Liability

Many commentators have criticized the American legal system for allowing plaintiffs to bring "frivolous" suits against the fast-food industry, arguing that consumers should be personally responsible for their actions.[238] The Personal

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235 *Id*. at 79 app. tbl. 30. In 1999, restaurant advertising was 3.4 million.

236 R. Craig Endicott, *100 Leading National Advertisers*, 74 ADVERTISING AGE, June 23, 2003, at S-1.

237 THE HENRY J. KAISER FAMILY FOUND., THE ROLE OF MEDIA IN CHILDHOOD OBESITY 10 (2004), http://www.kff.org/entmedia/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=32022.

238 *See* CTR. LEGAL POLICY MANHATTAN INST., TRIAL LAWYERS INC.: A REPORT ON THE

Responsibility in Food Consumption Act would prevent plaintiffs from holding the fast-food industry liable for obesity.[239] The National Restaurant Association has asked Congress to recognize that consumers should be personally responsible for their actions.[240] This is the industry's strongest argument against these lawsuits. One reporter summarized the argument as: "[y]ou're fat, your fault. . . . [P]eople can make their own choices about food and exercise."[241] Therefore, one of the negative consequences to fast-food liability, so the argument runs, is the policy implication of not holding people personally responsible for the harms caused by the exercise of their own free will.

Another consequence of extending liability would be the damage to the public perception of the judicial system. If plaintiffs were to be successful, undoubtedly there would be a strong public reaction to the outcome of the suit.[242] It would be cited as another example of judicial activism that interferes with the proper role of the legislature. It would be criticized as a blatant misuse of judicial resources. Ultimately, it could lead to damaging public skepticism of the justice of our legal system.

Of course, there are also economic consequences to imposing liability on the fast-food industry. The restaurant industry could suffer from decreased sales from negative publicity, increased insurance costs arising from the exposure to liability and the burden of litigation expenses.[243] And, the fast-food industry is

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LAWSUIT INDUSTRY IN AMERICA 2003, at 18-19, *at* http:\\www.triallawyers.com

239 Personal Responsibility in Food Consumption Act, H.R. 339, 108th Cong. (2003).

240 "Not only do the lawsuits we are discussing this morning fail to acknowledge the voluntary nature of the choices customers make, they also do not address the fundamental issue of personal responsibility." *Personal Responsibility in Food Consumption Act: Hearing on H.R. 339 Before Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 108th Cong. 35 (2003) [hereinafter *Personal Responsibility Hearing*] (statement of Christianne Ricchi, on behalf of the National Restaurant Association), *available at* http://www.house.gov/judiciary/87814.PDF.

241 Siobhan McDonough, *Weighty Issues: Americans' Flab Spurs War Along Political Lines*, SEATTLE TIMES, Sept. 23, 2003, at A3.

242 According to a 2003 Gallup Poll:

[N]early 9 in 10 Americans (89%) oppose holding the fast-food industry legally responsible for the diet-related health problems of people who eat that kind of food on a regular basis. Just 9% are in favor. Those who describe themselves as overweight are no more likely than others to blame the fast-food industry for obesity-related health problems, or to favor lawsuits against the industry.

Lydia Saad, *Public Balks at Obesity Lawsuits*, GALLUP POLL: TUESDAY BRIEFING, July 21, 2003, at 109, *available at* http://www.gallup.com/poll/releases/pr030721.asp.

243 INS. INFO. INST., OBESITY, LIABILITY & INSURANCE (arguing that the insurance industry should take the threat of liability seriously). "Given the increasing cost and even scarcity of certain types of liability coverage, the recent obesity-related litigation against the fast-food industry is of special concern." *Id*. at 16. *Personal Responsibility Hearing, supra* note 240, at 34-35 (arguing that liability for obesity could damage small businesses including her own). *See also* Meg Green*, Food Fright,* BEST'S REV., Aug. 2003, at 24 (discussing the repercussions for insurers caused by recent fast-food lawsuits).

certainly not the only one that could be held liable for obesity. The costs of future litigation and liability in industries across the board could potentially explode having a detrimental impact on the national economy.[244] Although large corporations such as McDonald's may have the resources to absorb these additional costs and the capacity to defend themselves, smaller companies would be less able to sustain these costs and more vulnerable to such lawsuits.[245]

C. The Rationale Against an Exemption for Fast-food Liability

Health commentators nationally and internationally have demonstrated that advertising by the food industry, and specifically the fast-food industry, has influenced the foods that children eat.[246] By taking away the threat of liability for their actions, Congress would be implicitly supporting the actions of these corporations. There should be a point where company action in search of sales and profitability at the expense of the public health becomes culpable. This culpability will be forever evaded if liability against these companies is foreclosed.

Congress should not interfere with the state's prerogative in exploring this culpability. The control of state courts is the province of the states, and federalism and comity suggest that states should be allowed to control their own product liability law. Recent experience shows that some individual states are

244 The ice cream industry has also been notified it is a potential target! Marguerite Higgins, *Lawyers Scream About Ice Cream,* WASH. TIMES, JULY 25, 2003, at A1. One study identified the following industries that could be targeted: agriculture, food processors & manufacturers, beverage makers, food distributors, grocers, restaurants & franchises, advertising agencies, TV networks/magazines/newspapers, toy manufacturers, and sporting/entertainment organizers. INS. INFO. INST., *supra* note 243, at 16. There have been many articles and studies written as to the negative effect of litigation on the economy. *E.g.* DAVID DIAL ET AL., TORT EXCESS: THE NECESSITY FOR REFORM FROM A POLICY, LEGAL AND RISK MANAGEMENT PERSPECTIVE 8 (2003) (discussing the economic impact of tort abuse on the states and national economies), *available at* http://server.iii.org/yy_obj_data/binary/727182_1_0/tortreform.pdf.

245 *See Personal Responsibility Hearing, supra* note 240, at 34.

246 Shawna L. Mercer, et al., *Possible Lessons from the Tobacco Experience for Obesity Control*, AM. J. CLINICAL NUTRITION 1073S, 1075S (2003)

> Television appears to be directly and causally related to the prevalence of obesity among children . . . . Televised food advertisements have a major influence on the dietary intake of children. . . . [A] recent study found that food products account for more than 60% of the products advertised on Saturday morning television programs for children.

Id. (internal citations omitted). Andrew Oliver, Note, *The Proposed European Union Ban on Television Advertising Targeting Children: Would it Violate European Human Rights Law?*, 20 N.Y.L. SCH. J. INT'L & COMP. L. 501 (2000). "Swedish law bans all television advertising that specifically targets children under the age of twelve. This prohibition . . . affects not only toy advertisements, but covers advertising for sweets and fast foods as well." *Id*. at 501. Sweden attempted to extend this ban to all of Europe to protect children from the effects of such advertising. *Id*.

moving toward restricting liability,[247] and there is a real value in allowing the states to be a "laboratory of experimentation"[248] to find the best solution to deal with the public policy issues presented by obesity. In the same vein, respect for the appellate process suggests that there is no need for the federal government to step in. The appellate process worked to overturn lawsuits brought against the gun industry,[249] and therefore, it is probably even more likely that the appellate process would be quicker to overturn suits for obesity. Without at least some evidence the states cannot handle the issues arising from obesity liability, Congress should allow the states to make their own individual decisions.

By foreclosing liability, Congress would also prevent other important functions of product liability litigation. Our product liability system "brings into public view decisions balancing the utility and the hazards of the products we use and depend on, [and] it allows the people to pass judgment on those decisions."[250] It also influences the behavior of corporate executives who make decisions whether to market an unreasonably dangerous product or risk the discovery process and exposure to the media.[251] Congress would also take away the incentive product liability provides the fast-food industry to display warnings and nutritional information and promote healthier alternatives.[252]

Of course, the food industry could take voluntary actions to curb its "obesity-encouraging practices" without an exemption

247 Louisiana has already passed legislation preventing liability for obesity and "[n]ineteen other state legislatures—Arizona, California, Colorado, Florida, Georgia, Idaho, Illinois, Kentucky, Mississippi, Missouri, Nebraska, New Hampshire, Ohio, Pennsylvania, South Dakota, Tennessee, Utah, Washington and Wisconsin – were consideraing similar bills as of March 1," according to the National Conference of State Legislatures. CBSNEWS.com, *House Passes 'Cheeseburger Bill'*, *at* http://www.cbsnews.com/stories/2004/03/10/health/printable605157.shtml (March 10, 2004). *See also*, National Conference of State Legislatures, Excerpt from Issue Brief on Nutrition and Obesity, *at* http://www.ncsl.org/programs/health/IBIntro.htm (Apr. 1, 2002) (detailing current state legislation dealing with obesity).

248 In the context of gun control, Justice Kennedy emphasized these values. "In this circumstance, the theory and utility of our federalism are revealed, for the States may perform their role as laboratories for experimentation to devise various solutions where the best solution is far from clear." United States v. Lopez, 514 U.S. 549, 581 (1995) (Kennedy, J., concurring).

249 *See e.g.* Hamilton v. Beretta U.S.A. Corp., 750 N.E.2d 1055 (N.Y. 2001); Merrill v. Navegar, Inc., 28 P.3d 116 (Cal. 2001).

250 Bogus, *supra* note 31, at 219.

251 *Id*.

252 *See* Timothy D. Lytton, *Tort Claims Against Gun Manufacturers for Crime-Related Injuries: Defining a Suitable Role for the Tort System in Regulating the Firearms Industry*, 65 MO. L. REV. 1, 51-52, 62, (discussing how the tort system has provided incentives for safety in the firearms and auto industries as a "[c]omplement to [l]egislative and [a]dministrative [r]egulation.").

from liability.[253] However, if it did not change these practices and Congress prevented liability, the fast-food industry would no longer be exposed to both litigation and regulation. The threat of litigation (and its subsequent effect on stock prices) is one of the most powerful tools available to change corporations' behavior.[254] As noted by Professor Cass Sunstein, "lawsuits are a form of regulation," but they make up "for a shortfall of regulation by government agencies."[255] Without the threat of litigation, Congress will find itself facing the pressure for resolving these problems, and any shortfall in the regulation of these industries would likely be remedied by either federal legislation or regulation.

Undoubtedly, the fast-food industry's exposure to product liability has costs,[256] but at this time those costs are not significant as compared to potential costs of future regulation or legislation. As addressed earlier, no present cause of action adequately supports liability, so an actual liability cost does not presently exist.[257] But what of the argument that small restaurants will be forced out of business if liability is extended? Even if liability were imposed, it is unlikely that the costs shouldered by the small restaurants would be significant. The small businesses will likely not be the first targets. It is more likely that the $125 billion-strong fast-food industry, dominated by large corporations (who, as shown in *Pelman,* are well-able to defend themselves) would be the first target. The cost equation must also be evaluated by taking into account the effect regulation may have on the corporate bottom-line. Liability costs are felt after a corporation has committed misdeeds. This allows the market to control costs by allowing the fast-food corporations to choose their level of self-regulation.[258] If liability is foreclosed, the only governmental control of these corporations' obesity-promoting behavior will be through government regulation or taxation. In the past few years, public health commentators have been calling for taxation of fast foods and for increased

253 Ben Kelley, *Fair Warning for Fat Peddlers*, WASH. POST, Aug. 13, 2003, at A27.

254 Samuel Loewenberg, *Are Lawyers the New Regulators?*, 2003 NAT'L J. 2640, 2640-41.

255 *Id*. at 2641 (internal quotation marks omitted).

256 Bogus, *supra* note 31, at 218.

257 Congressional Budget Office, Cost Estimate: H.R. 339 (Feb. 10, 2004) *at* ftp://ftp.cbo.gov/50xx/doc5037/hr339.pdf.

258 Carl T. Bogus, *War on the Common Law: The Struggle at the Center of Products Liability,* 60 Mo. L. Rev. 1, 82 (1995) (arguing that the "products liability system compensates for the shortcomings of administrative regulation" and "[i]t stimulates self-regulation, giving manufacturers a strong incentive to learn as much as possible about potential hazards and reduce risk."). *See* Lytton, *supra* note 252, at 52 (concluding that the "threat of tort liability provides incentives for the [gun manufacturing] industry to police itself").

regulation.[259] The Food and Drug Administration has responded and recently unveiled its strategy to reduce obesity by strongly encouraging restaurants to begin including nutrient information in menus.[260] Such encouragement could turn into regulation or taxation without the external controls of restaurant behavior from product liability. In order to avoid potentially crippling federal regulations, the fast-food restaurants themselves should welcome the opportunity to state their case in the courts.

Finally, in the aggregate, the costs do not outweigh the benefits provided by our product liability system as demonstrated by fast-food corporations' response to threatened litigation. The relatively few unsuccessful cases and their media exposure have brought beneficial changes to the way the fast-food industry does business. The fast-food companies have responded to the incentives to self-regulate and have reduced their exposure to litigation. The fast-food companies are now competing to show they can provide healthier alternatives and nutritional advice.[261] The success of companies demonstrating a commitment to supplying healthier alternatives and providing nutritional advice has spurred these changes across the industry.[262] Even McDonald's is changing its behavior and benefiting from that change. In October 2003, McDonald's named a director of worldwide nutrition and then in January 2004, launched an initiative called "Real Life Choices" in New York to provide nutritional education programs.[263] In April 2004, McDonald's

259 KELLY D. BROWNELL & KATHERINE BATTLE HORGEN, FOOD FIGHT 217-35 (2004) (arguing that a good approach toward eliminating obesity would be to "subsidize all fruits and vegetables with revenue generated by a tax on soft drinks, snack foods, and fast foods" and by making obesity a "priority in the four main [federal] food programs").

260 Press Release, United States Department of Health & Human Services, HHS Unveils FDA Strategy to Help Reduce Obesity (March 12, 2004). "Encouraging the restaurant industry to launch a national, voluntary effort to include nutritional information for consumers at the point of sale." *Id*.

261 Elizabeth Lee, *Fast Food Goes on a Diet,* ATLANTA J. CONST., Sept. 19, 2003, at A1. Consider what's happened in just the past week. McDonald's announced it was teaming up with Bob Greene to promote a Go Active meal for adults, with a salad, a pedometer to count steps and a bottle of water . . . Wendy's revamped the nutrition section of its Web site to provide more information on meal choices, including recommendations for people who are dieting . . . Burger King unveiled its grilled sandwiches with 5 grams of fat, and a light combo meal made up of one of those sandwiches, bottle water and a salad.
Id. Nancy Dillon, *McD's Goes Healthy in NY: But Nutritionists Query Program's Real Impact*, N.Y. DAILY NEWS, Oct. 7, 2003, *available at*, 2003 WL 65395464 (describing how McDonald's, Blimpie, and Burger King provide new products or nutritional advice on how to lower calories while eating at their restaurants).

262 Lee, *supra* note 261. Fast-food companies are changing their behavior because of the "success of chains that have heavily promoted healthier choices, such as Subway and Wendy's." *Id*.

263 Press Release, McDonald's Corp., McDonald's Corporation Announces Worldwide Nutrition Director (Oct. 8, 2003), *available at* http://164.109.33.187/content/corp/news/corppr/cpr10082003.html; Press Release, McDonald's Corp., McDonald's Real Life Choices Teaches Consumers How to Eat the McDonald's Food They Love and Stay on Track with

came out with a national campaign to provide "Adult Happy Meals" with salads, pedometers, and health advice for its customers.[264] Perhaps the most striking change, however, is McDonald's recent decision to stop "super-sizing" its meals.[265] This change appears to be in direct response to potential liability problems and shows the potential deterrent effect of the threat of litigation.[266] Furthermore, McDonald's new menus, offering salad as a healthier alternative, has driven the company to even higher profits.[267]

VI. CONCLUSION

As product liability law presently stands, the fast-food industry will most likely not be held liable for influencing the public's eating behavior. The existing theories of product liability do not appear to support such an action. *Pelman* demonstrates the difficulty courts have in assigning responsibility to the fast-food industry when plaintiffs have made choices with obvious risks. *Pelman* also presents the difficulty plaintiffs will have in establishing that fast food is a defective product, in creating a duty toward the plaintiff, and in finding that fast food caused their injuries. In the near future, these obstacles may be insurmountable.

Yet one is left with the unsettling feeling that obesity is not strictly a personal choice. It is undisputed that the food industry markets to children to influence both their behavior and, through them, their parents' behavior. Children are incapable of making these choices, and it is questionable that parents should shoulder all the blame for these actions when there are such powerful forces working against them. Whether the fast-food industry has

Their Diets (Jan. 6, 2004), *available at* http://164.109.33.187/usa/news/current/conpr_01062004.html.

264 Dave Carpenter, *McDonald's Rolls Out Adult Happy Meals*, ORANGE COUNTY REG., Apr. 16, 2004, at B1.

265 Press Release, McDonald's Corp., McDonald's Media Response to Core Menu and Super Sizing (Mar. 2, 2004), *available at* http://164.109.33.187/usa/news/current/conpr_030120040.html.

266 Albeit McDonald's has implied it is only a business decision based entirely on sales! Press Release, McDonald's Corp., McDonald's Sales Momentum Continues; Reports Record February Sales, Up 23% (Mar. 5, 2004), *available at* http://www.mcdonalds.com/corp/news/fnpr/fpr_03052004.RowPar.0001.ContentPar.0001.ColumnPar.0006.File.tmp/MCD%20Sales%20Update%20February%202004.pdf.

267 *See McDonald's Healthier Menu Brings Back Profits*, DAILY EXPRESS, Oct. 24, 2003 (describing the effect McDonald's healthier menus have had on profits in the United States), *available at* 2003 WL 65920716. *See* Press Release, McDonald's Corp., McDonald's Sales Momentum Continues; Reports Record February Sales, Up 23% (Mar. 5, 2004) (indicating that one of the drivers of its tenth consecutive month of improved sales was enhanced menu variety), *available at* http://www.mcdonalds.com/corp/news/fnpr/fpr_03052004.RowPar.0001.ContentPar.0001.ColumnPar.0006.File.tmp/MCD%20Sales%20Update%20February%202004.pdf.

created a public nuisance by promoting unhealthy products and whether courts should ever interfere in this area of personal choice are difficult questions. Ultimately, these issues are not completely answered by existing theories. Thus, it is wise to allow the federal government, state legislatures and state courts to grapple with these issues without a foreclosure of product liability for obesity. History has shown that the laws of product liability have adapted to hold manufacturers responsible for culpable conduct. Fast-food litigation should stand or fall depending on whether the public finds the industry's conduct culpable through both the litigation and the regulation process. The current pervasive presence of obesity in the United States suggests that this problem will not be reduced nor eliminated soon without continued attention to these issues.

An Iron Fist or Kid Gloves: *American Insurance Association v. Garamendi* and the Fate of the Federal Monopoly on Foreign Policy

J. Matthew Saunders[*]

I. INTRODUCTION

Prior to and during the Second World War, the Nazi government of Germany engaged in the wide scale theft of insurance policies held by Jews throughout Europe. In *American Insurance Ass'n v. Garamendi*, the United States Supreme Court struck down California's Holocaust Victim Insurance Relief Act (HVIRA), a statute aimed at helping Holocaust victims and their heirs settle claims against insurance companies by forcing the insurance companies to disclose information about policies sold in Europe between 1920 and 1945.[1] In a five-four decision, the Court ruled that the HVIRA conflicted with the federal policy of settling the claims through diplomatic channels.[2] Justice Souter, writing for the majority, stated:

> California seeks to use an iron fist where the President has consistently chosen kid gloves. We have heard powerful arguments that the iron fist would work better, and it may be that if the matter of compensation were considered in isolation from all other issues involving the European allies, the iron fist would be the preferable policy. But our thoughts on the efficacy of the one approach versus the other are beside the point, since our business is not to judge the wisdom of the National Government's policy. . . .[3]

Almost immediately, representatives of the Jewish community called the decision "tragic"[4] and "a crushing blow to the victims of

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1 American Ins. Ass'n. v. Garamendi, 123 S. Ct. 2374, 2379 (2003).

2 *Id*. at 2390.

3 *Id*. at 2393.

4 Charles Lane, *Court Rejects Law Aiding Survivors of Holocaust; Calif. Act Undercut Presidential Role, Ruling Says*, WASH. POST, June 24, 2003, at A11.

the Holocaust."[5]

Furthermore, the Court's decision in *Garamendi* reaches beyond the rights of Holocaust survivors. It has muddied the waters in an increasingly murky area of constitutional law—the nature of the federal monopoly on foreign policy. California's legislature felt compelled to act because, as stated in the HVIRA, "[a]t least 5,600 documented Holocaust survivors are living in California today. Many of these survivors and their descendents have been fighting for over 50 years to persuade insurance companies to settle unpaid or wrongfully paid claims."[6] The California legislature enacted HVIRA in a legitimate aim to eliminate "the further victimization of these policyholders and their families."[7] The Supreme Court's striking down of the HVIRA throws a glaring spotlight on the problem of determining where state authority ends in an increasingly interconnected global society. So far, the Supreme Court has provided little guidance to the states or the courts below as to what states can and cannot do in the global arena.[8]

That the federal government holds a monopoly on foreign policy was once a given, but in its application this idea has come under fire. As one commentator has remarked, "[m]ost everyone was comfortable supposing that the national government monopolized foreign relations until the Supreme Court actually began applying that notion."[9] *Garamendi* follows more than half a century of confusing and contradictory Supreme Court cases concerning this federal monopoly on foreign policy.[10] It represents a retreat from the ideas put forward in these cases, but it resolves none of the issues involved. In fact, in *Garamendi*, the Court fell into many of the same traps as it had in its previous jurisprudence, including having to infer what exactly the federal foreign policy was and to decide whether Congress or the President had ultimate authority over that foreign policy. Furthermore, on the ultimate question of whether there is any room at all for state action in the foreign policy realm, the Court remained silent. Thus, *Garamendi* gives little assistance to those who hoped it would clarify the role of the states on the global

5 Henry Weinstein, *Holocaust Insurance Law Negated*, L.A. TIMES, June 24, 2003, at B1.

6 CAL. INS. CODE § 13801(d) (Deering Supp. 2003).

7 *Id*. § 13801(e).

8 Emily Chiang, *Think Locally, Act Globally? Dormant Federal Common Law Preemption of State and Local Activities Affecting Foreign Affairs*, 53 SYRACUSE L. REV. 923, 925 (2003).

9 Edward T. Swaine, *The Undersea World of Foreign Relations Federalism*, 2 CHI. J. INT'L L. 337, 339 (2001) [hereinafter Swaine, *Foreign Relations Federalism*].

10 Edward T. Swaine, *Negotiating Federalism: State Bargaining and the Dormant Treaty Power*, 49 DUKE L. J. 1127, 1135 [hereinafter Swaine, *Negotiating Federalism*].

stage.

Part II of this Note explores the three prevailing theories in support of the federal monopoly on foreign policy: the dormant federal foreign affairs power, the dormant Foreign Commerce Clause, and direct preemption.[11] Part III discusses *Garamendi* and the opinions of both the majority and the dissent. Part IV explores the problems with the Supreme Court's ruling. Part V posits a solution to the unresolved issues faced in *Garamendi*, which involves recognizing a constitutional basis for the federal monopoly on foreign policy but limiting its application. Part VI concludes this Note with observations on the legal basis for the federal government's authority to conduct foreign policy and the future of state activity in the international arena.

II. THREE THEORIES ON THE SOURCE OF THE FEDERAL MONOPOLY ON FOREIGN POLICY

A. The Dormant Federal Foreign Affairs Power

Under the theory of the dormant federal foreign affairs power, one of the three prevailing theories on the source of the federal monopoly on foreign policy, any state law that has a direct impact on the federal government's ability to conduct foreign policy is invalid.[12] The dormant federal foreign affairs power has its roots in several Supreme Court cases from the early to mid-twentieth century. In *United States v. Curtiss-Wright Export Corp.*, the Supreme Court upheld a joint resolution of Congress giving power to the President to outlaw the sale of arms to combatants embroiled in a conflict in Bolivia and Paraguay.[13] Justice Sutherland, writing for the majority, said, "[t]he broad statement that the federal government can exercise no powers except those specifically enumerated in the Constitution, and such implied powers as are necessary and proper to carry into effect the enumerated powers, is categorically true only in respect of our internal affairs."[14] He went on to explain that in his view, "the states severally never possessed international powers," and that this power originated

11 The term "preemption" is often used, and not incorrectly, to describe all three doctrines. The dormant foreign affairs power and the dormant Foreign Commerce Clause are forms of field preemption; the federal government having intended to occupy the entire field of foreign affairs under these doctrines. The direct preemption theory envisions instances of conflict preemption, both explicit and implied. This note attempts to avoid confusion by using "preemption" to refer only to such conflict preemption.

12 Swaine, *Negotiating Federalism*, *supra* note 10, at 1144.

13 299 U.S. 304, 329 (1936).

14 *Id*. at 315-16.

in the states acting as a union.[15] Therefore, "[a]s a member of the family of nations, the right and power of the United States in that field are equal to the right and power of the other members of the international family. Otherwise, the United States is not completely sovereign."[16] In other words, there was no room for state action.

A few years later, in *Hines v. Davidowitz*, the Supreme Court struck down a Pennsylvania law that provided for the registration of immigrants within the state.[17] In doing so the Court said, "[t]he Federal Government, representing as it does the collective interests of the [then] forty-eight states, is entrusted with full and exclusive responsibility for the conduct of affairs with foreign sovereignties."[18] Furthermore, the Court stated, "for national purposes, embracing our relations with foreign nations, we are but one people, one nation, one power."[19]

The federal foreign affairs power doctrine crystallized, however, during the height of the Cold War. In *Banco Nacional de Cuba v. Sabbatino*, the Court, in ruling that the Cuban government had standing to sue in United States courts, integrated international law into federal common law. [20] The Court reasoned that the "concern for uniformity in this country's dealings with foreign nations" that is manifested in various clauses of the Constitution indicated "a desire to give matters of international significance to the jurisdiction of federal institutions."[21] Therefore, it would be inappropriate for a federal court to apply state common law to an issue implicating international law.

Sabbatino paved the way for *Zschernig v. Miller* four years later, in which perhaps the most direct embodiment of the dormant foreign affairs power appears.[22] In *Zschernig*, the Supreme Court struck down an Oregon law prohibiting a citizen of a foreign country from claiming an inheritance from a resident of Oregon unless certain conditions were met.[23] These conditions were meant to ensure the existence of reciprocity in inheritance rights between the United States and other nations and required foreign nationals to prove that this reciprocity existed.[24]

15 *Id*. at 316.
16 *Id*. at 318.
17 312 U.S. 52, 73-74 (1941).
18 *Id*. at 63.
19 *Id*. (quoting The Chinese Exclusion Cases, 130 U.S. 581, 606 (1889)).
20 376 U.S. 398, 426-27 (1964).
21 *Id*. at 427 n.25.
22 389 U.S. 429, 441 (1968); Swaine, *Negotiating Federalism*, *supra* note 10, at 1143.
23 389 U.S. at 441.
24 *Id*. at 430-31.

Furthermore, the law required foreign nationals to demonstrate that they could take property from an Oregon estate "without confiscation."[25]

Although the law as written applied to all nations, the Court found that in implementing it, probate judges regularly disfavored citizens of Communist countries.[26] They went beyond simply determining whether reciprocity existed and sought "to ascertain whether 'rights' protected by foreign law are the same 'rights' that citizens of Oregon enjoy."[27] If a right in question implicated a Communist-controlled state agency, then judges ruled that the right was not the same and that there was no reciprocity.[28] Most troubling for the Supreme Court was the reference in the Oregon law to "confiscation," which "led into minute inquiries concerning the actual administration of foreign law, into the credibility of foreign diplomatic statements," and into speculation as to whether inherited goods were actually delivered to the rightful heirs.[29]

This level of involvement was too much for the Court even though no treaty or federal law addressed the issue. Justice Douglas, writing for the majority, stated that "even in absence of a treaty, a State's policy may disturb foreign relations."[30] The Oregon law had "a direct impact upon foreign relations" and negatively affected the federal government's ability to conduct foreign policy.[31] By contrast, the Supreme Court upheld a similar reciprocity agreement in California, which relied on the statement of foreign ambassadors to prove reciprocity, because it only had "some incidental or indirect effect in foreign countries."[32]

A major criticism of the decision in *Zschernig* is that the Court lacked direct support for its statements, relying on dicta from *Curtiss-Wright* and *Hines*.[33] Because of this and because of the focus on Communist countries, the tendency has been to relegate *Zschernig* to the status of Cold War relic.[34] Today, few adhere fully to the reasoning of *Curtiss-Wright*, and, without express language in the Constitution, a treaty, or federal statute, the Court has been reluctant to confer power to the federal

25 *Id*.
26 *Id*. at 440.
27 *Id*.
28 *Zschernig*, 389 U.S. at 440.
29 *Id*. at 435.
30 *Id*. at 441.
31 *Id*.
32 *Id*. at 433 (quoting Clark v. Allen, 311 U.S. 503, 517 (1947)).
33 Swaine, *Negotiating Federalism*, *supra* note 10, at 1142-43.
34 *Id*. at 1145.

government at the expense of the states.[35] However, in light of the heightened tensions of the time, the *Zschernig* decision made sense. The Oregon law struck down in *Zschernig* did have the potential to spark an international incident, and the Court's expression of the dormant foreign affairs power—that a state law "with a direct impact upon foreign relations" was unconstitutional—reflected this reality.[36]

Despite the lack of direct support in the Constitution for a federal monopoly on foreign policy, proponents of the dormant foreign affairs power can point to numerous constitutional provisions for substantiation.[37] Article I, Section 8 gives Congress power "[t]o regulate commerce with foreign nations. . . ; [t]o define and punish Piracies and Felonies committed on the High Seas, and Offenses against the Law of Nations;" and "[t]o declare War, grant Letters of Marque and Reprisal, and make Rules concerning Captures on Land and Water."[38] Article II, Section 2 makes the President "Commander in Chief of the Army and Navy of the United States, and of the Militia of the several States;" and gives him the power to make treaties and appoint ambassadors, and to receive ambassadors.[39] Furthermore, the Supremacy Clause, located at Article VI, Section 4, states, "[t]his Constitution, and the Laws of the United States . . . and all Treaties made . . . under the Authority of the United States, shall be the supreme Law of the Land. . . ."[40] Finally, Article I, Section 10 bars the states from entering into any "treaty, alliance, or confederation."[41] Still, critics point out that while these provisions give the federal government broad power over foreign policy, it is far from clear that they impart *exclusive* power.[42]

The only other arguments available to advocates of the dormant foreign affairs power are historical and pragmatic ones.[43] During the Articles of Confederation period, the independent actions of several states led to disastrous results, including the disruption of much-needed trade with Great Britain.[44] The writings of Alexander Hamilton and James Madison in *The Federalist Papers* are often cited to support the proposition that the federal government needs unfettered control

35 *Id*. at 1142, 1150.

36 Peter J. Spiro, *Foreign Relations Federalism*, 70 U. COLO. L. REV. 1223, 1241-42 (1999).

37 Chiang, *supra* note 8, at 933.

38 U.S. CONST. art I, § 8.

39 U.S. CONST. art II, §§ 2-3.

40 U.S. CONST. art VI, § 4.

41 U.S. CONST. art I, § 10.

42 Swaine, *Negotiating Federalism*, *supra* note 10, at 1135.

43 *Id*.

44 Chiang, *supra* note 8, at 938.

over the foreign affairs of the nation.[45] Hamilton wrote, "The interfering and unneighborly regulations of some States, contrary to the true spirit of the Union, have, in different instances, given just cause of umbrage and complaint to [other nations]," and that these regulations needed to be restrained by a "national control" or else they "would be multiplied and extended till they became not less serious sources of animosity and discord than injurious impediments to the intercourse between the different parts of the Confederacy."[46] In addition, Madison wrote, "If we are to be one nation in any respect, it clearly ought to be in respect to other nations."[47] Many have argued that this danger has not diminished over time. To permit the states to conduct their own foreign policies would be to invite chaos, since the actions of one state could disrupt foreign relations for the whole nation.[48]

Critics, however, argue that increased globalization has given the states much greater direct access to the world at large and that foreign entities understand that a single state does not always speak for the whole nation.[49] They point out that individual states have always involved themselves in international matters to some extent. They "establish offices overseas, launch trade and investment missions, sign bilateral and multilateral agreements, and participate in international summits."[50] Denying the individual states any voice in foreign policy therefore runs contrary to the realities of a global marketplace.

Since the *Zschernig* decision the Supreme Court has not applied the direct impact doctrine, leaving its value as precedent in some doubt.[51] However, the Court also has never overruled *Zschernig*, and many lower courts have embraced the "direct impact" test it propounds.[52] For example, in *Deutsch v. Turner Corp.,* the Ninth Circuit applied the *Zschernig* "direct impact" test to a California law aimed at corporations who employed slave labor in Europe and Asia prior to and during World War II.[53] The law was enacted at the same time as the HVIRA and allowed victims of slave labor to sue for compensation for the

45 *Id*. at 936-37.

46 THE FEDERALIST No. 22, at 144-45 (Alexander Hamilton) (Clinton Rossiter, ed., 1961).

47 THE FEDERALIST No. 42, at 264 (James Madison) (Clinton Rossiter, ed., 1961).

48 Chiang, *supra* note 8, at 957.

49 *Id*. at 956.

50 Swaine, *Negotiating Federalism*, *supra* note 10, at 1130.

51 *Id*. at 1145.

52 Jack L. Goldsmith, *Federal Courts, Foreign Affairs, and Federalism*, 83 VA. L. REV. 1617, 1632 (1997).

53 324 F.3d 692, 709 (9th Cir. 2003).

work they were forced to do.[54] The court invalidated the California law because, in its estimation, the federal government had exclusive power in foreign policy, especially concerning the ability to wage war and to negotiate an end to war.[55] The court stated that "the Supreme Court has long viewed the foreign affairs powers specified in the text of the Constitution as reflections of a generally applicable constitutional principle that power over foreign affairs is reserved to the federal government."[56] Because so many lower courts have adopted the "direct impact" rule, it would seem appropriate for the Supreme Court to flesh out the doctrine, but so far the Court has refused to do so.

B. The Dormant Foreign Commerce Clause

The dormant Foreign Commerce Clause doctrine derives its legitimacy from the Interstate Commerce Clause in Article II, Section 8 of the Constitution, which gives Congress the power to regulate commerce both among the states and with foreign nations, and from the Import-Export Clause in Article II, Section 10, which prohibits states from laying duties on imports or exports without congressional consent.[57] The rationale of the doctrine is identical to that of the dormant Commerce Clause doctrine.[58] A state action is invalid if it intrudes into the field of foreign commerce, even if Congress has not yet chosen to regulate a particular matter in that area.

Japan Line Ltd. v. County of Los Angeles, a case in which the Supreme Court overturned a tax imposed by California on foreign-owned cargo containers in California ports, set out the test for whether a state law violates the dormant Foreign Commerce Clause.[59] According to *Japan Line*, if the state law in question prevents the federal government from "speak[ing] with one voice," it is unconstitutional.[60]

The Supreme Court further developed the "one voice" standard in *Barclays Bank PLC v. Franchise Tax Board*.[61] In *Barclays Bank*, several multinational corporations filed suit alleging that the worldwide combined reporting method employed by the State of California to calculate corporate

54 CAL. CIV. PROC. CODE § 354.6 (Deering Supp. 2003).
55 *Deutsch*, 324 F.3d at 711.
56 *Id*. at 709.
57 Swaine, *Negotiating Federalism*, *supra* note 10, at 1146-48.
58 *Id*. at 1146.
59 441 U.S. 434, 453-54 (1979).
60 *Id*. at 449.
61 512 U.S. 298 (1994).

franchise taxes unfairly taxed foreign-based multinational corporations twice.[62] The corporations claimed that the world-wide combined reporting method violated the Commerce Clause and the Due Process Clause.[63] Justice Ginsburg, writing for the majority, dismissed most of the corporations' claims because the world wide combined reporting method was "proper and fair."[64] Furthermore, the worldwide combined reporting method did not "inevitably" lead to double taxation, and other methods of calculating corporate taxes were just as susceptible to the dangers of double taxation.[65]

The Supreme Court's inquiry did not end there, however. In light of *Japan Line*, the Court investigated whether California's method impaired the federal government's "capacity to speak with one voice when regulating commercial relations with foreign governments."[66] The Court held that Congress, while aware of foreign opposition to the worldwide combined reporting method, had chosen not to forbid the states to employ it.[67] Numerous bills that would have prohibited use of the worldwide combined reporting method were defeated.[68] In addition, the Senate, in ratifying a treaty with the United Kingdom, deleted a provision of the treaty that would have precluded use of the method.[69] The Court also defended the California practice against opposition by the Executive Branch, discounting executive statements on the grounds that the Constitution conferred the power to regulate foreign commerce to the Legislative Branch.[70] As the Court stated, "[W]e leave it to Congress—whose voice, in this area, is the Nation's—to evaluate whether the national interest is best served by tax uniformity, or state autonomy."[71] Thus when Congress and the President differ, Congress prevails in matters of foreign commerce.[72]

Some hailed *Barclays Bank* as a victory for state power to determine foreign policy, at least on a limited basis. However, the decision still gave the ultimate power over foreign policy to a branch of the federal government, in this case Congress, which happened to have compatible views with California.[73] In this

62 *Id*. at 302.
63 *Id*.
64 *Id*. at 316.
65 *Id*. at 319.
66 *Barclays Bank*, 512 U.S. at 311 (internal quotation marks omitted).
67 *Id*. at 324.
68 *Id*. at 325-26.
69 *Id*. at 326-27.
70 *Id*. at 329.
71 *Barclays Bank*, 512 U.S. at 331.
72 *Id*. at 329-30.
73 Chiang, *supra* note 8, at 954.

way, the "one voice" test becomes virtually identical to the "direct impact" test under the dormant foreign affairs power theory, and is thus susceptible to the same criticisms.[74] Very little textual justification exists for granting Congress such power in situations where positive law enactments are absent.[75] Furthermore, because *Japan Line*, *Barclays Bank*, and the other cases using the "one voice" analysis all have to do with tax issues, the applicability of this test may very well be limited to foreign tax disputes.[76] At any rate, it is clear that the development of the dormant Foreign Commerce Clause adds yet another layer of complexity to the question of the federal monopoly on foreign policy: namely, whether the monopoly belongs to Congress, the President, or both.[77]

C. Direct Preemption

At the core of the direct preemption theory lies the Supremacy Clause, which states that the Constitution, federal laws, and treaties are "the supreme Law of the Land. . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."[78] Thus, "[s]tate and local measures touching on foreign affairs clearly cannot be maintained in the teeth of enacted federal law—including, at a minimum, federal statutes, treaties, and congressionally authorized regulations."[79] There is nothing controversial about this idea, which is fundamental to the functioning of the federal government. A state law which conflicts with a federal law, either expressly or by implication, is unconstitutional, regardless of its subject matter. The issue then is determining when a conflict occurs.

In *United States v. Pink*, the Supreme Court overturned several New York laws directed against the Soviet Union.[80] The laws, passed after the 1917 Revolution in Russia and the nationalization of the Russian insurance industry, denied the claims of the Soviet Union to assets of Russian insurance companies established in the state of New York prior to the Bolshevik takeover.[81] However, in 1933 the United States officially recognized the Soviet Union, and the Soviet government assigned its claims to the United States for collection.[82] The

74 Swaine, *Negotiating Federalism*, *supra* note 10, at 1148.
75 *Id*. at 1156.
76 Goldsmith, *supra* note 52, at 1637.
77 Swaine, *Negotiating Federalism*, *supra* note 10, at 1156-57.
78 U.S. CONST. art VI, § 4.
79 Swaine, *Negotiating Federalism*, *supra* note 10, at 1141.
80 315 U.S. 203, 234 (1942).
81 *Id*. at 210-11.
82 *Id*. at 211.

United States brought suit to acquire the New York assets.[83] The Supreme Court ruled that the agreement between the United States and the Soviet Union was valid and, relying on the Supremacy Clause, recognized the President's power to negotiate agreements with foreign governments.[84] The Court stated that "international compacts and agreements" have the same binding force on the courts as treaties, and, therefore, state actions in conflict with such agreements are invalid.[85]

More recently, the Supreme Court applied the idea of direct preemption in *Crosby v. National Foreign Trade Council*.[86] In 1996 the Commonwealth of Massachusetts adopted a law entitled "An Act Regulating State Contracts with Companies Doing Business with or in Burma (Myanmar)" ("Massachusetts Act").[87] The law prohibited state entities from doing business with organizations that also did business with the government of Myanmar and was enacted in response to the atrocious human rights violations of the military junta in power.[88]

Three months after the Massachusetts law went into effect, Congress passed the Foreign Operations, Export Financing, and Related Programs Appropriations Act ("Federal Act").[89] Among other provisions, the Federal Act authorized the President to apply sanctions directly on the government of Myanmar.[90] It also gave him the power to inhibit "new investment" by American entities in Myanmar and to explore diplomatic avenues "to bring democracy to and improve human rights practices and the quality of life in [Myanmar]."[91] The motivations for the Federal Act were similar to those of the Massachusetts Act.[92]

The National Foreign Trade Council, representing several business organizations adversely affected by the Massachusetts Act, filed suit in 1998.[93] The District Court granted a permanent injunction against the Massachusetts Act, stating that it "unconstitutionally impinged on the federal government's exclusive authority to regulate foreign affairs."[94] The First Circuit affirmed on the grounds that the Massachusetts Act

83 *Id*. at 213.
84 *Id*. at 230.
85 *Pink*, 315 U.S. at 230.
86 530 U.S. 363, 366 (2000).
87 *Id*. at 366-67 (citing MASS. GEN. LAWS ch. 7 §§ 22G-22M (2002)).
88 *Crosby*, 530 U.S. at 367; Chiang, *supra* note 8, at 928.
89 Foreign Operations, Export Financing, and Related Programs Appropriations Act, Pub. L. No. 104-208, § 570, 110 Stat. 3009-166 (1996).
90 *Crosby*, 530 U.S. at 369.
91 *Id*.
92 *See id*. at 370; *supra* text accompanying note 88.
93 *Crosby*, 530 U.S. at 370-71.
94 *Id*. at 371 (alteration in original).

violated the dormant foreign affairs power, the dormant Foreign Commerce Clause, and was preempted by the Federal Act.[95]

The Supreme Court, however, affirmed the First Circuit's decision solely on the preemption ground.[96] Justice Souter, writing for the unanimous Court, stated that the Massachusetts Act was "an obstacle to the accomplishment of Congress's full objectives under the [F]ederal Act" and that "the state law undermines the intended purpose and 'natural effect' of at least three provisions of the [F]ederal Act . . . ."[97] In explaining the Court's reasoning, he noted the difference between the two Acts. In many ways, the Massachusetts Act was much harsher than the Federal Act, and the Court feared that it would hamper the President's ability to implement the provisions of the Federal Act, especially its diplomatic components.[98]

Direct preemption is the least controversial of the three because it has clear constitutional support. However, in limiting the *Crosby* holding to direct preemption, the court deliberately closed off any discussion of the dormant federal foreign affairs power or the dormant Foreign Commerce Clause and disappointed those who had hoped for some clarification of the meaning and continued relevance of *Zschernig* and *Barclays Bank*.[99] This disappointment reflects the major shortcoming of the direct preemption approach, a shortcoming that in many ways spurred the *Zschernig* decision in the first place. There is not always a federal law or treaty in direct conflict with a state action, but in some way, it is clear that a state action intrudes into the ability of the federal government to conduct foreign policy freely. In such a situation, the direct preemption approach will not work to alleviate the problem, and the only options open to the courts are doctrines on which the Supreme Court has not commented.[100]

III. AMERICAN INSURANCE ASSOCIATION V. GARAMENDI – A STATEMENT OF THE CASE

A. Factual Background

Insurance policies and annuities were widely popular investments among Jews in Europe prior to the Second World

95 *Id*.
96 *Id*. at 372.
97 *Id*. at 373.
98 *Crosby*, 530 U.S. at 376-77.
99 *Id*. at 374 n.8; Swaine, *Foreign Relations Federalism*, *supra* note 9, at 338.
100 Swaine, *Foreign Relations Federalism*, *supra* note 9, at 338.

War.[101] These policies were held by individuals from every walk of life and covered everything "from life, property, and business assets to vehicles, art, and future dowries for holders' daughters."[102] With the rise of the Nazi government in Germany and the attendant persecution of the Jews, these insurance policies and annuities became targets for confiscation.[103] At first, this confiscation was indirect. Jews were forced to cash out their policies in order to pay the heavy taxes levied solely upon them or to pay the steep emigration fees if they wanted to leave Germany.[104] However, following the night of November 9, 1938—also known as *Kristallnacht*—on which Jewish-owned businesses throughout Germany were systematically looted and destroyed, the Nazi government convinced insurance companies to pay claims for damage arising out of the vandalism into the Reich treasury at a fraction of the value of the claims.[105] It was not long before the German government began taking the policies of Jews outright, and many insurance companies have been accused of colluding with the Third Reich in this large-scale theft.[106]

After the end of World War II, insurance companies offered a litany of excuses for their refusal to honor pre-war policies. They pointed to "the destruction of company records during the war."[107] They cited claimants' inability to produce death certificates for relatives who had died in concentration camps or the fact that policyholders had stopped paying premiums when they were deported to those camps.[108] In some of the most blatant cases, they informed claimants that they could not pay on the policies because the proceeds had already been paid—to Nazi officials.[109] Insurance companies further argued that they were relieved from paying on policies held in countries that became Communist after the war because the insurance industries in those countries had been nationalized.[110]

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101 Michael J. Bazyler, *The Holocaust Restitution Movement in Comparative Perspective*, 20 BERKELEY J. INT'L L. 11, 19 (2002) [hereinafter Bazyler, *Holocaust Restitution Movement*].

102 Adrienne Scholz, *Restitution of Holocaust Era Insurance Assets: Success or Failure?*, 9 NEW ENG. J. INT'L & COMP. L. 297, 299 (2003).

103 Bazyler, *Holocaust Restitution Movement*, *supra* note 101, at 19.

104 Michael J. Bazyler & Amber L. Fitzgerald, *Trading with the Enemy: Holocaust Restitution, the United States Government, and American Industry*, 28 BROOK. J. INT'L L. 683, 703 (2003) [hereinafter Bazyler & Fitzgerald, *Trading With the Enemy*].

105 Bazyler, *Holocaust Restitution Movement*, *supra* note 101, at 19-20.

106 Michael J. Bazyler, *Nuremberg in America: Litigating the Holocaust in United States Courts*, 34 U. RICH. L. REV. 1, 95-96 (2000) [hereinafter Bazyler, *Nuremberg in America*].

107 Scholz, *supra* note 102, at 301.

108 *Id*.

109 *Id*.

110 Bazyler, *Nuremberg in America*, *supra* note 106, at 97.

This preoccupation with the realities of the Cold War seemed to push the issue of reparations out of the spotlight, at least for a time. With the exception of a few scattered, mostly unsuccessful lawsuits in Europe on behalf of Holocaust victims and survivors immediately following the end of the war, there was little activity in this area until the 1990s and the fall of the Berlin Wall.[111]

In 1997, various Holocaust survivors and their heirs brought federal and state suits in New York and California against over a dozen insurance companies for their failure to pay claims.[112] Many of the insurance companies prominent in Europe before World War II are still prominent today and are, in fact, major players in the United States insurance industry, among them Assicurazioni Generali of Italy and Allianz of Germany.[113] As a result of this litigation and pressure from individual state insurance commissioners, Generali and Allianz, along with three other insurance companies, several foreign governments, and a collection of international Jewish organizations formed the International Commission on Holocaust Era Insurance Claims (ICHEIC) in order to process the claims of Holocaust victims and their heirs.[114]

In 1998, Congress also passed the Holocaust Assets Commission Act, requiring state insurance commissioners to investigate and create a record of insurance policies and other assets from the Holocaust era.[115] Furthermore, an agreement finalized in 2000 between the German and American governments allows for the creation of a fund to compensate Holocaust victims and their heirs and provides a general promise to comply with the procedures established by the ICHEIC.[116] The United States has negotiated similar agreements with Austria and France with respect to stolen assets of Holocaust victims.[117]

These agreements, however, are not without their critics. Insurance companies within the ICHEIC have a significant amount of control over the processing of claims, resulting in longer delays and smaller ultimate payouts than those yielded by litigation.[118] Additionally, early conflicts between the terms of the U.S.-German agreement and the procedures established by the ICHEIC have significantly hampered the ability of claimants

111 *See* Scholz, *supra* note 102, at 302-03.

112 Bazyler, *Nuremberg in America*, *supra* note 106, at 101-02. As of January 2000, these claims were all either pending trial or had settled. *Id*. at 102.

113 Bazyler, *Holocaust Restitution Movement*, *supra* note 101, at 20.

114 *Id*. at 21.

115 Scholz, *supra* note 102, at 309.

116 Bazyler & Fitzgerald, *Trading With the Enemy*, *supra* note 104, at 708-09.

117 *Id*. at 698-700; Scholz, *supra* note 102, at 322.

118 Bazyler, *Holocaust Restitution Movement*, *supra* note 101, at 22.

to receive compensation.[119] Furthermore, the unwillingness of the German and Austrian governments to make any reparations as long as lawsuits are pending in American courts has also complicated matters.[120]

Partly in response to Congress's enactment of the Holocaust Act, California passed the HVIRA in 1999.[121] According to the declaration of the legislature, "[s]urvivors are asking that insurance companies come forth with any information they possess that could show proof of insurance policies held by Holocaust victims and survivors, in order to ensure that closure on this issue is swiftly brought to pass."[122] The declaration goes on to say that "[i]nsurance companies . . . have a responsibility to ensure that any involvement they or their related companies may have had with insurance policies of Holocaust victims are disclosed to the state" and that the HVIRA "is necessary to protect the claims and interests of California residents, as well as to encourage the development of a resolution to these issues through the international process or through direct action by the State of California, as necessary."[123]

The HVIRA required "[a]ny insurer currently doing business in the state that sold life, property, liability, health, annuities, dowry, educational, or casualty insurance policies, directly or through a related company, to persons in Europe, which were in effect between 1920 and 1945" to disclose information pertaining to these aforementioned policies, including whether or not the proceeds had been paid to the designated beneficiaries.[124] Furthermore, failure on the part of an insurance company to comply with the provisions of the HVIRA would result in the suspension of that company's authority to conduct insurance business in California.[125]

It was not long before the HVIRA was challenged in the courts. In 2000, several insurance entities brought suit arguing the unconstitutionality of the statute by claiming that it violated the federal foreign affairs power and the Foreign Commerce Clause of the U.S. Constitution.[126] On these grounds, a federal district court granted a preliminary injunction against

119 Scholz, *supra* note 102, at 321.

120 Bazyler & Fitzgerald, *Trading With the Enemy*, *supra* note 104, at 700.

121 CAL. INS. CODE § 13800 (Deering Supp. 2003).

122 *Id.* § 13801(d).

123 *Id.* § 13801(e), (f).

124 *Id.* § 13804.

125 *Id.* § 13806.

126 Gerling Global Reins. Corp. of Am. v. Quackenbush, No. CIV. S-00-0506, No. CIV. S-00-0613, No. CIV. S-00-0779, No. CIV. S-00-0875, 2000 U.S. Dist. LEXIS 8815, at *12-13 (E.D. Cal. June 9, 2000).

enforcement of the HVIRA.[127] On appeal, the Ninth Circuit rejected these claims but remanded the case to the district court for consideration of the plaintiffs' due process claims.[128] The district court granted summary judgment for the plaintiffs on the grounds that the HVIRA violated the insurance companies' due process rights.[129] However, on appeal, the Ninth Circuit again reversed the district court and upheld the constitutionality of the HVIRA, ruling that it did not violate the foreign affairs power or the Commerce Clause.[130]

Ultimately, though, the Supreme Court struck down the HVIRA in *Garamendi* under the theory that it was preempted by the express foreign policy of the federal government as embodied in the executive agreements with Germany, France, and Austria and by U.S. involvement in the ICHEIC.[131]

B. The Majority Holding and its Reasoning

In deciding that the HVIRA was unconstitutional, the majority focused on the significance of the executive agreements between the United States and Germany, Austria, and France.[132] The petitioners, the American Insurance Association and various other insurance entities, as well as the United States government and several foreign governments as *amici curae*, argued that the HVIRA conflicted with the foreign policy expressed in these agreements.[133] The majority, favoring this argument, said "[t]here is, of course, no question that at some point an exercise of state power that touches on foreign relations must yield to the National Government's policy . . . ."[134] They cited the "concern for uniformity" that the framers of the Constitution expressed, as evidenced by the writings of Alexander Hamilton and James Madison in the Federalist Papers.[135]

The majority went on to say that, generally, there is no question that "there is executive authority to decide what that policy should be."[136] While admitting that the support for their conclusion "does not enjoy any textual detail," they cited the Constitution's vesting of power in the Executive Branch and

127 *Id*. at *48.
128 Gerling Global Reins. Corp. of Am. v. Low, 240 F.3d 739, 754 (9th Cir. 2001).
129 Gerling Global Reins. Corp. of Am. v. Low, 186 F. Supp. 2d 1099, 1113 (E.D. Cal. 2001).
130 Gerling Global Reins. Corp. of Am. v. Low, 296 F.3d 832, 849 (9th Cir. 2002).
131 American Ins. Ass'n v. Garamendi, 123 S. Ct. 2374, 2390 (2003).
132 *Id*. at 2386.
133 *Id*.
134 *Id*.
135 *Id*.
136 *Id*.

several cases, including *Curtiss-Wright*, which generally support the premise that there is executive authority to decide foreign policy.[137]

More specifically, the majority considered the power of the President to enter into executive agreements such as the ones with Germany, Austria, and France.[138] Citing *Pink*, they noted that, starting with George Washington, Presidents have negotiated executive agreements with foreign governments without Senate approval or congressional challenge, and that the practice has always been upheld by the courts.[139] They also dismissed the notion that executive agreements concerning World War II-era insurance claims were less valid because they took aim at foreign corporations rather than foreign governments themselves.[140] Justice Souter stated that "untangling government policy from private initiative during war time is often so hard that diplomatic action settling claims against private parties may well be just as essential in the aftermath of hostilities as diplomacy to settle claims against foreign governments."[141]

The majority thus concluded that "valid executive agreements are fit to preempt state law, just as treaties are . . . ."[142] However, because the executive agreements did not contain explicit preemption clauses, in order to determine the act's constitutionality they were forced to examine whether the executive agreements truly preempted the HVIRA.[143]

Continuing their inquiry, the majority turned to *Zschernig*. They noted the Court's claim in that case that "our system of government is such that . . . no less than the interest of the people of the whole nation, imperatively requires that federal power in the field affecting foreign relations be left entirely free from local interference."[144] This language echoes the broad statements of national power in *Curtiss-Wright* and *Hines*.[145] They also touched, however, on Justice Harlan's concurring opinion in *Zschernig* and his disagreement over the idea of a complete federal monopoly on foreign affairs, that for him a "conflicting federal policy" was necessary.[146]

137 *Id*.
138 *Id*.
139 *Id*. at 2387.
140 *Id*.
141 *Id*.
142 *Id*.
143 *Id*. at 2388.
144 *Id*. (alterations in original).
145 *See supra* text accompanying notes 14, 18.
146 *Garamendi*, 123 S. Ct. at 2389.

"It is a fair question," Justice Souter wrote, "whether respect for the executive foreign relations power requires a categorical choice between the contrasting theories . . . evident in the *Zschernig* opinions," but having brought up the question, Justice Souter declined to answer.[147] He reasoned that, under either view, legislation "in conflict with express foreign policy of the National Government" would be preempted.[148] The majority then concluded that the HVIRA conflicted sufficiently with federal policy as to be unconstitutional because it was clear from the executive agreements with Germany and Austria that federal policy mandated working within the procedures of the ICHEIC.[149] Citing *Crosby*, the majority noted that while the goals and motivations of the state and federal governments might have been similar, their approaches were not, and the HVIRA had the potential for frustrating the implementation of the federal policy by undermining the ICHEIC and annoying European nations.[150] Regardless of which was the better approach, California could not be allowed to frustrate the President's diplomacy.[151]

Finally, the majority dismissed California's argument, which paralleled those in *Barclays Bank*: that Congress, in passing the Holocaust Commission Act, condoned statutes such as the HVIRA; and that Congress, with its power to regulate foreign commerce, should control despite executive agreements to the contrary.[152] In so doing, the majority insisted that the President took the "lead role" in foreign policy,[153] and that the majority's reading of the Holocaust Commission Act did not authorize anything in the HVIRA.[154] In addition, the Court pointed out that Congress had not acted in disapproval of the President's actions.[155]

C. The Dissent

Justice Ginsburg, writing for the dissent, began by stating: "The President's primacy in foreign affairs . . . empowers him to conclude executive agreements with other countries."[156] She also agreed that such executive agreements have the power to

147 *Id.*
148 *Id.*
149 *Id.* at 2390.
150 *Id.* at 2392.
151 *See id.* at 2393.
152 *Id.* at 2394.
153 *Id.* at 2391 n.12.
154 *Id.* at 2394.
155 *Id.*
156 *Id.* at 2398 (Ginsburg, J., dissenting).

preclude state law.[157] However, in such instances, she insisted that the agreements be narrowly construed. Applying this reasoning, Justice Ginsburg concluded that the executive agreements with Germany, Austria, and France did not preclude the HVIRA,[158] that the United States' involvement in the ICHEIC concerned the actual settlement of claims, and that the HVIRA merely concerned disclosure—an issue which the executive agreements did not address.[159]

Justice Ginsburg also took issue with the majority's reliance on *Zschernig*, saying, "We have not relied on *Zschernig* since it was decided, and I would not resurrect that decision here."[160] She reasoned that *Zschernig* applies only to "state policy critical of foreign governments."[161] She also disagreed with the application of *Pink* and *Crosby*. In *Crosby* a federal statute was implicated, not merely an executive agreement, and while an executive agreement was at issue in *Pink*, it spoke directly against the activity of the state of New York.[162] In addition, she dismissed the statements of executive officials against the HVIRA, noting that similar statements of opinion were not controlling in *Barclays Bank*.[163] Justice Ginsburg felt that by giving weight to such statements and by inferring preclusion from the stated goals of the executive agreements, the Court was overstepping its bounds.[164] She concluded by saying, "judges should not be the expositors of the Nation's foreign policy, which is the role they play by acting when the President himself has not taken a clear stand."[165]

IV. STRETCHING DIRECT PREEMPTION TO ITS BREAKING POINT – PROBLEMS WITH THE REASONING OF *GARAMENDI*

It is evident from both the majority and the dissenting opinions in *Garamendi* that the Supreme Court favors the direct preemption theory of federal supremacy in the realm of foreign affairs. The majority, while seeming to pay homage to the dormant federal foreign affairs power theory in *Zschernig*, ultimately did not apply it, and the dissent was openly hostile to the idea.[166] Likewise, the majority dismissed the dormant

157 *Id*. (Ginsburg, J., dissenting).
158 *Id*. at 2399 (Ginsburg, J., dissenting).
159 *Id*. (Ginsburg, J., dissenting).
160 *Id*. at 2400 (Ginsburg, J., dissenting).
161 *Id*. (Ginsburg, J., dissenting).
162 *Id*. (Ginsburg, J., dissenting).
163 *Id*. at 2401 (Ginsburg, J., dissenting).
164 *Id*. (Ginsburg, J., dissenting).
165 *Id*. (Ginsburg, J., dissenting).
166 *Garamendi*, 123 S. Ct. at 2389, 2400 (Ginsburg, J., dissenting).

Foreign Commerce Clause argument formulated in *Barclays Bank*, noting that, in foreign policy, the President and not Congress has the "lead role."[167] The dissent did not even address the issue, despite the fact that the Ninth Circuit decision was based on the theory enumerated in *Barclays Bank*.[168]

However, the Court's reliance in *Garamendi* on direct preemption raises an issue: What is "express foreign policy?" Normally, this question is not so hard to answer. "No one disputes that properly enacted treaties, statutes, and executive acts have preemptive authority; as long as someone makes clear what the law is, supremacy usually takes care of itself."[169] In other words, the Supremacy Clause can easily be invoked if there is a federal statute or treaty on point or an executive agreement with a clear statement of its purpose and effect. As evidenced by the deep division amongst the Justices in the *Garamendi* decision, it is, however, questionable whether the Court had before it such a clear statement of foreign policy.

When the courts look to something less authoritative than a federal statute or treaty or a precisely stated executive agreement—executive pronouncements, *amici* briefs, or even mere silence—to make a case for direct preemption, three problems occur. First, the courts risk, as Justice Ginsburg cautioned in *Garamendi*, overstepping their bounds.[170] As stated in the unanimous *Crosby* opinion, the details of foreign policy belong to Congress and the President.[171] Moreover, "the Constitution does not make the judiciary the overseer of our government."[172] Simply stated, the judicial branch is not equipped to determine controversies related to foreign policy based upon anything other than explicit statements of such foreign policy from the other branches.

Second, in relying on documents such as congressional reports, debate transcripts, *amici* briefs, and failed legislation, or on silence for preemptive statements of foreign policy, the courts allow Congress and the President to exceed their constitutional powers.[173] In *Barclays Bank*, the Supreme Court ruled that Congress' acquiescence to California's employment of the worldwide combined reporting accounting method was enough of

167 *Id*. at 2391 n.12.

168 Gerling Global Reins. Corp. of Am. v. Low, 240 F.3d 739, 749 (9th Cir. 2001).

169 Swaine, *Foreign Relations Federalism*, *supra* note 9, at 343.

170 *Garamendi*, 123 S. Ct. at 2401 (Ginsburg, J., dissenting).

171 530 U.S. at 386.

172 Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 298, 330 (1994) (internal quotation marks omitted).

173 Swaine, *Negotiating Federalism*, *supra* note 10, at 1156.

a foreign policy statement to sanction California's actions.[174] In *Garamendi*, Congress' silence was interpreted as support for the President's actions in making executive agreements with Germany, Austria, and France and for the United States' involvement in the ICHEIC.[175] Given that the powers conferred to the federal government in Articles I and II of the Constitution are affirmative powers, there is little constitutional justification for this practice.

Third, in looking beyond positive executive or congressional statements to make a case for direct preemption, the Supreme Court has initiated something of a "turf war" between Congress and the President over which is the "one voice" of foreign policy. Under the dormant Foreign Commerce Clause theory espoused in *Barclays Bank*, the speaker is clearly Congress, and the Ninth Circuit's decision relied on this Supreme Court determination.[176] In concluding that the HVIRA did not violate the dormant foreign affairs power or the dormant Foreign Commerce Clause, the Ninth Circuit stated, "On the basis of the text, context, and history of the Holocaust Act, we conclude that Congress was aware of the states' involvement in this area and, at least implicitly, encouraged laws like HVIRA."[177] The decision in *Garamendi* flew in the face of this statement. Despite the fact that the sale of insurance clearly implicates foreign commerce, the Supreme Court (who's composition was virtually the same as in *Barclays Bank*) dismissed the dormant Foreign Commerce Clause argument and handed the reigns of foreign policy back to the President.[178] Such inconsistency undermines the ability of the court to provide the lower courts and the states with a workable rule.

V. VINDICATING *ZSCHERNIG* – A SOLUTION TO THE PROBLEM OF THE FEDERAL MONOPOLY ON FOREIGN POLICY AND ITS APPLICATION TO *GARAMENDI*

Given the apparent failure of the direct preemption theory in the absence of a federal law or treaty or a clear statement of policy, a workable rule is desperately needed to provide consistent direction to the lower courts. Despite the Supreme Court's seeming disdain for *Zschernig*, that case may very well provide the solution. After all, even a vague rule is better than no rule at all. By abandoning the precedent set in *Zschernig*, the

174 512 U.S. at 327-28.
175 123 S. Ct. at 2394.
176 512 U.S. at 331.
177 Gerling Global Reins. Corp. of Am. v. Low, 240 F.3d 739, 749 (9th Cir. 2001).
178 123 S. Ct. at 2391 n.12.

Supreme Court has left lower courts to fend for themselves, resulting in "any number of tests rules [sic] and standards."[179]

In addition, though there is little constitutional support for a broad foreign affairs power, it is not completely without constitutional basis.[180] Given the demonstrated practicality of having a unified foreign policy, it seems prudent to have a mechanism for curtailing state activity.

Moreover, while Congress or the President could preempt a state law at any time through a positive pronouncement, the damage to foreign relations is often already done. Applying a dormant foreign affairs test allows the judiciary to more efficiently curtail the damaging activity, especially in potentially inflammatory situations.[181] One of the criticisms of *Zschernig* is that its reasoning seems to be based upon a uniquely Cold War mentality and that it is simply no longer applicable to today's world.[182] Legal scholars have argued that increasing globalization has blurred, and in some cases erased, the line between strictly local and foreign affairs, and that the end of the Cold War has made foreign retaliation for state actions less likely and judicial intervention less necessary.[183] However, the events of recent years have shown how quickly the world can change. Those who shrug off *Zschernig* as nothing more than a relic of a tense, paranoid time in our national history do so at their own peril.

Granted, the danger in applying the *Zschernig* "direct impact" test—that the courts will overstep their authority—still exists. As laid out, the outcome of a *Zschernig* analysis "turns on a court's independent assessment of its foreign relations implications."[184] However, adding two more layers to the analysis would diminish this danger greatly. First, when looking for a "direct impact," courts should focus not on any specific foreign policy that Congress or the President has chosen but rather on the powers contained in Articles I and II of the Constitution. For instance, the Court should ask whether the state action in question would have a direct impact on the federal government's ability to regulate foreign commerce or to wage war. Doing so removes the Court's focus from the meaning of congressional silence or the implications of low-level executive statements and places that focus on the area of greatest judicial

179 Chiang, *supra* note 8, at 967.
180 *See supra* text accompanying notes 37-42.
181 *See* Spiro, *supra* note 36, at 1242.
182 *See* Goldsmith, *supra* note 52, at 1663.
183 *See, e.g.*, Spiro, *supra* note 36, at 1247.
184 Goldsmith, *supra* note 52, at 1637.

competence—interpreting the provisions of the federal Constitution. Second, the court should only strike down a state law under the *Zschernig* test when the danger of leaving it intact is greater. Such a requirement gives deference to the legislative and executive branches while allowing for swift action when necessary.

As previously mentioned, the Ninth Circuit in *Deutsch v. Turner Corp.* applied something similar to this modified *Zschernig* test to the California law in question in that case.[185] In applying *Zschernig*, it backed off from the sweeping statements of federal power found in *Pink*.[186] Further examination reveals that the court based this exclusive power on several of the enumerated powers concerning the conduct of war found in Articles I and II of the Constitution, and not on some vague general notion of federal foreign affairs power.[187] The court noted that the California law, because it implicated the ability of the United States to negotiate the end of hostilities as World War II drew to a close, was provocative by its nature and would be dangerous if allowed to stand.[188]

Using *Deutsch v. Turner Corp.* as a model for a *Zschernig* analysis of the HVIRA, the Court should first look at the specific bases for federal power which come into play. For instance, Congress has the ability to regulate foreign commerce, and "statutes that 'mainly involve foreign commerce' are among those least likely to be held invalid under the foreign affairs power."[189] Several states also filed a joint *amicus* brief in support of the HVIRA in *Garamendi* in which they explained that insurance is clearly a matter of commerce governed by Congress and that, "Congress was aware of the state activities in question . . . . Congress has not acted to stop those state efforts. To the contrary, Congress—through the U.S. Holocaust Assets Commission Act of 1998, and congressional statements—has encouraged the States to continue their efforts."[190] In addition, the states argued that HVIRA has only an incidental effect on foreign policy. They said, "[t]he HVIRA is directed to corporations, not governments. It does not turn upon the policies or structures of foreign governments. Moreover, its application is

185 Deutsch v. Turner Corp., 324 F.3d 692, 709-11 (9th Cir. 2003).

186 *Id.* at 710.

187 *Id.* at 712.

188 *Id.* at 711.

189 *Id.* (quoting Gerling Global Reins. Corp. of Am. v. Low, 240 F.3d 739, 753 (9th Cir. 2001)).

190 Brief for the States of California et al. as Amici Curiae Supporting Respondent at 15, American Ins. Ass'n v. Garamendi, 123 S. Ct. 2374 (2003) (No. 02-722).

not only evenhanded, but is also ministerial."[191] Furthermore, the Court in *Deutsch* argued that the "HVIRA does not attempt to hold defendants liable for their past wartime conduct; it therefore does not implicate the exclusive power of the federal government to make and resolve war."[192] If these assertions are true, then the HVIRA does not meet the "direct impact" test.

On the other hand, the requirements of the HVIRA may come into conflict with the President's ability to negotiate with other nations as bestowed by the Treaty Power. The United States' *amicus* brief filed in support of the petitioner insurance entities in *Garamendi* said, "HVIRA has generated the very tensions in international relations that the United States has sought to avoid, prompting protests from the governments of Germany and Switzerland concerning HVIRA's application to insurance policies written in those countries."[193] Furthermore, the brief cautioned:

> State government officials, who are not part of the process through which the Nation formulates and conducts its international relations, are not well positioned to evaluate what adverse impact their actions may have for those relations. They cannot, for example, be expected to make an informed assessment of whether, or how, or when a foreign government might respond to provocative state legislation, or how detrimental the response might be to various important interests of the United States as a whole.[194]

In addition, many of the prohibitions on the states in the Constitution can be viewed as aimed at preventing war, and in this light, any provocative state action flies in the face of these prohibitions and conflicts with the federal government's War Powers.[195] The government of Germany, in its *amicus* brief filed in opposition to the HVIRA, stated that "the HVIRA offends German and U.S. sovereignty. California's law is particularly offensive to Germany in light of the law's clear implication that the Federal Republic is either incapable or unwilling to achieve the proper resolution of unpaid Holocaust-era insurance claims."[196] Clearly the German government regards the HVIRA as a provocative state action causing tension in U.S.-German relations and implicating the federal government's War Powers.

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191 *Id.* at 19 (emphasis omitted).

192 *Deutsch*, 324 F.3d at 716.

193 Brief for the United States as Amicus Curiae Supporting Petitioners at 18, *Garamendi* (No. 02-722).

194 *Id.*

195 *Deutsch*, 324 F.3d at 711.

196 Brief for the Federal Republic of Germany as Amicus Curiae in Support of Petitioners at 19, *Garamendi* (No. 02-722).

Therefore, a strong case exists that the HVIRA has a "direct impact" on the power of the federal government to conduct foreign policy.

If the Court were to determine that the HVIRA had a "direct impact" on the federal government's ability to conduct foreign policy based upon the statute's implication of the Treaty Power and the War Powers, then the Court should continue the analysis by looking at the relative danger of allowing the HVIRA to stand. For example, the United States' *amicus* brief stated, "It is not for respondents to trivialize the potential implications of [foreign governments'] protests for United States foreign policy, especially at a time of international tension when relations between this Nation and its European allies are at their most sensitive."[197] Given the great desire to avoid harming the United States' relationships with its European allies any further and the importance of those relationships, the Court could deem the danger great enough to invalidate the HVIRA without resorting to the tortured application of the direct preemption theory found in *Garamendi*.

VI. CONCLUSION

It is clear from history and from the enumerated powers found in Article I and II of the Constitution that the federal government has substantial power to conduct foreign policy. While the rationale for a complete federal monopoly on foreign policy lacks substantial support, the Supreme Court acts on equally shaky ground in rejecting *Zschernig* and stretching the idea of direct preemption to its breaking point to strike down state laws that interfere with the federal government's ability to conduct foreign policy.

The decision in *Garamendi* illustrates the shortcomings of the direct preemption approach. In the absence of a federal law, treaty, or other official pronouncement, the Court is forced to look at other, less official sources for preemptive language, a practice which does nothing to diminish the danger of the judiciary interfering in the foreign policy prerogative of Congress or the President. In addition, by being inconsistent as to whether the Congress or the President has the final word on foreign policy determinations, the Supreme Court has left lower courts and state governments without guidance.

The *Zschernig* test is not so vague that it cannot be applied. *Deutsch v. Turner Corp.* illustrates such an analysis, and with

197 Brief for the United States at 18, *Garamendi* (No. 02-722) (citations omitted).

additional safeguards—narrowly construing the powers of the federal government and weighing the danger of allowing the law in question to stand—the *Zschernig* test could easily have been applied to the HVIRA.