

# JOURNAL OF LAW, ECONOMICS & POLICY

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## EMERGING CIVIL JUSTICE ISSUES

*John H. Beisner, Robert S. Peck*  
*Moderator: D. Bruce Johnsen*

**KAREN CZARNECKI:** Symposium on Civil Justice Issues at George Mason University. I will do some brief introductions of the staff who are here. I'll give you some housekeeping items and tell you a little bit about our programs at Alternative and Bruce Johnson, who will be moderating our first panel. First and foremost, I think most of you have met Jennifer Greg, who is our new program coordinator. You met her at the check-in table last night. She's, I believe, outside the room right now. If you have any questions with regard to reimbursements or anything like that, Jennifer can answer those questions or I certainly can. We also have had Mary Jones yesterday and Colleen Chirka who are our event staff. They're the ones that are doing multiple events back to back and doing all of the contracting. So please give them a good pat on the back because we love working with them. They're wonderful. They're both new as well.

I do want to mention that our second director, Henry Butler, who's normally here, is not here because he's speaking to a group of attorneys general in Oklahoma. Yeah, you can go and hiss. No. So he is not with us here today. The most important thing that you will all need to know is that the bathrooms are located outside the door and to the right. It's the most important announcement I do have.

A little bit about George Mason—George Mason is the largest public university in Virginia. It's about 3,000 students larger than VCU, Virginia Commonwealth University. There are three campuses. I hear there's going to be four campuses. This is the main campus you're on. The law school's located in Arlington and we're about 25 miles West of Washington D.C. right now, and this is where we have to have our larger programs because we can't host a group this size at the law school.

The Law and Economics Center has been around for quite a number of years and it's roughly hosted 4,000 judges across the different programs that we sponsor every year. This is the judicial education program that sponsors this institute and our flagship program is the Economics Institute Week 1. I know many of you—I recognize many faces who have attended that. We also have a week 2 program that we do twice a year. The Economics Institute Week 1 is hosted four times a year, and if you look at the back of your program book, if you have not attended one of those, if you want an intense five or six days of economics, statistics, scientific method, you will get it in that week 1 program.

The second division we have is the Attorney General's Education Program, where we host attorneys general under senior staff attorneys for dif-

ferent programs similar to yours, but focusing on what they do for a living. The third program we have is a Congressional Civil Justice Caucus Academy, which is roughly ten times a year. It's a point-counterpoint, sometimes debate on Capitol Hill, and one of our speakers this Morning, Mr. Peck, recently duked it out with Victor Schwartz, one of our old friends on Capitol Hill. It went very well. Nobody was bloodied or left with a black eye.

**D. BRUCE JOHNSEN:** They even had lunch afterwards.

**KAREN CZARNECKI:** We fed people barbecue, so it was very popular for the Congressional staff. The fourth program we have is the Searle Civil Justice Institute, where we do long-range studies. They're peer-reviewed. We just released a study on September 4th on the Foreign Corrupt Practices Act, which a lot of folks are talking about here in Washington.<sup>1</sup> And then, the last division of the LEC, as we call it, is the Manny program. That's the program for our academics, where we've got peer-reviewed conferences on emerging topics. So, that is our Law and Economics Center in a nutshell.

A couple of announcements this morning—we do value your time, and that's why we try to start and end on time. If it says that there's going to be a 15 or 20-minute break on the program, we will be stopping at that time for breaks. So, I do ask you, whether it's breakfast or lunch, we try to gather everybody five minutes or so ahead of time so we can always respect your time or respect the time of our speakers. I do want to ask you, similar to your courtroom, we would like you to turn off all cell phones and put away newspapers, and we want to respect the time of our guests here. We want to make this as productive as possible.

I know at the registration desk, we had a sign-up if you want CLE memos. We will give you a memo, then you can submit to your state bar association. A lot will accept it. Some may not. We did not get pre-approval from Virginia for this, as it was an evolving and changing program up until about two weeks ago, but we can provide you with the memo right after this program.

Another announcement—most of the program is going to be in here, and I know that the luncheon program will be in the Junior Ballroom, where we were right next-door. Tonight's reception is going to be from 6:00 to 7:00 in the ballroom foyer. I think the program says until 7:30, and then we have the optional dinner for Boxwoods. If you did not pick up a ticket for that, there are two seatings. I think the 7:00 seating only has one ticket left, but there are two different seatings because the restaurant cannot handle everybody all at once. So 7:00 and 8:30 and if not, we've got Chuck Khan. Where's Chuck Khan? He's got a quad that can fit five extra judges. He's

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<sup>1</sup> SEARLE CIVIL JUSTICE INST., THE FOREIGN CORRUPT PRACTICES ACT: AN EMPIRICAL EXAMINATION OF ENFORCEMENT TRENDS (2012), available at <http://www.masonlec.org/wp-content/uploads/2012/09/FINAL-FCPA-REPORT-PDF-FOR-WEB.pdf>.

going to an all-you-can-eat crab place about a couple miles down the road. So, if you want to pile into his car, that dinner's going to be on you, but should be a good time. He says he's done this once before, and it was very, very nice. What's the name of the place? Captain Pell's Crab something, something must be what you eat. Very good.

You also have your name tags. We ask that you wear them throughout the program. It makes it easier to get to know some of your colleagues who are here, and at the end, we will recycle those. We'll clean them, and we'll recycle them for the next program. It's the responsible thing to do. We believe in that. Also, the shuttle sign-ups, I think most of you have already taken care of that. Depending upon how many that signed up, we're going to get larger, medium-sized shuttles to take you to the airport immediately following the program here.

We also have a new system for evaluations. In the past, you would get an evaluation at the end of the program to fill out by hand. We've gone electronic. We've purchased C-vent as a program, and it's a relatively quick and painless process. During the last panel or the luncheon tomorrow, you'll get something electronically so either on your way to the airport or when you get comfortably back in your chambers, you can give us comments on all the presentations, any future topics that you think we should be covering in this program, or another program, and we're also asking you if you have any colleagues that might benefit from any one of the programs—you can give us their name and their court, and we'll track them down and send them an invitation to future programs. And last, travel reimbursements have not gone electronic yet. Jennifer will have those for you. Tomorrow you can fill them out, and leave them with her. You can send those back in. All right? That's all I have for housekeeping items.

Right now, I'd like to turn over the program to Bruce Johnsen, who is one of my colleagues at the law school Law and Economics Center. He's going to serve as the master of ceremonies for most of the program, and when he's got to dash out to teach, I'll be filling in for him. He's been at the law school since 1994 and he currently teaches economics and property rights. He has previously taught at Texas A&M, the Wharton School, and the University of Washington, and he also did a brief stint at the Securities and Exchange Commission. I will turn it over to him to discuss the foreman and introduce our two speakers this morning. Bruce.

**D. BRUCE JOHNSEN:** Thank you, Karen, and let me thank you, welcome you all and thank you all for being here. The Law and Economics Center is chugging along, putting out programs for judges, attorneys general, congressional staffers, so on and so forth, and we've really just had a great fall so far. We did survive Sandy with group week 1 judges. We hunkered down in the hotel and let the storm blow by us, but everybody in the end had a great time. I think I see a couple familiar faces out there from that program. In any event, this conference today and tomorrow will be part of

our outreach program to you all, involving various issues that come up from time to time. Before we proceed with the substance of the program, let me just mention something I think Karen didn't mention about reimbursements, right? You don't get your reimbursement until you fill out your evaluation form. So, we believe that incentives matter.

So, this panel will be about Emerging Civil Justice Issues. We have two distinguished speakers, which I'll introduce in just one moment. Let me just lay the ground rules. First of all, the panel will be roughly 80 minutes long. We'll give each speaker 20 minutes, then maybe amongst us we'll have a few questions, and then we'll open it up for questions to you all. We will be filming the presentations. Once we start with the questions from you all, the camera goes off, so we want you to be able to speak freely, question freely, and so on, and so forth. So, without belaboring anything further, let me introduce our speakers.

First, we have John Beisner from Skadden, Arps, Slate, Meagher & Flom's Washington D.C. office. John specializes in mass tort and class action litigation. He does both trial and appellate practice, and his practice has touched on the areas of anti-trust, consumer protection, RICO, ERISA, employment discrimination, environmental issues, products liability issues, and other issues as well. He's given testimony before Congress, and state legislatures on civil justice reform.

Then, following John's discussion, we have Robert Peck from the Center for Constitutional Litigation. Robert specializes in appellate practice. He has won numerous awards. We can't take up the entire 80 minutes with that so let me just hit a couple highlights that are interesting to me. He's on the board of overseers of the Rand Corporation's Institute for Civil Justice. He has won an award from Martindale and Hubble, the D.C. Champion of Justice Award, Justices Gold Medal Award, etc. He is the author of three books, the *Library Cyberspace in the First Amendment*,<sup>2</sup> *The Bill of Rights and the Politics of Interpretation*,<sup>3</sup> and *We the People, the Constitution and American Life*,<sup>4</sup> and finally, he has been a scriptwriter for PBS's award-winning *We the People* television program—is it television or radio?

**ROBERT PECK:** Television.

**D. BRUCE JOHNSEN:** Okay, so without further nonsense, let me ask John Beisner to come up and give us the benefit of his remarks. Welcome, gentlemen.

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<sup>2</sup> ROBERT S. PECK, *LIBRARIES, THE FIRST AMENDMENT, AND CYBERSPACE: WHAT YOU NEED TO KNOW* (Am. Library Ass'n, 2000).

<sup>3</sup> ROBERT S. PECK, *THE BILL OF RIGHTS & THE POLITICS OF INTERPRETATION* (West Pub. Co., 1992).

<sup>4</sup> ROBERT S. PECK, *WE THE PEOPLE: THE CONSTITUTION IN AMERICAN LIFE* (1987).



**JOHN BEISNER:** Good morning, everyone. I actually had two announcements to make myself. First of all, the car going to the all-you-can-eat crab place, just to clarify, five people can go but you can only bring four back, right? Since it's an all-you-can-eat place. I also wanted to note that for those of you who are not from this area, you may be encountering some strange behavior by those of us who are local here. It was brought home to me last night when my daughter, who's in high school, said to me, "Dad, is our phone broken?" And I said, "Why are you asking?" She said "Because the phone hasn't rung for about 20 minutes," and this is because, as many of you know, this was a battleground state in the just-completed election. For those of you who aren't from here, you didn't have to endure the constant phone calls telling you what you should think and then the follow-up phone calls finding out what you do think. So I'm fine that everyone is sort of in withdrawal now and needing to engage other people in conversation because you had constant phone calls for the last several weeks here.

I wanted to touch this morning on several areas of emerging legal issues, and the first that I wanted to address is the subject of third party litigation finance, which I think is one of those lurking issues that hasn't received nearly as much attention as it should.

Let me engage here in a bit of definition so that we're all clear what we're talking about. In our US legal system, several decisions were made over the years, collectively by those overseeing the evolution of our system that really, I think, make our legal system unique in the world. The first was a decision over the years that we would encourage access to our courts by permitting contingency fees. It's a very accepted part of our system now, but I think we sometimes forget the U.S. is virtually alone in the world in permitting contingency fees as a way of increasing access to our judicial system. The second decision that was made along the way was to adopt the American rule as it's known, which basically means that, in most cases, if one engages in litigation, someone decides to bring a lawsuit and fails in that endeavor, everyone pays their own fees and expenses. We're also, in the U.S., pretty unusual in that regard because in most places in the world, if you bring a lawsuit and you lose, there are some sort of loser-pay consequences.

So, those are two decisions that were made along the way to encourage access to our court system. What is happening now is that, under the rubric of further expanding access to our system, there is a fairly significant effort to permit and encourage investment in lawsuits. I'm not talking about [Inaudible] Counsel through contingency fees investing in lawsuits. That's been part of our system for a long time. We're basically talking about essentially hedge funds who are now investing in litigation in a very significant way. These are funding organizations that are basically saying, "Look, we will provide financing for the litigation," which basically means that instead of a full contingency process, the lawyers get paid up front in ex-

change for a share of the action that we will be paid. We, the investors in the litigation, will receive a percentage of whatever success, whatever result comes from the litigation. There are a number of organizations, very well-funded—hundreds of millions of dollars in some instances—who are now buying stakes in litigation across the U.S. The concern that I want to raise with that in here—I think there are three primary concerns to be raised with that—really get at what I think could be a very profound change in our litigation system that will result from that form of financing. Clearly, the decisions I talked about earlier in terms of access to the courts were profound changes that evolved over time and make our system unique.

But I think that this form of financing could have a transformative effect. The first effect that concerns me is that I think that if you have these entities that are pouring millions and over time—what I think could be hundreds of millions of dollars into the initiation of new litigation—it is hard to avoid the conclusion that this is going to result in a lot more litigation. But, I also think it could change the nature of that litigation. Right now, we have a process—and I have realized that to some people, contingency fee litigation remains controversial—but you basically have a process where an individual who believes he or she has a claim can go to an attorney who will review the claim and will make a judgment about whether, to be blunt about it, the claim is worth bringing. That decision is made on the basis of that attorney's deciding whether he or she wants to invest what is largely sweat equity in the case. Is it worth my time—do I think the likelihood of success here is worth the time that I'm going to be investing and my colleagues are going to be investing in this case? We could have a system if we wanted where we would basically say look, if you have a claim, the system, the government will in essence get you a lawyer and we're not going to exercise any judgment about whether the claim should be brought. Any claim is welcome in the court. You have a lawyer, you bring it. But we have a system with, frankly, sort of an informal process where you have attorneys working with potential clients to make a judgment about whether a claim is valid and whether it is worth bringing.

The concern that I think exists is that if you pour money into the system and you have funds that are making investments in large numbers of cases, that threshold at which the decision is made, "Yes, this case is worth bringing," will by definition come down. If you have these large funds that can make investments in lots of cases and leverage that investment over a large number of cases such that if one ship comes in, it's enough to cover losses on other cases that are not as successful. We are going to be lowering the threshold in which the decision is made, "Yes, I'm going to bring this lawsuit." I'm not saying that as a result, every case that will be brought will be totally frivolous, but it means that we will be approaching that line because to satisfy that investor, a lot more lawsuits need to be filed.

A second concern that I think exists is that it will be raising a lot of concerns over control of litigation. If you have investors who are looking

for a return on their investment, the decisions that are going to be made in cases with such funding are going to change. The decisions about when you settle a case may have a lot more to do about whether their perception is that you can get from the case an amount that satisfies the investors as opposed to the judgment than about whether the case is worth continuing. I think that as the ABA recently noted,<sup>5</sup> there are serious issues in whether or not the requirement that the attorney zealously represent the client in the case, the person who is asserting the claim, is going to change because the investors are going to want to have a voice.

They put money into the case, they have a stake in the outcome, they can say they're not going to control the case, but, if you're an attorney who is regularly looking to such investors as a way to engage in the litigation process, you can't help but listen to them to some extent. I think that we'll see that third party litigation finance will have the possibility as well of deterring settlement because, as I said before, the decisions in those cases are going to have a lot more to do about satisfying the investors than about the status of the litigation itself. We've seen in several other countries, the sort of profound change—I'm expressing concern about Australia, as many of you may know, has had third party litigation finance for quite a while now and basically decisions about lawsuits are quite unabashedly made by the investors. Class actions in Australia, the point is, really have nothing to do with it. It depends on the funder deciding that there's an issue that they want to pursue. They hire a law firm. They file the class action and off they go. The real concern I just wanted to raise with this group is perhaps there's a place for such funding. I haven't seen a case made that there are thousands of lawsuits out there that need to be brought that aren't being brought under our current system. I don't think that empirical analysis has been made or at least if it has, I haven't seen it. But, what's worrisome at the moment is that we are, as a system, not making a policy decision about whether we want this to be part of our litigation apparatus. I think that there needs to be a discussion about this. Maybe we come out and say, "It's just fine," or maybe we come out and say, "Yes, there are places where it's needed," but we need some significant regulation of this to make sure that it doesn't commandeer the system and change our litigation process radically. But, I wanted to flag that as an area where I think some very significant discussion is occurring because I think without you knowing, there are significant number of cases that are now in your respective courtrooms where the real party of interest on the plaintiff side may well be a hedge fund and not the individual that you are seeing in court every day.

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<sup>5</sup> AMERICAN BAR ASS'N COMM'N ON ETHICS 20/20, INFORMATIONAL REPORT TO THE HOUSE OF DELEGATES (2012) *available at* [http://www.americanbar.org/content/dam/aba/administrative/ethics\\_2020/20111212\\_ethics\\_20\\_20\\_alf\\_white\\_paper\\_final\\_hod\\_informational\\_report.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/administrative/ethics_2020/20111212_ethics_20_20_alf_white_paper_final_hod_informational_report.authcheckdam.pdf).

One thing I know that we are seeing as a litigation issue, that some of you may have encountered, is that notion of disclosure. In a lot of cases, there are now discovery disputes where the very simple question is being asked of the plaintiff in the case to identify all persons, leaving aside the main parties and the main counsel who have a contingent interest in the outcome of the litigation. So, the defendant at least knows who's on the other side of the lawsuit, who is really suing on this subject. I think there are a large number of issues, that is, it becomes better known the extent to which this financing is occurring. There'll be issues in cases that we really haven't had a chance to really to think through fully. I gave the presentation about nine months ago to a group of state Supreme Court justices on this subject with a representative of a funding organization participating as well. I think one of the most interesting questions came from one chief justice who said, "What are we going to do at trial down the road when the plaintiff stands before the jury and makes the argument that this David fighting Goliath here, who has been victimized by an anti-trust violation of some sort, should be given—this mom and pop store who has sued the large corporation—should be given a substantial recovery when the actual plaintiff in the case is now a hedge fund." We tell the jury that—that we're really fibbing to the jury by telling them that what this controversy is about is this smaller entity suing a larger entity—when in fact this is an economic battle between one group of investors and another group of investors.

The second topic I wanted to talk about this morning is potential reform in the discovery arena. This is a topic that is subject to constant discussion, but I do think that there is a growing concern in our legal system that we are spending far too much time and resources on discovery, almost in many cases to the exclusion of giving attention to the merits. That the amount of time that is invested in resolving disputes, the amount of time that is invested in mustering whatever information is requested by a party really has become a much larger part of a particular law suit than figuring out who's right and who's wrong, which is after all, the reason why we're in court in the first place. I just wanted to note in that regard, that the Federal Courts Advisory Committee on Civil Rules, I think, is engaging in what may be a very productive examination of the discovery process in our cases.

For one thing, there's sort of on the fast track at the moment—a potential reform that would limit the circumstances in which sanctions would be available for the failure to retain information. We change Rule 37<sup>6</sup> to basically say that, in the absence of willfulness or bad faith, the sort of gotcha game that often exist there with respect to retention practices, would not result in sanctions. One exception, being the loss of information, would irreparably deprive the party of any meaningful opportunity to present a

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<sup>6</sup> FED. R. CIV. P. 37.

claim or defense. So, unless a key document or a set of very key documents have been disposed of as a result of a failure to retain them along the way, that's not going to be sanction-able if this rule is adopted. I think it's a concern that a lot of cases that "gotcha game" ends up being the main focus. By "gotcha game" I mean the effort to really litigate whether every document has been properly retained often becomes more the focus of litigation than the merits.

The committee is also, as a result of a conference that was held at Duke University several years ago, I think, looking at a number of issues and one of the more interesting issues there is a fundamental re-examination of the question when did we decide that in a lawsuit, the party that is responding to discovery is the party that has to absorb that expense? If you think about it, in many of these cases, the discovery costs are millions and millions of dollars. So, if you're a defendant, even though no liability has been determined against you, you're required to spend millions of dollars responding to information that the other side wants to receive. Where is it written? Where do we come up with the fundamental premise that the defendant has to pay for that in the absence of any determination liability?

If you look back, this concept basically arose back in the '30s when discovery in the case basically meant that you went to the other side's office and looked at the box of documents that they had available. There weren't copying machines, so basically you took notes and you said, "Hold on to those documents. We might need them in trial." The expense involved in that was really fairly minimal. There wasn't a need to make a lot of determinations about cost-shifting, but I think that fundamental concept in a discovery process is at least being looked at again by the Advisory Committee. I'm not saying any radical change in that regard necessarily will occur, but at least it's being examined, and some questions are being raised about whether that fundamental concept is sound, particularly given that due process considerations have required a party to expend what are millions of dollars on defense expenses in the absence of any liability determination.

One last point that I wanted to cover is the subject of settlements in class actions, which received a fair amount of attention in a couple of hearings recently before the House Judiciary Committee. I think that the Committee's questioning on that subject recognized that, with the enactment of the Class Action Fairness Act<sup>7</sup> and some of its provisions on settlement requirements, that courts, the federal courts, have been increasingly inquisitive about the fairness of settlements that are achieved in class actions. But the concern of this hearing was with the growing use of *cy-près* settlements in federal courts. These have been not uncommon in state courts, particularly in California, for a number of years, but there was in the hearing at

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<sup>7</sup> Class Action Fairness Act of 2005, 28 U.S.C. §§ 1453, 1711-1715 (2012).

least some concerns expressed about the increasing frequency of *cy-près* settlements in federal courts.<sup>8</sup> To be clear, what I'm talking about are settlements where the members of the purported class—it's assumed they're not really going to be receiving benefits from the settlement, but the defendant simply agrees to pay a certain amount of money that will go to a charity and often a charity which the parties have concluded somehow relates to the subject of the settlement. But the bottom line is that the class members, the allegedly injured parties don't receive any direct financial benefit. They're not getting a check. I think that the concern that was expressed in these hearings is that is this a proper part of the class action process.

If you have a lawsuit where you know up front that you are not going to be able to deliver whatever recovery is achieved in the lawsuit to the allegedly injured parties, why is the court dealing with it? There are arguments that are there that under the Rules Enabling Act,<sup>9</sup> a lawsuit brought by individuals but not for their benefit just because it's a class action is a Rules Enabling Act violation. If an individual brought a lawsuit of that sort, I think there'd be standing issues probably raised with respect to it and if you are bringing a class action that really isn't for the benefit of the purported class members, but is for the benefit of the third party, for a charity, it raises, I think, some significant issues and some federal courts have begun to question this themselves as to whether that's a proper part of the overall class suits, class action regime. Thank you.

**D. BRUCE JOHNSEN:** Thank you, John.

**ROBERT PECK:** Already trying to seal something. Well, let me first thank Henry and Karen for inviting me back. Although I have to admit, just between you and me, that I'm a little upset with Karen. She told John and me before we began the session that we should say something important and then she steals our thunder by announcing the location of restrooms.

My focus tends to be on the United States Supreme Court and often times, when cases get up there, they turn out not to be what the justices thought they were. A good example—I was up there a decade ago—a case called *Jinks v. Richland County*,<sup>10</sup> which was over the constitutionality of the supplemental jurisdiction statute. Now, when I went to school, we used to refer to that as pendent jurisdiction. It now has a new title—supplemental jurisdiction. One provision of this act is that it has a tolling provision. So, if you file an action in federal court, and the court decides that state issues predominate, the Federal court can dismiss the case without prejudice so that it can be re-filed in state court, and if the statute of limita-

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<sup>8</sup> *Class Actions Seven Years After the Class Action Fairness Act: Hearing Before the H. Comm. on the Judiciary*, 112th Cong. 64 (2012) (statement of John H. Beisner, Partner, Skadden, Arps).

<sup>9</sup> Rules Enabling Act, 28 U.S.C. §§ 2071-2077 (2012).

<sup>10</sup> *Jinks v. Richland County*, 538 U.S. 456, 459 (2003).

tions had run during the time you were pending in federal court, you have an additional 30 days to re-file and stay court. The question was, is this constitutional under the 10th Amendment because here you are dictating to a state, a sovereign state.

The South Carolina Supreme Court on that basis had said that the statute was unconstitutional. This went with a trend in the United States Supreme Court at the time where a lot of federal statutes were being declared unconstitutional on federalism grounds. One of the things that the court said in the course of a case just one year before the South Carolina Supreme Court decided its case, was that it's likely that this supplemental jurisdiction statute was unconstitutional. So, here I am, bringing in the petition to the U.S. Supreme Court knowing they'll accept it because they liked to be the ones that declared federal statutes unconstitutional, and thinking that I'm sledding uphill. I looked at the court trying to decide how it is that I might be able to get five votes—and this is not an issue in which I think there's a swing vote.

As I looked at it, basically with Justice Souter, the architects of the case against me, I designed my case to try and turn him around and if I win him, I win the case. So, this basically became the “this is the-exception-that-proves-your-rule” type of argument heavily laced with original intent. So, I got up there to argue the case, and I got maybe a sentence or two out before Justice Ginsburg asked me the first question. It was a friendly question. I was glad to get it. Then Justice Souter asked me a more probing question, which I answered and then Justice Scalia forward with his haymaker. It turned out to be the question that I had anticipated, but to tell you the truth, advocates like myself like to do a little acting and so I put my hand to my chin and said, “That's a very good question, Justice Scalia,” waited a second as I pretended to think about my answer, and then gave my very well-rehearsed response, and instead of getting the follow-up question that I anticipated, instead Justice Scalia sat back and was thinking about this and I was realizing suddenly that he liked that answer.

Quickly got back to my argument, I got almost no questions after that. I ended my argument a little bit early, reserving the rest of my time for rebuttal, and my opponent got up. This is the person who had won his case in the South Carolina Supreme Court, and he was allowed two words before Justice Scalia decided to go after him. Essentially, since he didn't get to go after me, he decided to go after my opponent. So, he basically set it up as, “Your argument, A or B?” My opponent immediately said, “My argument is A,” and Scalia responded, “Well, that makes no sense whatsoever,” and ripped it to shreds. Well, my opponent, having experienced the appellate advocate, immediately switched gears and said, “Now that you've explained what you mean by A, my argument's actually B.” Scalia's response is, “That makes even less sense.” So, he tried one more tactic. He said,

“Well, the National Association of Attorneys General filed an amicus brief,”<sup>11</sup> and Chief Justice Rehnquist cut him off and said, “We decided that issue in 1978. We’re not revisiting it.” So, suddenly my opponent was the deer in headlights. His mouth was open. Nothing was coming out. I could look at the clock above the Justices and watch the seconds tick away, and I know it must have seemed like an eternity, but obviously he couldn’t think of what he needed to say at that point.

Suddenly Justice Breyer spoke up, and Justice Breyer said, “Well, Mr. Peck cited a case I wrote when I was on the First Circuit. Did you read that case?” Obviously, my opponent’s mind must have been a blank at that point, and he didn’t want a question about that case from the person who wrote it so he says, “I don’t know.” Well, Justice Breyer says, “That’s okay because the underlying issue had to do with this Icelandic epic poet, and I reprinted a part of his poem in my opinion.” He starts reading us the poem. We’re looking at each other. Everyone in the courtroom’s just trying to figure out what this is about, and he’s going on and on and on. Finally, Justice Scalia says, “I think I saw the movie.” Well, that caused everyone to laugh. Justice Breyer stopped.

Chief Justice Rehnquist, despite the fact that my opponent still had 17 minutes of his time left, invited him to sit down and knowing well, I waived rebuttal. One of the unanimous decisions written by Justice Scalia, because again, the case didn’t turn out to be what the justices assumed originally what it was going to be about. Now, I don’t know how much my strategy influenced this or how much Justice Breyer’s filibuster might have influenced the decision, but that happens with some frequency.

Last year, the Court decided the *Walmart* case.<sup>12</sup> You’re going to hear more about it soon. It was the class action that made the Guinness Book of World Records for the size of the class. The question the Court decided to answer was whether Rule 23,<sup>13</sup> the commonality requirement, was met when there was such decentralized decision-making at Walmart over these employment decisions. So, therefore, basically suggesting this class had to be broken up into more discreet parts where there was a common allegation. The Court refused. Part of the question presented to them that they chose not to answer was whether due process also required that, but the case that got less publicity at the time the Court decided *Walmart* was *Smith v. Bayer*.<sup>14</sup> *Smith v. Bayer* was another class action case dealing with certification. One plaintiff had filed in federal court. While that case was pending, but unknown to another plaintiff, that plaintiff filed in state court. The district court refused to certify the class, but the state court did certify the

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<sup>11</sup> Amicus Brief of Council of State Governments, *Jinks v. Richland Cnty.*, 538 U.S. 456 (2003) (No. 02-258), 2003 WL 145526.

<sup>12</sup> *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2550-51 (2011).

<sup>13</sup> FED. R. CIV. P. 23.

<sup>14</sup> *Smith v. Bayer Corp.*, 131 S. Ct. 2368 (2011).



class. So, when the question came up to the Supreme Court, they said, “Could you essentially take the second bite at the apple?” What the court decided was in the absence of certification, the other plaintiff who was not obviously included or anything, certainly wasn’t bound by the federal district court decision, and therefore could proceed with his class action.

So, one of the things that came out of this case was the fact that this case arose out of West Virginia, and West Virginia’s Rule 23<sup>15</sup> is identical in language to the Federal Rule, but West Virginia had the right to interpret its Rule 23 differently, and this has been the standard holding of the Supreme Court for years—that there is no reason why state courts have to interpret the Rules the same. In fact, a lot of state boards had looked at their versions of Rule 23 so that the rule was designed to be a liberal rule in favor of certification and have come out a different way. The result is that the Court had seen a series of cert petitions over the past year that had asked the court to try to impose their view as expressed in *Walmart* on the states as a matter of due process, and the Court has consistently turned down certiorari in those cases.

So for example, in a case coming out of Oregon called *Strawn v. Farmers Insurance*,<sup>16</sup> the question here had to do with the PIP policy, the personal injury protection policy that’s part of every auto insurance policy. What happened here was this fellow, Strawn, sought reimbursement of certain medical expenses and in his instance, his policy didn’t cover \$235 of those medical expenses. He said, “Why wasn’t that covered? It’s supposed to cover all reasonable medical expenses.” He got back a response from the claims adjuster that “We’re only covering 80%.” He said, “That’s not in the policy.” They said, “Well, this is the policy.” As it turns out from discovery, Farmer’s Insurance had lost a great deal of money in 1994 on the North Ridge earthquake in California and so they started a campaign that they called bring back a billion dollars to their reserves and they charged every state office to come up with a strategy to do so.

In Oregon, they decided they’d only pay 80% of PIP without announcing it. Now, not worthwhile bringing a lawsuit over \$235 and in most instances, the PIP 80% rule only affected a dollar or two at most of the claimants. So, we brought a class action in Oregon courts, and the argument that was made by the same lawyer who argued the Walmart case to the Oregon courts was that this is a violation of due process because we don’t know whether everyone in that class had read their policy and knew that it didn’t say 80% in it. So, the question of reliance was one that was not common to the class and ought to be treated differently. And the Oregon Supreme Court said, “No, this is a requirement of law. Every policy must have a PIP policy. You can’t sell an auto insurance policy in Oregon without one.”

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<sup>15</sup> W. VA. R. CIV. P. 23.

<sup>16</sup> *Strawn v. Farmers Ins. Co. of Oregon*, 258 P.3d 1199 (Or. 2011).

It's supposed to cover all reasonable medical expenses and you can't arbitrarily select a number like this without telling anybody and the policyholders had a right to assume that having bought a policy that by law must include PIP, they would get their reasonable medical expenses back. So, the Supreme Court denied certiorari in this case despite the fact that it was claimed that essentially Oregon was ignoring *Walmart*. Of course Federal Rule 23 doesn't apply in the Oregon courts.

The same kind of argument was made in the *Aubry* case,<sup>17</sup> the case coming out of Louisiana. This was a case involving claimants against the insurer of last resort, which was a state agency. The insurer of last resort essentially wasn't insured for property damage. This was property damage due to Katrina. The statute in Louisiana established a strict liability regime that if one of your policyholders contacts you about catastrophic property damage, you have 30 days to get back in touch with them just to either set up a process, or set up an appointment, or something. So, if you receive an email, you can return it by email. If you receive a letter, you can send a letter—whatever's appropriate in terms of being responsive to the contact from the policyholder. Well, almost all insurers in Louisiana succeeded in complying after Katrina with this. The only one that didn't was the state agency. They didn't to the tune of more than 18,000 claimants so at \$5,000 each in terms of fines, that amounted to a \$92 million fine that had to be distributed to each of those claimants, the policyholders. So, they went up to the United States Supreme Court saying they were denied due process. They did not have the opportunity to mitigate and therefore, the facts would have been different with respect to each policyholder. Again, certiorari was denied.

A third case worth mentioning is a case out of the Pennsylvania Supreme Court.<sup>18</sup> This case involved Kia Motors for a number of years in the late '90s. Kia manufactured a car called the Sephia. The Sephia had a problem. The unit that contained the brakes didn't have a way to dissipate heat. As a result, the brake pads would wear out very quickly within a month or two. Kia Sephia owners would go to their dealership saying something's wrong here. They would get their brake pads replaced. Sometimes they'd have to pay for it. Sometimes it would be covered under warranty and then a month or two later, they'd have to be back. So a class action was begun by owners of the Sephia over this issue. As it turns out, Kia said "Well, they ought not be certified as a class. Some of them had warranties, some of them didn't, even though they were asking for the diminished value of their vehicle given this situation and, more importantly, road conditions are different and people's driving habits are different. So as a result, brake pads will wear out at different rates depending on all these

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<sup>17</sup> *Taranto v. Louisiana Citizens Prop. Ins. Corp.*, 62 So. 3d 721 (La. 2011).

<sup>18</sup> *Samuel-Bassett v. Kia Motors Am., Inc.*, 34 A.3d 1, 11 (Pa. 2011).

things and that has to be determined on an individualized basis.” The Pennsylvania courts had none of it and the Supreme Court again denied cert.

So despite the fact that the Court has an enormous interest in class actions—one that continues this term with at least four cases involving class actions, two of which have already been argued—they were not interested in these cases in part because they’re not interested in imposing their regime on the states and they’re interested in the state’s finding their own ways to deal with class actions, whether they take a more liberal or conservative approach.

Now, one of the cases that the Supreme Court heard this term is a case called *Comcast v. Behrend*,<sup>19</sup> and the question before them fundamentally comes down to whether or not consumers in the Philadelphia area are paying too much for cable. Comcast had acquired the market portion by making a trade with one of their competitors and now basically controls the Philadelphia market. They were sued under the anti-trust laws and the question was: must the damages be proven at the first end to be class-wide and established before certification? So the question is, do you engage in this kind of dabber hearing about expert evidence about class action before the case, before you get to the merits of the case? And as it turns out, there’s a significant issue of whether or not Comcast had waived that issue. So it got to the Supreme Court, and the waiver issue tended to dominate at the end. There is a good chance that after all that, after all the briefing, the argument, and everything, it will be subject to a DIG, which is a dismiss as improvidently granted.

Now that happens from time to time. It happened in a return trip I made in a case called *Phillip Morris vs. Williams*.<sup>20</sup> That was a case involving a \$79.5 million punitive damage award when compensatory damages were only \$821,000. So a mere 97:1 ratio. The first time the Court heard full argument in the case, they decided to return the case on a jury instruction issue saying that, under due process, if properly requested, a defendant is entitled to a jury instruction that says that they may only ask for punitive damages for harm to the individual plaintiff and not for harm to others. A 5-4 decision was returned in this instance—the Oregon Supreme Court decided that it was not properly asked for because Oregon, for nearly a century, has followed a rule that everything must be clear and correct in all respects in jury instructions, otherwise there is no error in denying the instruction. While this instruction contains something along the lines of what the Supreme Court said, it also was actually wrong with Oregon law and so therefore there is no error in denying it. We went up to the Supreme Court a second time in which Phillip Morris sought two questions to be answered—one was grossly excessive punitive damages and two was Oregon basically sticking its tongue out at the U.S. Supreme Court and ignoring it.

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<sup>19</sup> Comcast Corp. v. Behrend, 133 S. Ct. 24 (2012).

<sup>20</sup> Philip Morris USA v. Williams, 549 U.S. 346 (2007).

The Court decided to take the second question only and after oral argument, in response to a request that I ended my argument with, it DIGed that case and decided to let it stand—the 97:1 ratio. So, a case can be different than it seems when it gets to the court. You know that very well, but in class actions it certainly seems to be the case where at least those of you who hear cases in state courts do not need to follow this Federal Rule 23 regime.

**D. BRUCE JOHNSEN:** Thank you, Bob. Anyway, let me kick things off. I know you're all shy about asking questions so I'll start. I have a question about everybody's litigation finance that John raised. Let me just, of course, start with a proposition that I suggest to my students from time to time. Sometimes we actually have too little litigation out there. That is, there is, in terms of clarifying precedent, some party may be reluctant to litigate what would be in the interest of a wide group of people to see some issue resolved. That could be firms that are horizontally-related in the industry or what have you.

We have the classic statement of incentives to litigate by Preston Klein, whose argument is basically within the world in which legal precedent is fairly certain, whether we have the American rule or the English rule won't matter. Much more in the lines of Casey Stable's statement when asked, "How do we eliminate the close plays in baseball?" He said, "Easy, just shorten the baseball." So, what we would just do with the American rule as opposed to the English rule is just replace one set of litigated cases with another set of litigated cases.

Of course, obviously, the legal rules aren't certain. Now this is where hedge funds come in. You all remember the Texaco-Pennzoil dispute back in the mid '80s, right?<sup>21</sup> Where—what was it—tortuous interference with a prospective business advantage or an agreement in principle by Texaco in inducing Getty Oil to sell its oil reserves for TexOil at the last minute and breaching the agreement in principle with Pennzoil. Pennzoil took Texaco to court in the state of Texas, won a \$10.5 billion judgment, which is more than market capitalization of Texaco. Texaco was really in a bad way, threw everything but the kitchen sink back at Pennzoil and they were fighting it out and Calpers, of all people, I think, stepped in and said listen, we don't stock in Texaco. We don't stock in Pennzoil.

This is a loser for us. Calpers and other institutional investors put great pressure, as I understand it, on the parties to settle and get it over with. Now, what about hedge funds interest in litigating? Certainly, hedge funds may own stock in firms, in an industry where those firms are horizontally related. Now I often think that one firm is kind of—should pursue litigation in the interest of the industry. It would be nice if they did, but in some

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<sup>21</sup> *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. App. 1987).

sense they can't capture all benefits. Maybe there's a precedent that needs to be clarified.

Well, in some sense, the hedge fund may then stand in for the interest of all members of the industry and that could be a driving force behind the interests of having hedge funds finance litigation. I'm not saying that's always the case. I'm not even saying it's necessarily the case. It strikes me as something to be considered so let me throw it open to John and Bob to respond if they like and how they like.

**JOHN BEISNER:** I guess the main point I would like to make in that regard is the hedge funds that I'm referring to in this regard, most of them at this point and it may change—there may be some evolution in this—are fundamentally investing in litigation. These are the reasons I refer to them as hedge funds as these are often run by people who have moved over from the more traditional hedge funds that you're talking about and in an economic period when hedge funds had a hard time finding things to invest in, what's the constant in the economy? Litigation—let's invest in that. So most of the funds I'm familiar with and again we know very little at this point about who all is investing here, but the ones that are doing do publicly are investing in litigation only. They don't have . . .

**D. BRUCE JOHNSEN:** They don't have a portfolio.

**JOHN BEISNER:** They don't have portfolios of stocks. Now again, I'm saying that in terms of those that are publicly identifying themselves as indulging in this activity. There could well be others that do have the mix that you suggest. But in essence, what they're doing is going out to investors and saying, "You know, you can't find your way in the regular market, how about investing in lawsuits?" They're collecting, as I said, hundreds of millions of dollars to put into litigation and are expecting a return from investing in litigation that's greater when they can get in more conventional markets.

**D. BRUCE JOHNSEN:** Okay.

**ROBERT PECK:** You know, I'm not an advocate of third party financing, but I'm not an opponent either. But it does strike me as I look at the debate about this that it seems to be a very one-sided debate. I recall in 1969, the Justice Department brought a huge anti-trust action against IBM.<sup>22</sup> It dominated the computer market. The lawyer who represented IBM said, "You know, by design, I'm not really much of a litigator. I'm a procrastinator. I like to keep things going and every day we keep this lawsuit going, IBM

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<sup>22</sup> United States v. IBM, 83 F.R.D. 97 (1979).

makes a lot of money.” He was able to keep it going for more than 10 years by which time, the computer market had so changed, the facts were no longer there to prosecute the anti-trust action.

I wonder, how much are investors really going to control any kind of litigation from the plain of sight where clearly the ethical rules require that you represent your client and not necessarily the funder because we have defense side insurers who are the real parties in interest, who are never revealed to the jury, who finance the defense, who have their own interests separate from it, who often have captive law firms that are representing the defendants, but really work for the insurers. So how different in that? I wonder.

Recently I had an argument at the Second Circuit, first time I took a pure products liability case to argue and it had a huge verdict, \$48 million, \$15 million of which was for pain and suffering and that is the largest amount any appellate court under New York law has ever approved. I only discovered after oral argument that there had been an investor in the case. So they were pushing the original trial lawyers in the case to try to settle. Now, I’ve got to say from my perspective, I thought the oral argument went very well. This was an incredibly well-prepared panel that knew the record in the case very intimately, knew details about all the cases, all [inaudible] lawyers subsided in their briefs and in fact came out 15 days after oral argument with a summary order in our favor. So, I think my judgment on how oral argument went was vindicated by that. Obviously that happened before any settlement discussions could have taken place, but there again, the only action that the investor said was suggesting settlement and the trial lawyer who had tried the case, who agreed that the oral argument went extremely well, chose not to pursue it.

**JOHN BEISNER:** I guess the one comment I’d make on that as I’ve heard the insurance analogy made before, but I think it’s really quite different. If you’re an insurance company that has a defense obligation case, you’re obviously not there for profit purposes. You are there to basically fulfill your contractual commitment in a way that’s consistent with minimizing your expense on the litigation and I’d also know that under Rule 26, your presence there is known. The jury may not hear it, but everybody in the case knows about it and can deal with the strategy in the case based on the pricings of the insurance company. I think it’s quite different from somebody who’s made a voluntary decision to invest in a lawsuit for profit. That is a very different concept. That’s not the reason the insurance company was there. I decided that I’m going to join, put my money into something that basically brings a defendant in involuntary, subjects them to the litigation process in the hope that at the end, I would get some money out of this that will exceed what my investment is. I think that is, from a market standpoint, is a very different concept and I’d further add, you don’t know they’re there, that the investor involvement presently does not necessarily

have to be disclosed. I said sometimes there's discovery, but in some cases you get it, in some cases you don't. But you really don't know who's on the other side of the lawsuits. I'm not sure that analogy is right.

One thing I would agree with you on, Bob, is that the presence of investors doesn't necessarily make the litigation longer. I agree with you in some instances depending on the investment circumstances, you may actually get pressured, as you're suggesting in the case you're involved in, that there'd be an earlier settlement. The investors want the money out now. But, the point is that you've got some real ethical issues with that because you now have this investor, not the real party in interest, not the claimant, who has got control of that process, or at least is exercising a lot of influence at that. I'm not sure from an ethics standpoint we figure that out. If you have a sophisticated plaintiff in the case and they've taken account of all in the circumstances and decide that they will share control of litigation with the investor, that may be one thing, but if you're in a mass tort where you got lots of people who are there with an investor involved, then they're individuals who may not be as sophisticated, that control may be completely elusive to them.

**BRUCE JOHNSON:** All right, thank you. We have questions. Yes?

**AUDIENCE MEMBER:** Maybe you can help me out. I have a recollection of some litigation I was involved in, whether it was a bar by some states in respect to the sale of litigation. I don't know if my recollection is correct or not. You might want to comment on that.

**JOHN BEISNER:** Yes, I should note that the state laws are, like in most things, quite variable on this issue and the notions of champerty and maintenance are still very much alive in some jurisdictions, but it's being hotly debated—that concept where you'd be looking back in ancient history in some states to find the last time the Supreme Court commented on this subject of champerty or maintenance could well be a hundred years ago. You're now seeing cases on this subject that are being presented by this, but in many jurisdictions, those prohibitions on either helping to start litigation, the champerty concept, or maintenance investment in an existing litigation, those concepts have been overruled.

I should mention in that regard, there's another form of litigation investment that is prompting a lot of activity in state legislatures at the moment. Before, I was talking about entities that actually invest in the litigation itself. There's also a kind of a related industry of companies that make loans to plaintiffs in cases, consumer lending, and they basically, you'll see—for those of you who watch any late night television—you'll see these ads all the time of, "If you have a lawsuit, we'll give you money with respect to your claim now," and they usually give non-recourse loans to individuals who have claims. The ads talk about 2% or 3% interest. What may

not be clear to the borrower is that's monthly, so you're talking about 36% interest on these loans and a number of states have started looking at whether some regulation of these loans are known.

So this is another form of lending in the litigation context. It's quite different, I think, from the other. Some of you who are involved in mass tort cases may be running into this because an issue I have seen in a number of proceedings is that when a settlement is brokered or it's being discussed for a large number of claims in the case, these companies will come in to make loans at that point, at the same rates of interest. You kind of wonder 36% per annum and they're going to be getting money soon, but I have seen a number of instances, at least some instances, where judges have had to step in because these claimants start coming in the court and say, "You know, I thought I was going to get money out of this, but I got this loan and now I'm not getting any money because of 36% interest ate up everything I was supposed to get." They're expecting the court to do something to help them out at that point. So this is a whole other area of investor activity in litigation now that I think may be causing some headaches in some circumstances.

**D. BRUCE JOHNSON:** Yes, you. Next.

**KELLY LEE:** Good morning. I'm Kelly Lee. A couple of cost shifting questions, one in reference to this topic of third party pay litigation, is that spawned in any discussion on if there is more of a proliferation or practice where there's a third party payment of this type of litigation or financing. Does it lend to more discussions about wisdom and cost shifting and whether or not there might be more argument for that? Also another cost shifting question about, it's good for me. I enjoyed hearing you bring the issue up of discovery that's been such a big issue that I've seen so much for years, especially when you're talking about maybe equally weighted parties, and it seems to be a very slow shifting thing but there are some shifts, at least in the Eleventh Circuit and in the state of Georgia, but it is slow. Do you see that being more of a trend that you, with the electronic discovery and more of equal weighted parties, that they're being more of a sharing of expenses among the discovery issues?

**JOHN BEISNER:** Let me address the third party litigation-funding question first. The answer to your question is yes. There are some proposals out there at the moment for federal legislation on third party litigation finance and an element of some of those proposals is to say if a third party is funding the case, everybody pays their own costs on discovery. So, if you ask the other side for something, you pay for it and that's one of the proposals, the belief being if you've got investors who are involved in the case who are there basically for profit purposes, and these sort of access to justice considerations, that may be the justification for saying that the producing



party would pay for discovery evaporates. So, has anybody embraced that principle? No. I mean no court has had to face that issue but there is a proposal out there to go that direction.

On cost shifting in discovery, I think there have been some changes. You do see somewhat more receptivity to cost shifting in the federal courts but I did an article that was published I guess 18 months ago in the *Duke Law Journal*<sup>23</sup> coming out of the Duke conference, part of which is to look at in how many instances have courts actually used the two step part of Rule 26 that says if the discovery's directly related to your claims, you get that discovery, but if it's just related to the subject matter of the litigation, you have to get the court's permission, and there may be some cost shifting as opposed to that point.

At that time, when I looked at that 18 months ago, very few courts have invoked that provision and I shouldn't be putting it on the courts. It would hasten to add very few defendants that try to use that provision to achieve cost shifting. If you look at the minutes of the discussion of the advisory committee looking at this, they're seeing some courts that are doing this more consistently, but the vast majority of federal courts, producer pays remains the norm and I think that I don't know what they'll ultimately conclude, but that whole issue has been reopened and I think what a lot of people are arguing for is more of a decision point in each case of saying who's going to pay for this discovery. I think that a lot of it is being driven by the electronic aspect of this.

I mean I'm in a number of cases, mass tort cases, where the defendant is easily, fairly early in the case has paid \$30 to \$40 million more than anything just to keep everything in place in case somebody does ask for it. I mean, that's the amount of the expenditure that's involved. This isn't production. Nobody's decided any of this as relevant or potentially relevant to anything. It's just an abundance of caution particularly with the sanction concerns that are out there just trying to keep a whole company data in place so that it's available is an enormously expensive proposition. And it really becomes a major point of leverage in a litigation if you're sitting there as a defendant and you're saying, "Gee, I can settle a case or I can spend \$40 million just to comply with discovery." The system is out of [inaudible] at that point because decisions are being made not on the meritorious-ness of the case, but just merely the pure expense from discovery.

**D. BRUCE JOHNSEN:** Yes?

**AUDIENCE MEMBER:** Typically, when I have a final pre-trial conference in a complex civil case, I will require that all persons with settlement authority be present at the final pre-trial, in order to reach a settlement if it's possible.

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<sup>23</sup> John H. Beisner, *Discovering A Better Way: The Need for Effective Civil Litigation Reform*, 60 DUKE L.J. 547 (2010).

That might be one way to make sure that third party funders are involved and accessible. Do you have any suggestions about how to encourage cases to settle to identify if there are third party funders, as a court to facilitate the settlement process if they are involved, and I guess the other question is to prevent a case that should settle from settling, to prevent a third party funder from preventing a case from settling if there are reasons why the case should settle. So, I mean, how—I guess I'm asking a bunch of questions at once, but they all go to the point of what do I do as a trial judge to facilitate settlement when third party funding is involved in the litigation?

**ROBERT PECK:** Let me first tackle that by saying I don't think you need to do anything differently. The fact of the matter is most cases still settle. The impetus for settling is great for both sides and any attempt to formalize the involvement of the third party funder in the settlement I think is a mistake to give them a status that law does not recognize for them and to suggest to the lawyers that they are a real party in interest when they shouldn't be.

**JOHN BEISNER:** I think that the time to invest, to identify the third party investor, is probably earlier in the litigation as opposed at the settlement stage. I tend to agree with Bob. I think the ethical concern that you have at that point is that the funder is going to exert undue influence over the settlement decision and so to sort of say what makes you formally a party at the table may take it the wrong direction and I tend to agree with Bob on that.

On the other hand, I think that it's probably important for the parties to know up front and, indeed I think in Rule 26, there ought to be a requirement that anybody who's got a contingent interest in the outcome of the litigation be identified because that's when you need to know about that is up front so you're fully aware of the strategies that are occurring on all sides of the litigation. But I tend to agree with Bob. I worry about formalizing their presence at that late date in the case. That's the point in which you're hoping that the real parties in interest are making decisions.

**D. BRUCE JOHNSON:** All right, that concludes our panel. You're of course welcome to follow up in person with our speakers. Let me thank them for their participation.

EMPLOYMENT LITIGATION: EMERGING TRENDS IN  
WAGE & HOUR LITIGATION AFTER *DUKES V. WAL-*  
*MART*

*Ellen C. Kearns, Charles A. Shanor, Christine E. Webber, Lisa A. Schreter,  
Elizabeth Becker  
Moderator: Tammy D. McCutchen*

**KAREN CZARNECKI:** Please take your seats. Roger, I'm going to call upon you. Roger Wilson. That's the problem when I get to know your names; it's not good. We're thirty seconds ahead of schedule, but we've got a lot of wonderful speakers today. And we've got a lot to talk about in the world of employment litigation. I'm going to introduce our moderator today. And she will introduce the rest of the panel, and they have promised it will be a lively conversation, discussion, not a debate though, right? Well, maybe. That's okay. If it is, we'll accept that as well. Tammy and I got to work together at the Labor Department not too long ago where she was the administrator of the Wage and Hour Division at the US Department of Labor.

Currently, she's a shareholder with Littler Mendelson where she counsels management clients on compliance with the Fair Labor Standards Act and state wage hour laws. I remember fondly our day's discussion on Part 541 of the FLSA, the white collar overtime regulations.<sup>1</sup> So it was the first time they were updated in roughly 50 years, and boy, that was a fun time we had then, really fun. Before joining the Department of Labor (DOL), Tammy was the senior counsel at the Hershey Company, and she's also practiced law in Chicago, and she clerked for Judge Daniel Manyon at the U.S. Court of Appeals for the Seventh Circuit.

She is on the Legal Advisory Board at the National Federation of Independent Business. And she's chair of the Federalist Society's Labor and Employment Practice Group. Please join me in welcoming her to moderate today.

**TAMMY D. MCCUTCHEN:** Thank you very much, Karen. It was quite an interesting time at DOL when we were doing the regulations. In 2001 when I was confirmed as wage and hour administrator at DOL, wage and hour law was a niche practice. We were like the tax attorneys of the employment law world, sitting off in a corner and thought to be very strange. Today, however, FLSA—class and collective—in the federal court system, the

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<sup>1</sup> 29 C.F.R. § 541 (2013).

FLSA collective actions actually outnumber all types of discrimination class actions combined.<sup>2</sup>

So it is—although we don't have numbers on the state side, most people agree that wage and hour class actions and collective actions are now the most ubiquitous types of employment law cases that might come before you. How many of you have had a wage and hour case in your courts? We'd love to have a quick show of hands, quite a few of you! They're very common, and we're going to talk today generally about—we're going to focus on the life of a case of a wage and hour class or collective action. Generally, there are two different types of claims that might come before you.

One of them is known as a misclassification case. In a misclassification case, the question is whether an employer properly classified an employee as exempt from the overtime requirements under state or federal law.<sup>3</sup> Some examples, like the ubiquitous assistant manager in a retail restaurant context, we ask: "Is that person really an executive with supervisory authority, or does he have none; does he fail to exercise supervisory or discretionary authority?" Most recently, the U.S. Supreme Court ruled on the classification of pharmaceutical sales reps and found that those sales reps were properly classified as outside sales employees.<sup>4</sup>

The other type is what's commonly known as off the clock work. And the question there is did the employees perform work for which they were not paid? Sounds like it should be easy, but I actually gave about a two hour presentation on the definition of what is work. So the issues could be very complex. Some common types of actions that you might see is the *Milbright* case. Under federal and state law, if an employer provides employees with a 30 minute break in which they don't work that doesn't have to be paid. The question in many, many cases is whether or not their unpaid 30 minute meal break was interrupted with work and thus making that meal break having to be paid.

Another common type of action which many of our panelists have been involved in is the dreaded *Donning and Doffing* case.<sup>5</sup> And in that type of case, the factual situation commonly in the food processing industry (beef, chicken, other food processing), is an employee comes in to work, and before they punch the time clock, they're changing into uniforms and personal protective equipment, standing in line to get the equipment, putting it on, walking to their workplace. And the issue is: are they being paid for that

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<sup>2</sup> Mot. for Leave to File Amicus Curiae of the Chamber of Commerce of the U.S. and Brief Amicus Curiae in Support of Petitioner, 551 F.3d 1233 (11th Cir. 2008) (No. 01-1015), 2009 WL 1179318, at \*2.

<sup>3</sup> See *Ahle v. Veracity Research Co.*, 738 F. Supp.2d 896 (D. Min. 2010).

<sup>4</sup> *Christopher v. SmithKline Beecham Corp.*, 132 S. Ct. 2156 (2012).

<sup>5</sup> *Sandifer v. U.S. Steel Corp.*, 678 F.3d 590 (7th Cir. 2012) *cert. granted*, 2013 WL 598470 (U.S. Feb. 19, 2013) (No. 12-417).

time, and how much time does it take? Wage and hour actions are unique among employment litigation, in my opinion, for several reasons.

First, under the Federal Fair Labor Standards Act, we have an opt-in procedure for class certification.<sup>6</sup> Employees actually have to file their intent with the court to become a member of the class, while at the same time, the state claims tend to be your traditional opt-out class actions. And we're going to talk a little bit today about those sorts of dual standards. Also, under the FLSA, there's actually no private waiver of FLSA claims. So the only way an employer can end a case and be comfortable that they're ending a case is through a settlement through a court or through the Federal Department of Labor.

Also, unlike, other class actions such as discrimination class actions, liability and damages in a wage and hour case are dependent upon very specific factual situations. On a misclassification case, what is the particular job duties that employees performing day in and day out, week in and week out? And even though you have the same job title as another employee, you might be performing different duties. And so you really have to look at the specific duties. On off the clock claims, how often were meal breaks interrupted? How long was the interruption?

If it's an interruption that happens only infrequently or sporadically for just a couple of minutes, that's generally considered to be *de minimis* time that doesn't have to be paid. This last issue with the specific factual situations is why some courts have applied the US Supreme Court's decision in *Dukes v. Wal-Mart* to deny certification of wage hour class actions.<sup>7</sup> However, it's not uniform, different courts looking at the decision and applying it to their own facts have come out on both sides of the issues. Now, *Dukes*, of course, was a sex discrimination case dealing with Federal Rule Procedure 23.

It reversed the Ninth Circuit, finding that the class should not have been certified. The focus of the decision was on commonality. It was also an issue, of course, under state standards. The Supreme Court found that the district courts must perform a rigorous analysis of Rule 23 requirements, which will necessarily overlap with a merit determination. Plaintiffs, the Supreme Court said, must affirmatively demonstrate with significant proof at class certification stage that class members have suffered the same injury. That is, plaintiffs have to present a common contention of law and fact, which is central to the validity of each of the class members' claims.

The Supreme Court further held that 120 declarations that were filed by class members out of 1.5 million class members, 120 out of 1.5 million, was insufficient to establish class-wide violations. They also agreed with *Dukes* that certification under Rule 23(b)(2) improperly denied the employ-

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<sup>6</sup> Penalties (Fair Labor Standards) Act § 216, 29 U.S.C. § 216 (2012).

<sup>7</sup> *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

er its constitutional right to raise individualized affirmative defenses. The questions raised by *Dukes* and other cases in the wage and hour world include things like should the FLSA opt-in standards for class certification be the same or different than state left out standards or Rule 23? Should it be allowed that a court certifies simultaneously an FLSA opt-in suit with a state law opt-out suit?

And of course, with the Supreme Court decision discussing the type of proof that a plaintiff has to present at the class certification stage, the issue of what type of discovery should occur before the class certification decision has become more into focus. Our distinguished panelists are going to address these and other issues for you today relating to wage and hour class and collective actions. Let me introduce them.

I'm going to start way on the end with Christine. Christine represents employees in some of the most high profile cases that are out there, including *Dukes v. Wal-Mart* and the Dawning and Doffing case against Tyson Foods.<sup>8</sup>

She is a co-chair of the Class Action Committee of the National Employment Lawyers Association. Her JD is from the University of Michigan, and she clerked for Judge Will on the Northern District of Illinois. Next, we have our guy.

**CHARLES A. SHANOR:** I'm the token.

**TAMMY D. MCCUTCHEN:** Charles is a professor of law at Emory University in Atlanta, Georgia where he teaches labor and employment law. He has a Bachelors and Masters from Oxford. His JD is from here in Virginia, the University of Virginia. He's a Rhodes Scholar. He clerked for Judge Tuttle on the Fifth Circuit, and he is a former general counsel of the Equal Employment Opportunity Commission here in DC. Lee is next, appropriately, our other panelist from Atlanta. Lee is my partner at Littler Mendelson in our Atlanta office, and she represents employers in complex employment class and collective actions.

She's a frequent speaker and writer on today's topic. Before becoming a lawyer, her first career where she started learning the complexities of wage and hour law was as an HR professional. Her JD is from Georgia State University. Next, we have Ellen Kearns. She's a partner in Boston, Massachusetts at the law firm, I always pronounce it wrong, Ellen, Constangy, Brooks, and Smith. She literally wrote the book on the FLSA. She is the Editor-in-Chief of the ABA's treatise on the FLSA. Her JD is from Boston College.

And finally, last but certainly not least is Dr. Elizabeth Becker. Elizabeth has an MA and PhD in economics from Clemson University. She is a

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<sup>8</sup> In re Tyson Foods, Inc., 694 F. Supp. 2d 1358 (M.D. Ga. 2010).

labor economist, and that is a subject she writes on frequently. She serves and consults as an expert in a broad range of employment disputes, including discrimination and wage and hour class actions to address issues relating to certification, to liability, and to damage. And without further ado, we are going to start with Lee.

**LISA (LEE) A. SCHRETER:** I'm really honored to have the opportunity to speak to all of you about a topic that is near and dear to my heart and probably is a great burden to all of you. So I saw from the raised hands that many of you have had or are currently handling wage and hour cases. The message I would leave with all of you is they are coming to a court near all of you soon. Wage and hour litigation, as Tammy has mentioned, is really ubiquitous. It has assumed a prominence in employment litigation that no one could have projected twenty years ago. And it really provides an area that is rife for opportunity to develop the law.

The Fair Labor Standards Act, the federal law that controls the payment of minimum wage and overtime, has been a statute that's been around for more than seventy years.<sup>9</sup> And it's a statute that's come of age. At the same time, many of you are in jurisdictions where state wage and hour laws have really developed case law really in the last ten years. And so one of the things that we find in the area of wage and hour litigation that is quite common is sometimes, there are no judicial answers to the questions that our cases are presenting to all of you. And you may often find yourselves developing new law.

That makes this area of the law quite challenging for all of us and certainly very interesting to us, perhaps less interesting to all of you. What I'm going to talk about this morning is a little bit about the procedural structure of these cases and why it matters. When I talk with clients, and I'm on the defense side, I talk about class actions in the wage and hour context as the sport of kings. It is among the most expensive litigation out there. And for many of our clients and my clients, this can sometimes be business changing litigation in a way that very few other forms of litigation can.

As a new lawyer, I never imagined myself being involved in cases where the settlement dollars would be in excess of \$10 to \$20 million. I started out as a humble employment discrimination lawyer handling Title VII cases, often single plaintiff cases. And the stakes in this litigation literally are into the many millions of dollars. The panel we have here today, I have a very illustrative opposing counsel, Christine Webber on the end. I believe that you will hear a lively debate from all of us. Unfortunately, she's outnumbered a bit today because there are a number of defense counsel on the panel and only one plaintiff's counsel.

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<sup>9</sup> Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended in scattered sections of 29 U.S.C.).

But I know Christine is up to the task of disagreeing with all of us as we move forward. So in terms of procedure, and really I'm here to kind of do a layup shot for everybody else to talk a little bit about what are the standards that we're talking about, and what are the problems that they present? Obviously, I tell this story from the jaded perspective of a defense employment lawyer, and I hope you will forgive me for that.

In terms of the structure that we're talking about, under the Fair Labor Standards Act, unfortunately, neither the Supreme Court nor Congress have given us any real guidance on what is the structure that should be applied to these cases in terms of deciding whether a group of employees should be brought together in what is known as a collective not a class action. And so what all of the lawyers on this panel have struggled with is what does a collective action mean, and how do we arrive at a collective, and what are the legal standards that are to be applied?

I will pose for you the provocative statement that I believe that the courts that have been interpreting the standard for whether a collective should exist or not have been wrong. And we've written about this. All of you have been provided access to the legal article on that. But what you'll hear the panel talk about today is really the majority of courts in this country have applied what we call an ad hoc, two stage standard to determine whether or not a collective of employees should be brought together.<sup>10</sup> Most courts have said that Rule 23 does not apply whether you're talking about the state law equivalent or the federal equivalent under the Federal Rules of Civil Procedure.

We believe that is wrong. And what the panelists will talk about, Ellen in particular, is why we believe that's wrong. We believe the courts without any guidance really from the Supreme Court and very little guidance from the Courts of Appeals, and let me step back if I might for a moment to explain why it is that we haven't gotten much guidance from the Supreme Court or the Court of Appeals. The decision to send notice, and the two stage inquiry that we refer to as this ad hoc approach, the first stage is really more appropriately referred to as the notice stage.

Plaintiff's counsel, such as Christine, will come into court and say "Your Honor, we believe that you should send notice to a class of similarly situated individuals." The courts to date have applied a relatively lenient standard at that notice stage and basically said we want to have some evidence that shows us that the individuals are similarly situated. Courts vary a little bit in terms of the amount of evidence that they'll require at this initial stage. Being the jaded employment lawyer, I would tell you I call the stage the limbo standard because there appears to have been a race across the country to apply the lowest possible standard to certification.

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<sup>10</sup> See, e.g., *Morgan v. Family Dollar Stores, Inc.* 551 F.3d 1233, 1260-62, (11th Cir. 2008).



Again, that's coming from a jaded defense lawyer. And I suspect Christine will have a different comment on the standard that's being applied. The second stage is really the stage at which the employer knows of the potential action, the notice has gone out, individuals have been invited to join the collective, and have in fact opted in. The second stage is whether or not the case should proceed to trial as a collective with representative testimony from a group of plaintiffs who join the case. What distinguishes an FLSA case to date from a Rule 23 more conventional class action that all of you I know are familiar with is under the Fair Labor Standards Act, Congress imposed what's known as an opt-in requirement.<sup>11</sup>

That opt-in requirement was actually intended to hold down these types of actions. And in fact, the opt-in requirement was Congress' way of requiring individuals who get involved in these cases to be involved in these cases and to participate in those cases as a plaintiff as opposed to the distant class representative. Under Rule 23, and hence, these cases are referred to as opt-in collective actions.<sup>12</sup> So when notice goes out to a group of individuals, they are effectively invited to join the case. If they choose not to join the case and not opt-in, they are not bound by the judgment, and they don't participate in the resolution of the case.

In contrast, in the Rule 23 case, these are the conventional class actions, and the court will apply, as Tammy has referenced, a more rigorous analysis whether you're doing this under state law or you're doing this under federal law and the Federal Rules of Civil Procedure to determine whether or not the case should proceed as a class. What all of us will be talking about from here is what does that mean in terms where you have these cases? What does that really mean for all of you as judges who bear the burden of deciding whether or not these cases should proceed?

What I would posit to all of you is the certification decision is the pivotal battle in both of these cases, whether you're looking at this under Rule 23, or you're looking at this under the Fair Labor Standards Act, and you're deciding whether to send a notice out to a group of individuals, this decision has real consequences for the case. In the FLSA context, we did a quick study in the Southern District of New York, which is a magnet jurisdiction for many of these cases. And out of roughly 250 of these cases that have been filed, only fifty of them went on beyond the notice stage. So the vast majority of these cases in the FLSA context settle after the decision is made to send notice out to the class.

There are obviously many burdens that fall on an employer in terms of cost, the expense of litigation, and the disruption to business. And many of these factors, in my experience as a defense counsel, drive employers to settle these cases rather than take them to trial. In fact, it is the very rare FLSA case that ever gets to trial. Part of that has to do with the nature of

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<sup>11</sup> Penalties (Fair Labor Standards) Act § 216, 29 U.S.C. § 216 (2012).

<sup>12</sup> See *Longcrier v. HL-A Co., Inc.*, 595 F.Supp.2d 1218 (S.D. Ala. 2008).

the statute, which is a fee shifting statute. So as an employer, one of the things that you're doing is you're accruing your own attorneys' fees as you're defending the case. But potentially, you have the plaintiff's counsel accruing fees on the other side.

And the fee equation is an important one for many employers in terms of deciding whether to proceed on these cases. In the Rule 23 context, we also have the initial stage where the plaintiffs will come forward and offer whatever evidence that they have that a case should proceed as a class. From there, that decision can be taken up on an interlocutory appeal. In the FLSA context, really no such procedural mechanism is available. And I take you back to my point earlier that there has not been much direction from the Court of Appeals or from the Supreme Court in terms of the appropriate standard and how courts have been interpreting that standard and applying it in cases.

That problem has been magnified because there is no way to take these decisions up to the Court of Appeals and get further review. We've had very little guidance in terms of what is the correct standard. And the courts have been filling those gaps with the result being this two stage, ad hoc standard. So with that, I want to turn it over to our next speaker to talk about really the next stage as we move into this.

**ELLEN C. KEARNS:** I apologize to Christine at the beginning because we'll have two management attorneys banging away at this point. But I'm very excited as a defense lawyer because the idea of challenging the two step process used to certify collective actions I thought was just sort of written in stone and couldn't be reconsidered. But after *Dukes*, the landscape may be changing. *Dukes*, as you know, involved a Title VII claim.<sup>13</sup> And it was a claim that women workers at Wal-Mart were not given a fair shake. They couldn't move up in the management realm. And the court, in looking at the certification of the class, denied certification in *Dukes*.

So my point is that we should look at the teachings of *Dukes* in an FLSA context. Now plaintiffs, including Christine, have argued that *Dukes* is irrelevant to the FLSA obligations because the requirements for pursuing a 216(b) class action<sup>14</sup> are independent of, and unrelated to, the requirements for class action under Rule 23. And some district courts have agreed with that position. But others have not. And others are beginning to look at the defendant's position that the *Dukes* decision displaces the two step analysis and looks to the illuminating and instructive language in *Dukes* for a consideration when a notice motion is before them.

To these courts, discussion of the propriety of a class action generally provides guidance in deciding when certification of a collective action under the FLSA is appropriate. So thus under 216(b), as in *Dukes*, it is not

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<sup>13</sup> Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011).

<sup>14</sup> Penalties (Fair Labor Standards) Act § 216, 29 U.S.C. § 216 (2012).

enough for a plaintiff to raise a common question as to whether they and other employees with some similar job duties were properly classified as exempt.<sup>15</sup> Rather, the answer to that question must be susceptible to proof that can be extrapolated to the class plaintiffs seen to represent. Let me give you an example. Let's say you have a job description for a particular job that is set forth as an exempt position.

And the job description is carefully worded, and it seems to give a lot of discretion and independent judgment to the position at issue. The plaintiff's claims come forward, and they say well, I don't care what the job description says. I don't do that. I don't do all those things that are in the job description. Defense would argue those are individual defenses. The job is an exempt job. If you don't do that job, then that's an individual defense that maybe you shouldn't be in the job or you missed out on the rules but that the job is the job. So this concept of individual determination is not new FLSA collective action jurisprudence.

For example, I call your attention to a case called *Johnson v. Big Lots* down in Houston, Texas, which decertified a whole class based on a due process concern.<sup>16</sup> And in another case called *Mike v. Safeco Insurance*, which denied collective action again because the proof in the case was specific to individuals.<sup>17</sup> Now, as Lee points out, FLSA cases have a two-step process to certify a class. In your experience as state court judges, the plaintiff comes in and under Rule 23 has to meet the requirements of Rule 23. Not true in FLSA. They come in, and they say okay, first of all, we just have to show that the employees are similarly situated.

If we show they're similarly situated, a notice goes out. And as a result if the notice goes out, people opt-in. Following the opt-in process, we have discovery. And discovery can take one, even up to two, two and a half years, a very expensive process for the employer. So we're very excited on the employer side then to look at *Dukes* and say okay, what does the *Dukes* decision mean in this two-step process? And we argue that what *Dukes* is saying is that the Rule 23 class action standards apply in a Rule 216(b) FLSA collective action. How does this work? Well, defendants argue that Congress intended the similarly situated inquiry to be co-extensive with the Rule 23 class certification.

And these courts argue that in that instance then, in an FLSA collective action, the court should look at numerosity, commonality, typicality, and adequacy of representation right at the get-go to determine whether an FLSA class should be certified. Now, defendants argue that this approach is the only approach authorized under the Federal Rules of Civil Procedure, the Rules Enabling Act, and the Due Process Clause of the Constitution. That is they argue that the courts do not have flexibility to create this com-

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<sup>15</sup> *Id.*; *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

<sup>16</sup> *Johnson v. Big Lots Stores, Inc.*, 251 F.R.D. 213 (E.D. La. 2008).

<sup>17</sup> *Mike v. Safeco Ins. Co. of Am.*, 274 F. Supp. 2d 216 (D. Conn. 2010).

mon law of a two-step process. By the way, the two step process occurred in 1987, that's how new it is, in a case called *Lusardi v. Xerox Corporation*.<sup>18</sup>

And in the *Lusardi v. Xerox Corporation*, the district court approved of the sending of a notice early in the litigation.<sup>19</sup> After the notice went out and people opted-in, the court then went back under a motion to decertify and, in fact, found that the plaintiffs were not similarly situated. They said there are disparate factual and employment settings for the individual plaintiffs, and that the defenses that were available to Xerox appear to be individual to each plaintiff, and that fairness and procedural considerations make collective treatment inappropriate.

So you might argue well, what's the sense, Ellen? What difference does it make? Because in the end, the court decertified the class, so we didn't have to go forward with decertification. Why does it matter? Because as Lee pointed out in her study, 50 of 250 in her study—I have another study, which shows that there were 2,500 collective actions in a particular district in 2011, and only fifty filed for decertification. So the cost to the employer of actually going through the discovery, getting everybody teed up for depositions and providing discovery documents is so expensive that most employers decide to settle before going to the decertification standard.

As a matter of fact, in one case, a case involving 15,000 punitive class members, the court decided that it would allow conditional certification to go forward, even though it noticed that of the 2,500 FLSA class actions filed in that district, only 24 had a reported decertification decision. So I know we'll hear from Christine that it all gets worked out in the end. But in our view, at least the defense view, we question the basis for a two-step process. We argue that *Dukes* seems to say that the two-step process is not valid under Rule 23. And that Rule 23 is the basis for which you should decide a class action certification.

**TAMMY D. MCCUTCHEN:** And I think we're going to hear from Christine next.

**CHRISTINE E. WEBBER:** Good morning. I'm delighted to be here and honored to be able to speak up for all the plaintiffs who are not here to be represented on the panel. I confess this is sort of what my typical day looks like. So it was interesting to hear Lee and Ellen bewail the poor, beleaguered defense attorneys and their clients being so beleaguered by the plaintiffs' bar because this is the "beleagueredness" that you usually face. There's really far fewer of us trying to manage all this litigation.

Because I'm the only representative of the plaintiffs' bar here today, I'm going to try and touch at least briefly on several topics we agreed to

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<sup>18</sup> *Lusardi v. Xerox Corp.*, 118 F.R.D. 351 (D.N.J. 1987).

<sup>19</sup> *Id.*

address today and not just this very interesting initial challenge that Lee and Ellen have raised but obviously do want to start there and give some of the plaintiffs' perspective on this. I want to start with a little history because as was mentioned, Section 216(b), which is part of the FLSA statute and has been for about 70 years that is what dictates that collective actions can include similarly situated persons, and only those similarly situated persons who affirmatively opt into the litigation.<sup>20</sup>

So that's a creature of statute. There was a suggestion that in passing that statute, Congress intended Rule 23 to be the mechanism by which that statute was enforced. However, at the time that Congress passed the amendments to the FLSA that incorporated Section 216(b), there was no Rule 23 in its current form. So I don't think that Congress back then could have anticipated the current form of Rule 23 and decided to adopt that. In fact, it was the very absence of a federal rule that would specifically control FLSA collective actions in the way that Congress wanted that led them to spell it out by statute.

And of course, as Lee is usually fond of reminding me, the Rules Enabling Act means the statute must control over the federal rules.<sup>21</sup> And I think this is a circumstance that courts for decades have been deciding that Section 216B is its own standard. And Rule 23 can't apply because Congress had something else in mind. To me, to say that Rule 23 standards must apply is sort of like saying the standards for joinder must apply. There's joinder, there's class certification, there's lots of rules out there. But where Congress has set up its own scheme, that's what we're going to have to follow for FLSA cases.

Of course, with state law claims, Rule 23 or the state law equivalent of Rule 23 will be what will govern because none of the states seem to have adopted this scheme that Congress did back in the '30s. There was also suggestion that there's sort of a dearth of authority explaining how this two-step standard should be applied. While it's certainly the case that there have not been a large number of Supreme Court decisions as we've had in the Rule 23 area, there's actually been quite a lot of authority from circuit courts addressing both initial notice and, more frequently, the decertification standards and when a case can actually proceed as a collective action going to trial.

There have been a number of decisions going back many years, particularly from the fifth and eleventh circuits, so it's not even cases coming from the more liberal courts in the country to set up this standard. And courts have uniformly adopted both the idea that Rule 23 standards are not applicable to FLSA collective actions and also that the specific process that should be used is the initial notice followed by the decertification consider-

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<sup>20</sup> Penalties (Fair Labor Standards) Act § 216, 29 U.S.C. § 216 (2012).

<sup>21</sup> Rules Enabling Acts, ch. 646, 62 Stat. 961 (1948) (codified as amended in scattered sections of 28 U.S.C.).

ation and the determination finally of whether the case will proceed to trial as a collective action.

And so there's really been a high degree of consistency, I would say, in what courts have been doing in allowing notice. And a lot of it goes to the very structure of the FLSA collective action. A lot of Rule 23 standards are designed to protect absent class members' due process rights because if they're going to be part of the litigation without their consent or without their knowledge, then you want to make sure that their interests are being appropriately represented.

As courts have found, a lot of those concerns and, therefore, a lot of the need to have the typicality and adequacy analysis falls away when, as in the FLSA, you're limiting the class to those people who affirmatively choose to opt-in and join that class. They choose by signing their opt-in form to say yes, these are my class representatives. So they don't need the court to say are these representatives adequate because you have the individual consent of each plaintiff saying they're going to be part of the case. So the reason for the differentiation in standards between Rule 23 and 216(b) really does make a lot of sense. To address *Dukes*, I want to say first of all, of course, that *Dukes* didn't say anything about 216(b).

There's no reference to the FLSA Section 216B to collective actions to anything other than these are standards that apply to Rule 23. So given the legion of cases, including circuit level authorities saying that Section 216(b) doesn't follow Rule 23 standards, it's not surprising that there has been a legion of cases finding that *Dukes* has nothing to do with how collective action standards will be interpreted. And the *Bouaphakeo* decision in Iowa coming down shortly after the *Dukes* decision was one of the first cases to address this in depth.<sup>22</sup>

But there have been a legion of cases from around the country reaching the same conclusion, which is *Dukes* doesn't control 216(b). Of course, when it comes to Rule 23 cases or when state law claims are made, *Dukes* Rule 23 standards are going to apply, although even then, courts have primarily found that there is very little impact on wage and hour cases because the determinations that need to be made are so different. In *Dukes*, the concern was that you had to identify motive. There wasn't a challenge to the fact that we could show, for example, that women were paid less on average when you controlled for various factors.

But what the court said is you couldn't show the motive without having more individualized inquiry. But as many courts have recognized in wage and hour cases, motive is not an issue. It doesn't matter why somebody wasn't paid overtime, only that they weren't paid overtime. Unlike in *Dukes* where the Supreme Court found that decisions were all made at the individual store level, and so having a nationwide case they thought would

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<sup>22</sup> *Bouaphakeo v. Tyson Foods, Inc.*, 2011 WL 3793962 (N.D. Iowa 2011).

be a manageable way to get at the individual intent of those store managers.<sup>23</sup> When you have, for example, in this classification case, that is rarely, if ever, a determination as to whether to classify somebody exempt or not that is made at the local level.

That's almost always a central corporate decision. And so many courts have found that those cases remain, even under the *Dukes* standards, highly appropriate for collective or class treatment. The donning and doffing cases<sup>24</sup> that Lee and I have spent so much time on—also, there's not been a single case that I found in which even applying *Dukes*' standards courts have said those are not appropriate to treat on a collective basis because really it's a legal dispute over is this sort of time compensable or not?

There's not really a whole lot of dispute other than around the edges over the fact that employees at all these food processing facilities have to go through certain dawning pre-shift and doffing post-shift, and that is the very type of common issue that *Dukes* said that you can answer with common evidence or the class as a whole that is appropriate for class treatment. And thus, we've actually seen very little impact even in the Rule 23 wage and hour cases from *Dukes*. There were cases that were decertified prior to the *Dukes* decision coming down, and there's going to continue to be cases that are decertified post-*Dukes*.

Some of the other issues that we promise to talk about are some of the discovery issues that come up in these cases. And there was a particular suggestion that these cases can be very expensive to litigate. So coming from most of my practice having been in the Rule 23 Title VII class action area, to me, the wage and hour cases are so much cheaper by comparison. But really, I think a lot of this has to do with getting control of discovery and having effective case management.

If there's a good case management in place and the parties are brought together early and often to resolve discovery issues, narrow discovery requests, and get produced quickly what's really, truly core to the case, often, discovery can be much more efficient. I think that's particularly important in the area of electronic discovery. I know that there's a lot of fear and loathing towards ESI or electronically stored information.

And what I found in my practice is that having lots of interactive process, having lots of cooperation, can be helpful not only for the plaintiff seeking to discover information but can also allow the plaintiffs to significantly narrow their demands once they have the sort of information from the defendants they need to be able to do so. And so a lot of the things that can cause these cases to become more expensive are things that a good case management can really minimize and address. One of the techniques I've seen recently that I think has been very effective is increased use of random sampling and selecting opt-ins for discovery.

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<sup>23</sup> Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011).

<sup>24</sup> See *IBP, Inc. v. Alvarez*, 546 U.S. 21 (2005) as an example of a donning and doffing case.

In these cases, obviously, you're not going to have discovery of every single one of 1,000 class members. That would be antithetical to the whole notion of a class or collective action. And in Rule 23 context, there's actually a lot of case law making clear that the class members are not subject to the usual discovery process of interrogatories and document requests and so on. With opt-ins, that's not the case. But still, the very nature of a collective action means that courts will generally limit the number of people subject to such discovery.

And traditionally, there were a couple of different approaches, some in which the defendants would just choose—they're given their limit of this is how many people you can depose or serve written discovery on. And the defendants would choose the people. Some courts have taken an approach where the defendants would choose half the people and the plaintiffs would choose half the people. What I've seen in the last couple of years is the increased use of a random selection. And if you're trying to get at what does a cross section of the class look like? What is a fair representative sample so that I know I'm seeing the full range of potential variation in facts?

It seems to me that a random sample is really going to give you the best and most accurate picture of that as opposed to letting either defendants or plaintiffs cherry pick their respective best opt-ins to serve their particular point. It's likely that you can always find outliers who are the person who worked 80 hours a week off the clock consistently and kept a neat journal of it to prove that that's the case. And you can always find the outlier who never worked a minute over forty hours or never had duties the same as anybody else.

But if what you're trying to decide is do we by and large have a cohesive collective here, getting a random sample seems to give a far faster and more accurate way to get to that picture and allow the court to make the determination of whether, ultimately, the case should proceed to trial on a collective basis. I have two minutes? Okay. In that case, I just want to touch briefly on settlement issues, and I will actually say I know there was a suggestion that most of these cases settle before going to trial. That's true because that's true of every type of civil action there is.

I haven't had any notable quicker settlements in my wage and hour cases. But then the settlement that I just finished implementing came after 12 years of litigation. So I hear about these defendants who cave early just because you get notice out and get a class certified. But I've yet to actually see the species in the wild. Perhaps I'm just suing the wrong people. But in any event, eventually, as in all civil cases, we often come down to settlement, and there are some specific features of the FLSA that make the settlement process a little bit different.<sup>25</sup>

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<sup>25</sup> Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended in scattered sections of 29 U.S.C.).



As was pointed out, you can't relieve yourself of liability under the FLSA without supervision of the settlement either by the Department of Labor or by a judge.<sup>26</sup> It doesn't have to be a federal judge. But you need to have court approval. And the role of the court is a little bit different in determining whether an FLSA settlement should be approved than a class or collective settlement under general Rule 23 standards because there's really substantive requirements of the FLSA that the court has to ensure are being met. In fact, even if it's an individual non-collective action, the court would still have to grant approval for a settlement to be effective in the FLSA context.

And part of what the court is required to look at in those settlements are whether there's basically enough of a dispute over what the wages are that are owed to justify the compromise that's being made in paying the employee any less than 100% of their back wages. And so one of the first things the courts will look at is there really a bona fide dispute over FLSA coverage or what the FLSA would say is require to be paid under the particular circumstances of that case. An issue that has come up a lot in FLSA litigation and cases involving hybrid state and federal litigation is the scope of releases.

And this is where, again, the fact that the courts role in the FLSA is to make sure that the employee is not waiving rights that the FLSA gives them and not giving up such rights without compensation. Often, employers will want a general release or at least a release from all potential wage and hour claims. And where that can be an issue is where, for example, the only thing that's been litigated is the FLSA claims and not state law claims.

The *Kakani vs. Oracle* decision out of the Northern District of California back in 2007 was one of the first to call attention to this concern and actually refused initially to approve a settlement because the scope of the release was so much broader than the scope of what had actually been litigated.<sup>27</sup> And it was going to actually extinguish rights to state law claim rights for people who had never opted-in to the litigation under FLSA and who might never receive notice of the settlement.

And the court refused to approve that settlement for that reason, and there's been increased attention, I think, since then to the scope of the releases that are being sought and approved and making sure that they are limited to the scope of the case that was actually litigated. Another issue that comes up in wage and hour settlements in particular is there have been a few attempts to file settlements under seal interestingly, even in collective action cases. And courts have not been looking too kindly on that maneuver. It makes sense with a collective action or the class case that there's really a public interest to be served in keeping the settlement public.

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<sup>26</sup> *Id.*

<sup>27</sup> *Kakani v. Oracle*, 2007 WL 4570190 (2007).

And then just as one sort of observation, often, the effectiveness of a collective action or class action settlement depends on having a good process in place to actually find the class members who are supposed to benefit from the settlement. And I always hate to see on random samples. So what does *Dukes* have to tell us about this? *Dukes* actually rejects the notion of trial by formula specifically using exactly that language that the court disapproves of that specific approach that was proposed in the *Wal-Mart* case.<sup>28</sup>

There was an important case decided on appeal in California earlier this year that extends some of that logic and some of that argument into the wage and hours sphere.<sup>29</sup> In *Duran vs. U.S. Bank*, a random sample was used to determine both liability from its classification and to determine damages.<sup>30</sup> It would seem that the use of random samples has been rejected both in *Dukes* and in important state law case.<sup>31</sup>

*Duran* and *Dukes* can be distinguished from some of the other proposed uses of random sampling. The use of random sampling as a defense is not over because the issue is not yet settled. There are two different ways that you can use random sampling: when you've got a misclassification claim in addition to off the clock work, and when only non-exempt employees claim they weren't paid for some of their overtime. *Duran* and *Dukes* were both misclassification claims and claims for unpaid overtime for those misclassified employees.

The *Dukes* decision's logic linked the disapproval of the use of the random sample to the fact that it deprived Wal-Mart of an opportunity to raise individual affirmative defenses. Those individual affirmative defenses would be largely focused on the question of misclassification itself rather than on the number of hours of overtime worked. The situation was the same in *Duran*; it was really a misclassification case that included a claim for unpaid overtime.<sup>32</sup>

Random samples would still be quite supportable when simply determining the quantity of unpaid overtime for non-exempt employees. Another distinguishing feature of *Duran* has to do with the quality of the sample drawn and the quality of the data gathered relative to earlier uses of random sampling. In *Bell* for example, a random sample—a pilot study determined a random sample's ideal size in order to achieve a reasonably accurate and reliable measure of the number of overtime hours.<sup>33</sup>

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<sup>28</sup> *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

<sup>29</sup> *Duran v. US Bank*, 137 Cal. Rptr. 3d 391 (Cal. Ct. App. 2012).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*; *Dukes*, 131 S. Ct. at 2561.

<sup>32</sup> *Duran*, 137 Cal. Rptr. 3d 391.

<sup>33</sup> *Bell v. Farmers Ins. Exchange*, 9 Cal. Rptr. 3d 544 (Cal. Ct. App. 2004).

From the pilot study and representative testimony statisticians from both sides agreed to have a sample of about 300 people.<sup>34</sup> Experts from both sides cooperated together to randomly select a sample of 300 people and estimate the number of overtime hours (it was about 10 hours of overtime and the margin of error was less than an hour).<sup>35</sup> The study ultimately said with a 95% confidence that the overtime hours worked ranged somewhere between nine and eleven hours a week.<sup>36</sup>

If you look at *Duran*, on the other hand, a sample initially included only twenty people.<sup>37</sup> A misleading margin of error is a consequence of that small sample (the average number of overtime hours worked was about twelve, and the margin of error was plus or minus five hours). There really was an enormous range without reliability produced from the representative sample. It's a very distinguishing feature that a large random sample reliably drawn may still offer evidence that would be acceptable to a finder of fact.

Treatment of non-respondents is the other key requirement for reliable sample evidence. In *Bell*, there was a very high response rate;<sup>38</sup> whereas in *Duran* the sample size was very small, and the non-response rate was really high.<sup>39</sup>

Ultimately, there were five people from the original sample that didn't respond, a 25% non-response rate.<sup>40</sup> That is a very, very high non-response rate. It also calls into question the reliability of the data gathered from the remaining employees.

There is one more element, retroactive recall. There's research that shows people tend to overstate the number of overtime hours that they've worked, even when they're not involved in litigation and where they have a financial incentive to recall more hours.

**ELIZABETH BECKER:** Retroactive recall really is something that needs to be kept in mind with respect to reliable evidence, because even for a large sample with a high response rate the measurement error may not be reliable. While there still are some open questions about the reliability of random sampling as evidence, properly constructed, it is evidence that can be informative to a finder of fact.

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<sup>34</sup> *Id.* at 726.

<sup>35</sup> *Id.* at 722.

<sup>36</sup> *Id.*

<sup>37</sup> *Duran*, 137 Cal.Rptr.3d 391.

<sup>38</sup> *See Bell v. Farmers Ins. Exchange*, 9 Cal.Rptr.3d 544 (Cal. Ct. App. 2004) (explaining that the response rate was "over 90 percent . . . , a response rate regarded as producing a reliable and accurate sample").

<sup>39</sup> *Duran*, 137 Cal.Rptr.3d at 437.

<sup>40</sup> *Id.*

**CHARLES A. SHANOR:** Well, I'm a double token actually because everybody else up here is an expert on the Fair Labor Standards Act, and my background is essentially as an employment discrimination and labor lawyer. And as it turned out when I went to Washington as general counsel EEOC, there were a huge number of Age Discrimination and Employment Act cases, which are covered under the same procedural mechanisms and so on but with some changes, particularly some that Congress enacted subsequently to that time period under the Fair Labor Standards Act. So my topic really is to deal with hybrid actions.

And when you all put your hands in the air as to how often you have dealt with Fair Labor Standards Act related matters, the thing that I found myself saying is many more of you, if we had this meeting five years from now, would put your hands in the air. Here's why. It really has to do with hybrid actions, and I'm going to draw a picture on the board and talk a little bit about hybrid actions and how they work. With a hybrid action, you have state law, which is the state wage and hour statute; and federal law, which is the Fair Labor Standards Act. These laws can differ in a number of ways.

These statutes may differ in the statute of limitations periods (two, three, four years; maybe more depending upon the jurisdiction), or plaintiff's recoverable dollar amounts (plaintiffs may get double damages or liquidated damages, even treble damages in some jurisdictions). There are clearly variations from state to state, but the larger the recoveries, the more likely it is that you will see these cases in favorable state courts as opposed to federal courts. The procedures for each, of course, are different.

Typically for state wage and hour laws, have Rule 23, compared to 216(b) collective actions, there are some differences. For example, Florida says that the plaintiff has to notify the employer and give the employer a chance to voluntarily comply before filing suit. There are no doubt other differences between state and federal laws. The problem is: how do you put together a complaint that alleges state and federal law violations, and what should be done about that complaint? First of all, that it depends a whole lot on the specifics of the case.

If I take these two laws as I've done up here and said they're totally separate, that's one mental picture of what's going on in these cases. I could take a picture that goes like this with an overlap of state and federal laws but with some common core in the middle. Or I could draw a picture that says here is the state law, and here's the federal law with a nearly total overlap. Factually, the cases cover a wider range. Imagine a situation where the leading case says federal courts shouldn't be hearing this state action or state issue where, for example, the leading case has about 4,100 plaintiffs in this group.

Conversely, in terms of the opt in federal group, there are only about 400 to ten times as many state claimants as federal claimants. Going the other way, imagine a class of 228 all are potential Rule 23 class members at

the state level and 204, or 208 I think it is, in the federal action, a much larger ratio. These facts matter. It matters if the action is initially filed in state or federal court. It matters if you file in state court as a plaintiff with your complaint.

In more plaintiff-friendly jurisdictions plaintiffs may be filing only state actions, not FLSA actions. If it goes to federal court then the question is whether there is supplemental jurisdiction. And that has to do with whether or not the state law—well, let's say the federal tail is wagging the state dog or whether the tail and the dog are pretty much the same. The tail and the dog are pretty much the same, the court will exert supplemental jurisdiction. If the federal and state laws are really different, then the federal court is likely to take out the state cause of action finding now supplemental jurisdiction. In terms of the range of procedural mechanisms that can be used to deal with these cases, again, some of these cases involve three, four, five people. Others involve thousands of people. If you have three, four, or five people, the typical procedural mechanism would be joinder under Rule 20 in the federal system.<sup>41</sup> If you have 4,000 people, it looks like on numerosity grounds alone, joinder is impractical.

Somewhere in between this pure joinder and class actions under Rule 23,<sup>42</sup> is the collective action under 216(b).<sup>43</sup> There's a lot of history behind § 216(b). The Fair Labor Standards Act ("FLSA") was passed in 1938 as part of the New Deal.<sup>44</sup> At the time, congress favored labor unions (and drew popular support). Eventually, when congressional favor and popular support for unions waned, in 1947, Congress passed the Portal to Portal Act.<sup>45</sup> It cut back on unions.

With the Portal to Portal Act Congress started to worry about individuals who have real injuries being in the courts, rather than unions suing employers with "across the board" kinds of actions. Therefore, in 1947, coming from a lost world of spurious class actions, there were opt-in class actions existing in between union actions and individual actions. It was a mechanism for doing two things at once: keeping unions and non-injured people out of court, and get systematic chiseling employers to defend claims from opt in groups, not just individual claims (which would be too little money an issue to ever litigate, or too expensive for the plaintiff).

So we've talked a little bit about the process of dealing with initial certification and final certification, Rule 23 certification, and FLSA 216(b) certification. I guess basically, I think there's a misnomer out there about

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<sup>41</sup> FED. R. CIV. P. 20.

<sup>42</sup> FED. R. CIV. P. 23.

<sup>43</sup> Penalties (Fair Labor Standards) Act § 216, 29 U.S.C. § 216 (2006).

<sup>44</sup> Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended in scattered sections of 29 U.S.C.).

<sup>45</sup> Portal-to-Portal Act of 1947, ch. 52, 61 Stat. 84 (codified as amended in scattered sections of 29 U.S.C.).

initial certification in 216(b) cases. It is essentially a mechanism for providing notice to people who may want to opt in. In other words, it moves the opt-in process from a purely voluntary system to a judicial notice system that presents the nature of the claim and class characteristics so the individual can opt-in to the action.

Final certification, or so-called certification, in the 216(b) action is a lot more like the Rule 23 certification, which under *Dukes* and other cases has to be rigorous and has to meet all the standards, four parts of 23A, and one of the parts—incidentally, always we’re talking about 23(b)(3) class actions and Fair Labor Standards Act cases because we’re dealing with money, and we’re dealing with wages, which are individualized. So that’s kind of the picture as I see it as a non FLSA litigator trying to kind of sort this stuff out.

There’s mention that’s been made of the appeal process. Plaintiffs can’t appeal a notice decision, even if you call it preliminary certification, and courts support this perspective. However, in a final certification, granting or denying that certification is essentially the determinant of event in the litigation, which is why Congress in about 1994 or 1995 provided for automatic appealability in such situations.

From a plaintiff’s perspective, here’s how an opt-in situation works. You need to get all of your opt-ins in court as fast as you can because every person who delays on opting-in loses part of the time period in which they can recover money for it. And so, from a plaintiff’s perspective, you want to get notice out and responses as quick as possible, which means right after you file the complaint, you want to do that preliminary certification or notice gathering process. Defendants have a lot of reasons to kind of hold off litigating an issue as long as they can from an economic perspective.

Rule 23 carries lots of other components to it as well, and sometimes—and there are pieces of Rule 23 that may not look quite so good from a defense perspective as it looks in terms Rule 23 vs. the 216(b) opt-in process. Defense counsel prefers to have a rigorous certification process. That’s in the defense’s interest, and there are a lot of things to be said for that, frankly. But they run the downside of drawing in, in a particular case, a lot more unnamed individuals who don’t sign and send in the form.

People don’t sign and send in forms for a lot of reasons. Somebody gets a form, and it’s about litigation, tear it up. They think “the last thing I want is to be involved in litigation.” Low wage workers may say “if I sign onto this, I may get fired.” There are a lot of ways in which people can respond to and not send opt-in notices that would be covered in typical “opt-out” class actions. Therefore, it’s a careful blending and balancing of 216(b) collective actions with the new world of Rule 23 class actions.

My time is up. I’ll stop. I do want to raise one last issue that maybe we’ll talk about in the panel. I’m sure there are people who know more about it than I do. But there is a big issue out there not about waivers as total waivers, but about agreeing to arbitrate labor and employment actions

including Fair Labor Standards Act practices. So it may be that you'll get a case where the plaintiff files a complaint, and the employer comes in and says "but you agreed to arbitrate." So you shouldn't be before the court. Your initial reaction with a full docket is to arbitrate.

With respect to arbitration clauses in labor and employment actions (including FLSA actions) in the federal courts and under the Federal Arbitration Act of 1925, there's a push toward arbitration. The courts are kind of split right now about how arbitration plays out in this particular area of the law. In *Raniere* in the Southern District of New York in 2011, the court held that it was an aggregation of substantive rights of the employees to force them to arbitrate<sup>46</sup> because it is a substantive component of the Fair Labor Standards Act to have collective actions. Well, there are a bunch of other courts that say that's not substantive but rather it's a procedural mechanism for enhancing rights.

**ELLEN C. KEARNS:** One of the primary reasons that wage and hour cases are so popular today is that they involve strict liability statutes. Intent is not considered. If you didn't pay overtime, you lose. If you didn't pay minimum wage, you lose. If you're unaware employees were working overtime (they worked at home), you lose. Plaintiffs' attorneys who were practicing age discrimination, sex discrimination, race discrimination, (where you have to prove through the shifting burden of *McDonnell Douglas* that the employer intended to discriminate<sup>47</sup>) now are entering in a wage and hour field, where intent is immaterial.

**TAMMY D. MCCUTCHEN:** Now, Christine, you mentioned that you view wage and hour claims as cheaper. Is that why?

**CHRISTINE E. WEBBER:** There are lower barriers to entry for wage and hour cases. First, there's only a small number of plaintiffs' firms that do big Title VII class actions because of the enormous investment in the experts to develop the analysis and discovery. Wage and hour cases rely on experts a lot less. They're not generally used to prove liability just some calculation for damages. Therefore, wage and hour cases are substantially cheaper just in terms of expert costs. Secondly, plaintiffs are not proving intent because the statutes proscribe strict liability.

From a human perspective, when you're not accusing an employer of race or sex discrimination, they're less defensive and treat it more like a business decision, which can lead to more efficient litigation, although not always. But definitely, I found that when you're basically accusing people of widespread sexism that tends to make them dig in their heels, and they really push to the bitter end before they'll consider settling a case. So I

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<sup>46</sup> *Raniere v. Citigroup, Inc.*, 827 F. Supp. 2d 294 (S.D.N.Y. 2011).

<sup>47</sup> *McDonnell Douglas Corp. v. Green*, 411 U.S. 729 (1973).

think the fact that you don't have to prove intent, that it is strict liability, is a big part.

Lower barriers to entry from limited expert testimony and strict liability attract more plaintiffs' lawyers who have stepped forward to do wage and hour cases because they require less investment.

**ELIZABETH BECKER:** Further, NERA studied the dollar amounts of the settlements in recent years. Even though they are (1) less expensive to litigate, and (2) they definitely do have a much smaller and more constrained role for experts, the dollar amounts of the settlements are still considerable.<sup>48</sup> An average case settles for about \$5 million. So cases are cheaper to litigate and still provide plaintiff's with substantial benefits.<sup>49</sup>

**TAMMY D. MCCUTCHEN:** Now, you both mentioned cost of expert witness. So I want to take a little while to have you guys explore that topic. I myself have served as an expert witness. Why you ask or you're wondering. There seems to be a trend not on the sampling side, of course, and the damages side for both sides to hire former DOL employees whether investigators or management and myself to serve as expert witness to inform the court about what DOL had done. Now, even though I've made some money off of doing this, sometimes my testimony has been accepted. Sometimes the courts say no. You're testifying on the merits. No thank you.

What do you guys think about this whole trend of hiring the former DOL to come in and educate the court about wage and hour law?

**CHRISTINE E. WEBBER:** Sure. I have to say, I've actually not ever retained an expert to do that. I've faced some retained by defendants. And I'm somewhat skeptical of it because I think it's very hard to find a rule that doesn't involve having the expert either tell the judge what the law is, which is the judge's job and not something I think we need expert testimony about, or tell the court what the facts are, which is what I really like juries to be finding.

And so I'm skeptical of how much they really add to the litigation, although I'm sure that with some of the complex determinations of misclassification or something that, frankly, there are some judges who probably like hearing from somebody with DOL expertise about what's really interpretation of the law, even though that's something that's committed to the court. I'm sure some find them helpful.

**AUDIENCE MEMBER:** So from the defense perspective, I think it's be careful what you ask for. I think there are appropriate cases where testimony

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<sup>48</sup> Dr. Denise Martin, Dr. Stephanie Planich, & Janeen McIntosh, *Recent Trends in Wage and Hour Settlements*, NERA ECONOMIC CONSULTING (2011).

<sup>49</sup> *Id.*



from representatives of the Department of Labor can be quite important. Under the Fair Labor Standards Act, Congress actually delegated the authority to write the white collar regulations for exempt positions.<sup>50</sup> And so in some respects, the Department of Labor does, as recognized by Congress, have a special expertise when it comes to interpreting the white collar regulations and whether somebody is misclassified or properly classified. I share, I think to some extent, some of Christine's skepticism, and this is a rare day.

In fact, it's the second time today that I find myself agreeing with Christine. So all of you should go out and buy lottery tickets today. I share some of that skepticism. I think it really is a case by case analysis, and I think it depends on the legal issues in the case.

**ELLEN C. KEARNS:** *Perez vs. Radio Shack*<sup>51</sup> is a great case to consider Department of Labor employees as expert witnesses. The issue in that case considered the understanding of a "supervisor" under the FLSA and Radio Shack's supervision policies. Under the Fair Labor Standards Act, in order to be a supervisor, you have to supervise 80 hours a week. In *Radio Shack*, the supervisors work thirty-seven and a half hours a week, sometimes thirty hours a week. The question was if you take two thirty hour a week persons, and they supervise sixty, did that meet the test? One Department of Labor person said no, it's absolutely eighty or you're out, the other said, it's a little flexible, it could be anywhere from sixty to eight.

The court was clearly frustrated, with all due deference, by having two witnesses from the same department and threw them both out and said this is the role of the court or the jury to decide this factual question.<sup>52</sup> And I think that's right. And I think what Christine says is right. That in areas of law, in fact, those are the roles of the court not the experts.

**TAMMY D. MCCUTCHEN:** In my defense on that, I was brought in only after the plaintiff's lawyer had hired an expert witness. And the defense had tried to get that expert witness disqualified, and the court said no, I want to hear from them. And then I was brought in as a rebuttal to that expert witness. So I think a lot of it might be to avoid the battle of the experts by not allowing the plaintiff's lawyer to start it by bringing in a former DOL person to opine.

**CHARLES A. SHANOR:** I have never testified as an expert in a Fair Labor Standards Act case, but I've had some experience doing that in Title VII and ADEA cases that's consistent with my professorial role I guess. Gen-

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<sup>50</sup> Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended in scattered sections of 29 U.S.C.).

<sup>51</sup> *Perez v. Radio Shack Corp.*, 2005 WL 3455858 (N.D. Ill. E. Div.).

<sup>52</sup> *Id.* at \*4.

erally the court ought to be deciding questions of law but sometimes, it's useful for experts to provide context and frame the analysis. It may help each side of the litigation to see the strengths and weaknesses of the litigation. Most of the cases in which I've been an expert are ones that don't go to trial or don't get to testify. They get settled. And so maybe as an expert, you can have some role in that connection.

Further, with respect to arbitration, an arbitrator may be more willing than a judge to take an expert witness on things that are basically legal.

**AUDIENCE MEMBER:** When you have an opt-in collective action under Section 216(b) with supplemental state law claims under Rule 23, isn't one of the ways to address the competing claims, the scope of the claims, under state law versus federal law to limit the Rule 23 class to those who actually opted in? In other words, you have the same group of plaintiffs who have opted into the collective action under Section 216(b), instead of treating Rule 23 as an opt out class, simply limit the scope of that class to those who opted in in the federal action.

Are there cases that addressed the Rule 23/Section 216(b) procedural issues, which would sort of address some of the issues that you've alluded to, Charles.

**CHARLES A. SHANOR:** It's a very interesting suggestion and, thus far, courts have yet to separate the actions Rule 23 and Section 216(b) actions when supplemental jurisdiction is present. One problem with severing the actions is that it alters the Rule 23 mechanism, the point of Rule 23 is to bring in people who don't opt-in.

**AUDIENCE MEMBER:** Alternatively, don't you run the risk of adjudicating the rights of those individuals who chose not to opt in in the federal capacity?

**CHARLES A. SHANOR:** To some extent, yes. Plaintiff and defense attorneys will differ in their opinions on the matter. The best way to view that issue is render unto the state seizers what is the state seizers, and render unto the federal seizer what is the federal seizer, limited by the one recovery rule for any given individual.

**LISA A. SCHRETER:** There is a real danger that in doing so, walking away from the Rule 23 requirements on the state action.

**CHRISTINE E. WEBBER:** There's really an important purpose served by giving employees the opportunity to have an opt-out case as well as an opt-in case because, frankly, employees are terrified of opting in. The opt-in rates in FLSA actions are varied but they range from below 10% (in the worst cases) to 15 to 20% (in the typical case) because people are worried

that if they step forward, they'll be fired.<sup>53</sup> On the other hand, when people have a chance to be an absent class member (such is the case in an "opting-out" class), opt out rates are far lower than their opt-in rates.

When state law is established a protection for employees, they should be able to take advantage of that sort of more anonymous process for participation. The DC, second, third, and seventh circuits have all said dual classifications under Rule 23 and Section 216(b) are not a conflict. It's not a problem for courts to have people in the Rule 23 state law class who are not part of FLSA claims and vice versa. It means that I think you have to craft the notice carefully to make sure people understand the differences between the two. There's a growing consensus that there's no reason for federal courts not to exercise such jurisdiction.

This hasn't been litigated as much in the state courts but so it remains to be seen how state courts treat the issue.

**AUDIENCE MEMBER:** Maybe I'm dating myself, but I was regional director of the Department of Labor back in the 70s, and at that time, we had a group of solicitors that were handling all the Fair Labor Standards Act provisions. And I'm trying to get it straight in my own mind where the solicitors left out and you folks jumped in.

**TAMMY D. MCCUTCHEN:** Under Section 216(b) as it's written, the plaintiff does not have to file in an agency beforehand; they can go straight to court, or even notify their employers of their complaint.<sup>54</sup> With a three year statute of limitations max under the federal law, an employee can wait two years after they've been fired before telling their employers that they weren't paid correctly. Plaintiffs can simultaneously file in a state DOL, federal DOL, state court and federal court because there are multiple jurisdictions.

Now, against state governments, the solicitor has the sole power to enforce. In practice, Department of Labor typically handles about 40,000 complaints a year.<sup>55</sup> Less than 1% (between 200 and 400 per year) of those go to litigation through the solicitor's office which litigates on behalf of those employees. Most of those cases are settled administratively.

**AUDIENCE MEMBER:** And as you recognize, the enforcement mechanism is different where the solicitor is bringing the action. So the solicitor will be bringing in enforcement action, and there is no similarly situated inquiry that occurs there. So when the solicitor acts to bring an action against an

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<sup>53</sup> Gregory K. McGillivray, *Current Trends in Pursuit and Defense of Hybrid FLSA and State Wage and Hour Litigation*, AMERICAN BAR ASSOCIATION, (2007).

<sup>54</sup> Penalties (Fair Labor Standards) Act § 216, 29 U.S.C. § 216 (2012).

<sup>55</sup> Eileen Ambrose, *Labor Department Inundated with Worker Complaints*, BALTIMORE SUN, Mar. 13, 2011.

employer, all of the individuals who are the subject of that lawsuit pull in under the enforcement action. And as Ms. McCutchen said, they are rarer really almost every day than they have been in the past.

**TAMMY D. MCCUTCHEN:** Section 216 says that once the secretary of labor files the lawsuit on behalf of a class of employees, the private right of action terminates for those employees who had not already filed a suit of their own.<sup>56</sup>

**ELLEN C. KEARNS:** It does appear, however, that solicitor-filed lawsuits are tapering off. In the first edition of the FLSA treatise, the number of cases that were styled “the secretary versus the company,” is astonishing. In the second edition of the treatise, has a totally different in the table of cases it’s “Plaintiff versus the company.” Between 1999 and 2010 that the plaintiff’s role has begun to represent most of the cases in the courts today.

**ELIZABETH BECKER:** At the same time there are cases in states like Massachusetts, California, Illinois, New York, and Washington State, which have additional remedies consistently showing up in wage and hour litigation because their remedies or laws are more favorable to employee-plaintiffs.

**AUDIENCE:** In the overtime cases that suggest that the employer does not even have to know that the employee is working overtime, they can be working overtime at home, my question is can the employer have any internal policies that can protect them against—for instance, a policy that says overtime has to be pre-approved. Will that protect an employer?

**LISA (LEE) A. SCHRETER:** The case law under the Fair Labor Standards Act has suggested that simply having a policy that prohibits working and not reporting your time is not enough to shield from liability as an employer. However, defense lawyers have argued the ancient doctrine of avoidable consequences, which dates back to the time of Cicero. It stands for the proposition that a litigant should not put themselves in harm’s way (and avoid harm if they are in its way).

Defense counsel is increasingly arguing this doctrine in the courts today. Employers take steps beyond a mere policy: they train their employees on proper time keeping, they train their managers on what their obligations are under federal and state law, they provide employees with a complaint mechanism where if they claim they’ve been instructed to work off the clock by their supervisor, there’s a 1-800 number where they can raise those concerns. Where an employer has taken that type of an aggres-

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<sup>56</sup> *Id.*

sive approach to compliance, a plaintiff should not be allowed to come into court and say I didn't avail myself of any of those remedial measures (under the doctrine of avoidable consequences).

Plaintiff's attorneys should be able to recover for that. In those circumstances, an individual doesn't have a recovery because they had mechanisms available to them to ensure that they were paid. Still, the Supreme Court has absolutely encouraged employers to comply in the first instance and to adopt policies and procedures that are designed to achieve compliance without resorting to litigation.

So, where employers take these steps, they shouldn't be punished by the individual who has refused to take advantage of those steps and instead has chosen litigation.

**CHRISTINE E. WEBBER:** However, basically, a lot of these policies are put in place so that if the employee later reports the time, they get fired for having not reported the time in compliance with the policy. On the other hand, if they don't do the work, they get fired for not doing the work, even if they ask for approval for overtime, it's denied because of budget constraints. For employees they're in a catch 22 under the doctrine of avoidable consequences as argued above.

The FLSA is designed to avoid such a situation. The standards are; (1) if you suffer or permit (for employees), and (2) if you knew or should have known (for employers). There aren't cases where the employer had no reason to know because after all, the employer is responsible for its managers. The corporate HR may have no idea what was going on, but that doesn't mean that the managers in the stores or facilities who didn't know what was going on or that there weren't lots of other evidence being submitted to the employer that would indicate it was going on.

For example, in *Reich v. Great Lakes Indian Fish & Wildlife Commission*,<sup>57</sup> game officers who were submitting arrest reports and documentation showing that they had been out doing work on behalf of the employer outside of the time that they submitted on their weekly timesheets. The employer would have to have their head in the sand not to know that their employees were above the forty hours that they were reporting. Cicero or not, employers should be allowed to put their head in the sand, take advantage of all of that labor, and then turn around and say "but we don't have to pay for it."

**ELLEN C. KEARNS:** There are some cases on the meal period (e.g., "lunchtime"). Under the meal period scenario, the employer automatically deducts a half hour for your half hour lunch, and the employer doesn't check to see whether or not you took the full half hour or, in fact, you worked 15

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<sup>57</sup> 4 F.3d 490 (7th Cir. 1993).

minutes and took 15 minutes for lunch. In those cases, employers have adopted policies to support the “avoidable consequences” theory—at the end of the day, an electronic timecard asks the employee, “Did you get a full thirty minutes today? If not, how many minutes did you work during your lunch?”

In those cases, there are at least two cases out there; the courts did not find the employer liable. This particular employee said couldn’t clearly remember if they worked or not, so they left the question blank. Thus, where the employer makes an effort to ask “did you work during your lunch period” and plaintiff does not indicate one way or another, the plaintiff loses.

**CHARLES A. SHANOR:** If you’re trying to figure out what’s the right balance between employees exercising their rights freely and not get fired versus the employer having strict liability, consider the *Alorith* and *Faragher*<sup>58</sup> cases. While those Supreme Court cases concern employer defenses in sexual harassment cases, some principles and understandings may transport to wage and hour cases.

The second point is that there are retaliation cases. A directed research project suggest retaliation cases may find their cause of action under the Fair Labor Standards Act suggests, at least in theory, to protect the employee who gets fired for exercising Fair Labor Standards Act rights.

**TAMMY D. MCCUTCHEN:** In the FLSA, there are some good faith defenses. There are two of them under the Portal to Portal Act: if defendant can plead and prove that it had a good faith belief it complied with the law, a court no longer has discretion to order liquidated damages; and good faith activities can extend the statute of limitations under the FLSA from two years to three (at three years, it’s the plaintiff’s willfulness). Even without making new law, an employer acting in good faith can limit damages to two years of back wages and no liquidated damages.

And Lee, I think you wrote an article—did you write an article on transferring [inaudible] to the wage and hour context?

**LISA (LEE) A. SCHRETER:** I did.

**TAMMY D. MCCUTCHEN:** Balance is really necessary because there is a lot of frustration of employers.

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<sup>58</sup> *Faragher v. City of Boca Raton*, 524 U.S. 775 (1998).

## WHAT AN EFFECTIVE CORPORATE COMPLIANCE PROGRAM SHOULD LOOK LIKE

*J. Paul McNulty, Jeff Knox, Patricia Harned*

**KAREN CZARNECKI:** For our lunch, we have a very interesting topic for you today, and I am going to introduce our moderator who will then give some substantive remarks about the topic and then introduce our speakers, and they do anticipate a lot of questions from you guys, so listen attentively if you want to ask a very directed or very pointed question. Paul McNulty is the former Deputy Attorney General of the United States, and he is also a former U.S. Attorney in the Eastern District of Virginia. He spent twelve years working for the U.S. Congress, for the House Ethics Committee. He was also Chief Counsel of the House Subcommittee on Crime for eight years and Chief Counsel in Communications Director for the House Judiciary Committee.

He is currently a partner with Baker & McKenzie, where he leads the business crimes and investigation practice. He is a member of the litigation practice group, and he chairs the firm's Global Corporate Steering Committee. In that capacity, he conducts internal investigations, offers strategic counsel dealing with the U.S. government that is difficult enough in itself, and he advises on best practices for compliance with U.S. international legal requirements and regulations. So, I will turn it over to Paul McNulty right now.

**PAUL MCNULTY:** Thank you. Thank you very much. It is a real privilege to be here with you. I have long admired the work of the Law and Economics Center, and to be able to participate in this program is really a thrill so thank you for the opportunity, and I'm very glad to be joined by Patricia Harned. Pat is the president of the Ethics Resource Center. I have the privilege of serving on the Board of Directors of that center. It's a very historic organization that is a leader in the area of surveys and benchmarking, in best practices, in compliance. Pat's involved in advising companies regularly on compliance programs. Jeff Knox is here. Jeff is actually a very significant player in the Department of Justice enforcement efforts in fraud and particularly FCPA. He's the Principal Associate Deputy, or Principal Deputy Chief, of the fraud section, and the fraud section oversees a wide range of white collar crime prosecution.

The FCPA, Foreign Corrupt Practices Act<sup>1</sup> has been one of the key areas of enforcement in recent years, and so Jeff has an opportunity to over-

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<sup>1</sup> Foreign Corrupt Practices Act, 15 U.S.C.A. §78a (1977).

see more than a hundred attorneys and look at this issue of compliance from the enforcement side, which could be very valuable for our discussion. He was also a prosecutor in Brooklyn, the Eastern District of New York. So, that's our group here, and what we like to do is talk a bit about this compliance issue with you and then engage in a discussion to think about some of the applications of these issues to the thoughts and the work you've been doing.

I think this topic fits very well into the themes and the issues that the Law and Economics Center program is all about because compliance is the effort companies make to try to prevent misconduct, and when those efforts are made and misconduct occurs, the question is, does it make sense to hold the companies accountable for that misconduct when they have made this effort? That's something we are going to talk about. So, it is a lot about balancing economic interests and incentives with accountability in the law, it really fits well into the things that you have been discussing.

Now compliance therefore—let me just define it just in case some of you have been involved in other areas of the law and don't really know what this is all about—it can be defined as really kind of a system of ethical standards and practical procedures, and controls that are developed and implemented in a company to try to conform that company's behavior globally to public policy expectations. FCPA, anti-corruption, issues are a great example. Public policy expectations with regard to corruption had been evolving very rapidly over the past decade.

With the signing of conventions and international agreements in this area in the late 90s, we have seen more and more enforcement not just in the U.S., but many other countries around the world. Almost every month, we used to hear of a new law being passed by a different country, and I was just in Italy last week and the Italians have a brand new anti-corruption law, and they are going to be pushing much harder in that area to try to shift the country in a different direction.<sup>2</sup> Mexico has a new law.<sup>3</sup> Brazil is writing its new law right now. It just goes on and on.

So, with that enforcement of anti-corruption laws comes naturally a response from multinational corporations to try to avoid that enforcement and to put in place programs that might accomplish that. So, that is where you see the public policy expectation, the system of controls, standards, we do not do this, we do not do that, procedures, here is how we are actually going to make this work practically, and then the implementation of all that. It is a proactive thing. It is the kind of thing you really have to say, this is some-

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<sup>2</sup> Philip Pullella, *New Italy Law Tackles Rampant Corruption*, REUTERS, Oct. 30, 2012, <http://www.reuters.com/article/2012/10/30/us-italy-corruption-idUSBRE89T1MT20121030>.

<sup>3</sup> Ivan Castano, *Mexico Launches Anti-Corruption Law as Wal-Mart Scandal Worries Government*, FORBES, April 27, 2012, <http://www.forbes.com/sites/ivancastano/2012/04/27/mexico-launches-anti-corruption-law-as-wal-mart-scandal-worries-government/>.



thing we are going to accomplish. We are going to go out and make this happen, in our company around the world.

It is a hot topic; it is a very hot topic. If you pay attention to this issue of compliance, you will know that not only law firms, but vendors of all sorts in training and other compliance businesses and conferences, there is hardly a week where a conference is not taking place somewhere, not just in the U.S. but around the world relating to compliance. It is a very hot topic. You may ask, “Why is it such a big deal? How big of a deal has it been? Is it something really new?” I think the answer in short is the enforcement risk has increased substantially. When the enforcement risk increases, companies need to manage that risk like they manage all the risks. They have operational risks, strategic risks, financial risks, and legal risks. In the area of legal risks, enforcement, regulatory risk is a major concern.

Think about the way that enforcement risk has increased in the past decade. You have this enforcement of the FCPA, I will talk about that more in just a moment, and antitrust enforcement, both in the U.S. and the competition enforcement in the European Union, which is dramatically increased in very substantial penalties. Trade sanctions and trade penalties, some of the penalties being paid by companies lately in the area of trade, are staggering and equal some of the penalties we have seen in the area of FCPA enforcement. Data privacy, another huge area of risk in enforcement regulation, anti-money laundering, fraud in various forms but certainly accounting fraud, securities fraud, financial crimes of different types. All those things have increased substantially over the past decade, creating a much more difficult environment in relation to business conduct.

So, along come mechanisms to try to prevent violations of law, now these mechanisms can be expensive, very expensive. The question is “well, should we spend the money on compliance programs?” The answer to that, back to the enforcement risk, is perhaps best said by Siemens executive a few years back after Siemens paid \$600 million, actually \$800 million to the US authority, \$600 million to the Munich prosecutor and another \$100 million to the World Bank as a part of its global settlement of its corruption problems.<sup>4</sup> Over a billion dollars, well over a billion dollars spent just in the penalties, not to mention all of its remediation, investigation efforts and so forth.<sup>5</sup> But the Siemens executive said if you think compliance is expensive, try non-compliance.

When I heard that, and that has actually been passed around quite a lot, but I heard it the first time originally in Germany when this fellow said it, and the moment he said it, I thought, “That is really what it comes down to.

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<sup>4</sup> See Jeffrey J. Meager & Matthew J. Fader, *Siemens Pays Record \$800 Million to Settle Foreign Corrupt Practices Act*, K&L GATES: FOREIGN CORRUPT PRACTICES ALERT (Dec. 23, 2008), <http://www.klgates.com/siemens-pays-record-800-million-to-settle-foreign-corrupt-practices-act-charges-12-23-2008/>.

<sup>5</sup> *Id.*

It may be very expensive but if non-compliance in terms of penalties and reputational harm and business and law and so forth, and all of that is even more expensive than you are going to spend the money you have to on compliance.” So it is preventative, but it also is a mitigation issue, meaning that when it comes time to decide whether or not to charge a company or how significant a company’s penalty turns out to be in this business, well, the effort made to try to prevent it is a part of the equation, or at least it should be and that is the mitigation side.

So, somebody might say on a board of directors or the senior management, “Come on, let’s be realistic, we can spend all this money but we got over 100,000 employees or 50,000 employees spread out all over the world in high risk countries. Do you really think that we are going to be able to prevent every act of misconduct?” And the answer is “no, although we may be able to prevent a good bit of it, but no, we will not be perfect.” But, the effort to prevent can be a significant argument for reduction in the penalty that we may face. That is the mitigation point. So, that is why compliance is such an interesting point. Why, it is going to be increasingly important to you? Because, as you deal with business crime, as you deal with corporate prosecutions, increasingly what you are going to hear are arguments along the lines of “we knew about this risk, we studied this risk and we tried to systematically prevent it through a robust set of controls aimed at this risk.”

So, with regard to our now accountability for the conduct, we want that to be seriously considered in the result or the resolution of this matter. In one form or another, that is the issue. Now legally, it does not block as we know because legally the corporate entity is held accountable for the conduct of its employees so it is really more a question of consideration and discretion as to how the efforts to prevent will impact the enforcement of law against the company itself. Okay?

So, before I ask my colleagues here to share their views, I want to give you just a few—well, I want to mention quickly six milestones in the development of this to give you some historic context very quickly, six milestones that bring us to what we are talking about today – the first milestone is the Federal Sentencing Guidelines twenty-one years ago, almost to the day, it was November of 2001, no 1991, that the organizational sentencing guidelines went into effect, giving federal judges a guide as to the way in which companies will be sanctioned along with individuals.<sup>6</sup> And within those organizational guidelines was included an issue of compliance as mitigation for the penalty.<sup>7</sup> In fact, you’ll see at the table this report, and Pat will, I am sure, mention something about it, but it is the report that Pat’s group put out this past year looking at the 20<sup>th</sup> anniversary of those organi-

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<sup>6</sup> UNITED STATES SENTENCING COMMISSION GUIDELINES MANUAL (Nov. 1, 1991), *available at* [http://www.ussc.gov/Guidelines/1991\\_guidelines/Manual\\_PDF/1991\\_Guidelines\\_Manual\\_Full.pdf](http://www.ussc.gov/Guidelines/1991_guidelines/Manual_PDF/1991_Guidelines_Manual_Full.pdf).

<sup>7</sup> *Id.*

zational guidelines and some of the key things that ought to be considered 20 years later, and compliance is a major theme of this report.<sup>8</sup>

So, compliance programs were anticipated as a way of reducing the penalty, and the sentencing commission said there are seven elements of an effective compliance program.<sup>9</sup> They named the seven elements and that started a scramble within companies and law firms to see if the company would be in a position to argue that it had a pre-existing compliance program that met the standard if the time came when the company would be before a court and facing the possibility of a sentence.<sup>10</sup> That is the first milestone to sentencing guideline, started the compliance issue in motion.

So, that was '91, in '98, Eric Holder is the Deputy General and Eric Holder is wrestling with this question: how do we decide when to charge a company and not just the individuals? Since that was a discretionary decision by prosecutors, what should we be considering at that charging stage? He came up with a set of principles for consideration in charging corporations guidelines that still exist to this day.<sup>11</sup> Those guidelines include one element—they had eight elements, now there are nine—but one element was a pre-existing compliance program.<sup>12</sup> Eric Holder's memo modified by Larry Thompson, modified by Mead, the McNulty memo, modified by my successor, but the bottom line is there still is consideration for a compliance program as one of the charging factors in enforcement of business crimes.<sup>13</sup>

The third milestone was Enron's collapse and Sarbanes-Oxley.<sup>14</sup> In Sarbanes-Oxley, we now have a new focus on corporate governance, new consideration as to what the responsibility of directors would be, more independent directors. Before Sarbanes-Oxley, it was somewhere around 25% of board members were independent board members, independent directors. After Sarbanes-Oxley, within a year, it was 75% or more. So, there was a major change in governance during that period of time. Internal controls became a critical factor. Risk assessments were required as a part of a compliance program. So, you really could see a much greater concern at the very top of the company about compliance after Sarbanes-Oxley.

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<sup>8</sup> THE ETHICS RESOURCE CENTER: THE FEDERAL SENTENCING GUIDELINES FOR ORGANIZATIONS AT TWENTY YEARS (2012), available at <http://www.ethics.org/files/u5/fsgo-report2012.pdf>.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> Mem. From Eric H. Holder, Deputy Att'y Gen., U.S. Dep't of Justice, Federal Prosecution of Corporations (June 16, 1999).

<sup>12</sup> *Id.*

<sup>13</sup> Mem. from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Justice, Principles of Federal Prosecution of Business Organizations (Dec. 12, 2006); Mem. From Larry D. Thompson, Deputy Att'y Gen., U.S. Dep't of Justice, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003); Mem. From Eric H. Holder, Deputy Att'y Gen., U.S. Dep't of Justice, Federal Prosecution of Corporations (June 16, 1999).

<sup>14</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

Then in 2007, we have this FCPA surge beginning. I mentioned the Siemens case. When I left the DOJ five years ago, a company called Baker Hughes had paid the highest penalty of all time for an FCPA violation, \$44 million. Today, if you take the top twenty FCPA settlements, Baker Hughes is barely hanging on to the top twenty. They are now down to about seventeen on that list. Since that time, there have been all these other settlements that much greater and exceed that Baker and Hughes penalty. Siemens is still the all-time highest penalty at 800.

So, the FCPA surge has sent companies again scrambling to think about how to prevent that kind of enforcement risk and with these settlements, Jeff and his colleagues insert into the agreements, typically every agreement, some type of attachment about the compliance program of that company, basically saying that as a part of this agreement, the company will have a compliance program of this sort. So, for all the rest of the companies, they can look at every one of those settlement agreements and say a-ha, that is what the DOJ is thinking these days or the SEC about compliance at least in the context of the FCPA.

Then last year, 2010, we had the passage of the U.K. Bribery Act.<sup>15</sup> You might think, “What does the U.K. Bribery Act have to do with any of this?” In the U.K. Bribery Act, they did something very novel. Outside the U.S., the idea of holding companies accountable for the conduct of employees is actually not that common, but the U.K. said that if an employee or an associated person or party pays a bribe on behalf of the company, the company will be liable for that, period. But, if the company can show that it had adequate procedures designed to prevent corruption, then it would avoid that accountability. So, it creates a presumption of accountability for the company and then its defense. Since that law was passed over a year ago, we have not seen those adequate procedures or that adequate procedures defense in action. The serious fraud office of the U.K. has not brought a case in which that defense needed to be asserted so everyone’s still waiting to see exactly how it is going to work.

But, in designing that law and then following up with guidance, the U.K. identified six factors for adequate procedures to prevent corruption or compliance program. So, and then last milestone and it does not seem to be as significant as the sentencing guidelines or Sarbanes-Oxley, but the DOJ settled the case in May with Morgan Stanley,<sup>16</sup> and in that case, Morgan Stanley, according to those of us who can read the documents and draw our conclusions from that, came forward and made that compliance argument along with some other things such as voluntary disclosure to the DOJ and the SEC but they said look, we made extraordinary efforts to prevent this corrupt act in China including multiple training sessions of this employee,

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<sup>15</sup> Bribery Act, 2010, c. 23 (U.K.).

<sup>16</sup> *United States v. Peterson*, No. 12-CR-224 (E.D.N.Y. Apr. 25, 2012).

notifying this employee of what was expected of him and nevertheless, he circumvented our controls after all that effort.

Apparently, we can just comment on this, but apparently the DOJ accepted that argument, and the settlement with Morgan Stanley indicates that it can work, that a strong compliance program under the right circumstances might actually be a sufficient mitigation for a corporate enforcement action. So, the Guidelines, the Holder memo, Sarbanes-Oxley, the FCPA surge, the U.K. Bribery Act, Morgan Stanley case, that was just in May and now we are here, and the question is, what is a compliance program, can it work, and will this increasingly be an issue that courts will have to wrestle with when deciding whether the whole company is accountable?

When we look at all of these compliance standards and lists and so forth, at Baker & McKenzie, since we have kind of a global practice, and I am running around the world all the time, kind of keeping our team on one page, we use five elements to summarize all these different compliance issues or compliance, the content of compliance programs. We take the sentencing guidelines, and we take all of these settlement agreements that DOJ enters into, and we look at the U.K. Bribery Act and the Organization of Economic Cooperation and Development, and we look at any list that comes out, and we say, what are the commonalities between all these different standards about compliance? How do you harmonize them?

We harmonize them in five ways. First, leadership, that within every strong compliance program, there is a leadership component—tone at the top, sufficient resources for compliance, governance issues that make compliance work in that company. Secondly, risk assessment. For every compliance program list, there is somebody to step back and say where are we, what do we do, how do we do it, and are we effectively managing the risk that is ours? Do we know our risk well enough? Third, standards and controls, if we know our risk, now do we have the policies in place that say what we cannot do and the procedures, the controls in place, to ensure our employees know what is expected of them.

Fourth, training, we have to make sure that everybody gets the information and knows what is expected of them—training and communication. Then finally, fifth, oversight—monitoring, auditing, and responding to misconduct allegations, oversight of the program, vigorous oversight to ensure people know what they need to be doing. They are doing it. We are auditing and we are investigating when something goes wrong. Leadership, risk assessments, standards of controls, training, and oversight, that is sort of our language within our practice and how we work with companies to build their programs.

**PAUL MCNULTY:** So, that is where we are in terms of the lay of the land and now I would like to call on, I will make use of the panel and make you go, say Jeff, will you go next? Okay, we will do Jeff because we had talked about this order. Let's hear now the perspective from the DOJ on all of

this, and then Pat will give the business side of it, and then we will get you involved in the discussions, some questions about it, okay? Thank you.

**JEFF KNOX:** Thanks, Paul. So I was in private practice and then a prosecutor in New York for several years before coming down to Washington to join the Fraud section and when I first got here to Washington, the idea of a prosecutor becoming an expert about corporate compliance programs or needing to understand and think about corporate compliance programs seemed sort of silly. It did not feel like the job of a prosecutor. We investigate crime and we prosecute crime. It seemed more appropriate for in-house counsel or an accounting firm, maybe a consulting firm, but not for us.

But, in the time I had been down in Washington investigating and prosecuting companies, I had really kind of come to realize and appreciate how critically important it is to understand compliance programs, to evaluate them because at the end of the day, the decision on whether the whole of the company is criminally responsible to take that step of indicting a company, a corporation, often comes down to a number of factors and one of the most, and sometimes even decisive factor, is that company's corporate compliance program. Whether the company from the top of the organization to the bottom had a commitment to ethical conduct, and enforcing, requiring ethical conduct among its employees or conversely whether it did not, whether it promoted win at all costs type mentality in its sales staff, placing bottom line ahead of ethical conduct, very important.

Because of this, as a prosecutor, as a white-collar prosecutor, certainly in the fraud section where we look at a lot of companies, becoming an expert in corporate compliance is not an option. It is essential. It is critical. It is critical in our exercise of prosecutorial discretion. So how do we do it? Paul mentioned the principles of corporate federal prosecution of business organizations. As a federal prosecutor, that is really the starting point for us and those principles tell prosecutors to ask three very simple common sense questions: First, is the company's compliance program well-designed? Second, is it being applied in good faith? And third, does it work?

What I found in my experience prosecuting and supervising these cases is that companies most often get tripped up on question two. Nowadays, most companies have very strong compliance programs on paper but it is the enforcement and the implementation that gets them into trouble. It is the commitment by senior level executives to foster a culture of ethical conduct. That really gets me to what I think may be the number one hallmark of an effective compliance program, which Paul mentioned, but I could not agree with more strongly, which is the tone at the top of the organization, the commitment of senior level management.

You would be surprised at the number of companies that walk through our doors that have fantastic corporate compliance programs on paper, but find themselves in big trouble even though they were obvious, patently ob-

vious, red flags of criminal conduct that were there to see but were not because of either deliberate ignorance or conscious disregard, or when a well-intentioned compliance officer raises the tough question with the sales executive. In this situation, she was bullied into not following, and did not demand answers, did not demand accountability and senior management. When push came to shove, she decided to favor the bottom line in getting that big deal over actually getting that big deal, but only if you can do it legally and ethically.

I think it is critically important that we look for this in every case. Whether there is a message from the very top of the organization, that ethical practices are required no matter what. So, that is really one hallmark, and I think the principal hallmark. The other ones, Paul, I think, pretty much nailed them so I am not going to spend time on them; but, he mentioned risk assessment, standards in controls training, oversight, which is it. Those are the very basic concepts but are often overlooked and not followed. So, as a prosecutor, when I am making a charging decision, I am evaluating the effectiveness of the program, the structure of the program. Those are the factors. Those are the elements that I look to.

Now, to give you an example of how these decisions play out in practice, I thought it might be interesting to focus on two case studies, and Paul actually mentioned both of those. One involving Siemens,<sup>17</sup> and one involving Morgan Stanley.<sup>18</sup> Everyone here has heard of these companies. Siemens, a large international conglomerate based in Germany, over 400,000 employees, a huge business with foreign governments in infrastructure projects, energy projects, technology projects, Siemens routinely would enter into billion dollar plus contracts with foreign governments. It was its core business and yet for years, within this core business, there was a culture of corruption that pervaded Siemens throughout the world.

Our investigation found that Siemens, over a several year period, paid over \$1.3 billion in corrupt payments to government officials, often through intermediaries. Siemens throughout this organization had an elaborate system to make these payments and hide the payments from auditors, from regulators, from some levels of management. They had things like cash desks in which employees literally can take out up to a million euro in cash and you would see situations where Siemens, these are high level executives, delivering suitcases full of cash to third party intermediaries to hand over to government officials. Seems like something more than an organized

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<sup>17</sup> Jeffrey J. Meager & Matthew J. Fader, *Siemens Pays Record \$800 Million to Settle Foreign Corrupt Practices Act*, K&L GATES (Dec. 23, 2008), <http://www.klgates.com/siemens-pays-record-800-million-to-settle-foreign-corrupt-practices-act-charges-12-23-2008/>.

<sup>18</sup> Jessica Dye, Reuters, *Garth Peterson, Ex-Morgan Stanley Executive, Sentenced to Nine Months in Prison Over Bribery Allegations*, THE HUFFINGTON POST (Aug. 17, 2012), [http://www.huffingtonpost.com/2012/08/16/garth-peterson-morgan-stanley\\_n\\_1792556.html](http://www.huffingtonpost.com/2012/08/16/garth-peterson-morgan-stanley_n_1792556.html).

crime family would do but these are senior well-respected sales executive at Siemens in Europe and South America, in Russia, in Africa, doing just that.

Siemens maintained these offshore, off-books accounts in safe-haven jurisdictions that were used to make bribe payments and were kept out of the watchful eye of their auditors and regulators. Siemens' most notorious practice was hiring what they called consultants or sales agents and paying them huge cuts of these billion dollar deal, sometimes 3 or 5%.<sup>19</sup> These consultants were not really consulting. What they were doing was funneling bribes to government officials.<sup>20</sup> They were hired because they had relationships with officials; sometimes even family members or business colleagues of officials, and it was really a pay-to-play mentality in this industry at the time.

Siemens had a corporate compliance program but was completely inept. They failed to discipline employees caught paying bribes. They failed to investigate credible allegations of corruption, rather would just sweep them under the rug. Siemens had a compliance department. It had six lawyers. So in an organization of 400,000 employees, you had six who are responsible for the monitoring of this conduct.

All other support staff, but six, and no commitment by senior level management to enforce a culture of ethical conduct; in fact, it was really the opposite. In many cases, very senior level members of Siemens including the board specifically condoned the conduct and some cases were actually participating in bribes. I indicted a Siemens board member just last year who was involved allegedly with a scheme to pay close to \$100 million in bribes to win a billion dollar contract in Argentina.<sup>21</sup>

There was no clear message from the top of the organization that corruption was unacceptable. Instead the message was keep your sales figures up, meet your sales goals, and do whatever you need to do, just do not let us know about it. So, in that case, in investigating Siemens, and it comes time to deciding what is the right result, it really was not that difficult of a decision.<sup>22</sup> In that case, we felt compelled not just to go after and prosecute individuals, but also to hold the company itself criminally responsible.<sup>23</sup> We charged and convicted the parent company, Siemens AG, and also three subsidiaries with FCPA violations, subsidiary in Bangladesh, Argentina, and Venezuela.<sup>24</sup>

Paul mentioned a result of the cases over a billion dollars in criminal and civil penalties to pay to the DOJ, the SEC, the Munich public prosecu-

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<sup>19</sup> *Siemens (Foreign Bribery Actions)*, THE TRACE COMPENDIUM (2013), <https://www.traceinternational2.org/compendium/view.asp?id=124>.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*



tor's office, the entire executive management of Siemens either resigned or were kicked out. New management structure came in. Independent compliance monitor came in. Completely revamped Siemens' corporate compliance program and has been very effective in doing that. Today, Siemens is considered really the gold standard for how compliance programs should be. It was the exact opposite a decade ago.

Now, contrast Siemens with the other company that Paul mentioned, Morgan Stanley. Everyone has obviously heard of Morgan Stanley, global financial institution, more than 60,000 employees. Now, compared to Siemens' compliance program, Morgan Stanley's was phenomenal; 500 dedicated compliance officers just to compare to 500 officers for 60,000 employee organization versus six attorneys for 400,000 employee organization. The compliance executives had direct reporting line to the board of directors. Comprehensive anti-corruption training throughout the institution, sophisticated payment approval process, very close oversight and scrutiny, and due diligence of third party agents. These are the sort of the so-called consultants that Siemens used, and in many of these FCPA cases are the go to method for facilitating and hiding bribe payments.

So, just briefly, the facts of Morgan Stanley.<sup>25</sup> The case centered on the managing director, senior level managing director of Morgan Stanley, named Garth Peterson.<sup>26</sup> Mr. Peterson worked in Morgan Stanley's Shanghai office, and the transaction we are looking at involved a joint venture investment of office towers in Shanghai.<sup>27</sup> Morgan Stanley teamed with the local real estate arm of the Shanghai government.<sup>28</sup> It is called Yang Yue and the structure of the transaction involved setting up special purpose vehicles to invest the money and then those vehicles in turn would invest the money into these office tower projects.<sup>29</sup> Morgan Stanley understood that these special purpose vehicles were owned and controlled by the Chinese government, and engaged in due diligence to confirm that.<sup>30</sup>

The fact is, they were not controlled by a Chinese official.<sup>31</sup> They were controlled by Garth Peterson, the managing director of Morgan Stanley, and they were used as part of a scheme to enrich themselves.<sup>32</sup> So, we are looking at that transaction and it comes time to make a criminal prosecution decision, against individuals, Morgan Stanley, and evaluating Morgan Stanley's compliance program was a critical factor that we looked at. I mentioned the sophisticated training program they had. Garth Peterson

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<sup>25</sup> Dye, *supra* note 18.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> Dye, *supra* note 18.

<sup>32</sup> *Id.*

himself was trained in seven different occasions on the FCPA, and received thirty-five CPA compliance reminders. There was extensive due diligence not only of these special purpose vehicles, but also of the transaction itself.

Morgan Stanley hired an outside law firm to review documents, and to conduct interviews. The message that we perceived in our investigation is that there was a good faith effort to really understand the deal, to get to the bottom of it, and to make sure it was legitimate. At the end of the day, it did not work, and as Paul mentioned, it does not always work. But, from my perspective, and our perspective on deciding what should we do with Morgan Stanley, we decided as a matter of prosecutorial discretion that the right result was not to prosecute Morgan Stanley and decline that case; instead, focusing on Garth Peterson who was really the mastermind of this scheme and went to elaborate measures to hide it from Morgan Stanley and its compliance officers.

The result was that we charged and convicted Garth Peterson up in New York and, as I mentioned, we declined to bring the case against Morgan Stanley, as did the SEC.<sup>33</sup> So, just to wrap this up, comparing Morgan Stanley to Siemens, you can see how important the two institutions' compliance programs were in shaping the decisions that we ultimately made against the two institutions, and why Morgan Stanley got a pass whereas we felt compelled to prosecute Siemens, and I submit that as judges who may need to decide punishment, criminal penalties or civil penalties against companies, your calculus will likely be similar to the ones that prosecutors make in charging decisions. It is an important part of the sentencing guidelines, and I think it is really a common sense evaluation of trying to determine whether to charge, how to charge, and what the appropriate punishment should be. Thanks.

**PAUL MCNULTY:** Thanks, Jeff. We'll now hear from Pat.

**PATRICIA HARNED:** Well, thank you for allowing me to be here this afternoon. Jeff invited you to eat your cheesecake and so if you are now suffering from sugar shock or sugar coma, wave your hand for coffee if you need to. My task is to talk about the corporate perspective and the value of an ethics and compliance program. Just by way of background, I want to talk about where that comes from in some of the data points I am going to share with you. The Ethics Resource Center since 1994 has fielded a longitudinal study called the National Business Ethics survey that actually has become sort of a benchmark for both companies and I would imagine a large number of enforcement officials, as they are looking at the trends that are happening in companies and what we can expect to see in terms of the types of misconduct.

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<sup>33</sup> *Id.*

The ERC also uses that data to look at the actual things that are being measured and how effective I think the data is in a compliance program. So I want to talk about that and talk about the value of a program for companies, but then also I wanted to talk a little bit about the challenges that companies face in trying to achieve the government's expectations of an ethics and compliance program. So, the first thing I want to say is when we look at what makes an effective ethics and compliance program, it is one thing to be able to point to various elements that a company has put into place, the things that Paul has talked about and codes of conduct and training programs along with other things. But, the purpose of an ethics and compliance program is to change behavior, improve conduct, and reduce the likelihood that misconduct will actually take place.

So, we first look from employees' perspectives within a company to see what an ineffective program is. First of all, there are essential elements generally in place, and interestingly, the sentencing commissions, Chapter 8 of the Federal Sentencing Guidelines for Organizations, tend to be the foundation of most programs that are in fact improving employee conduct and perceptions.<sup>34</sup> So, when we go into an organization and try to establish what is happening there and the outcomes of their ethics program, there will be some common elements there, a code of conduct or some form of set of standards that are communicated broadly, regularly, and consistently to all employees. These standards not only say, here are the regulations and you should not overstep these bounds, and here is the law we are going to obey it; but, they are also a set of values that include principles that the company regularly communicates as a part of its business decisions and as a part of its expectations of how employees should act.

But, there are also a number of other things, like training, that we have heard Jeff and Paul both mention. The purpose of training—and the studies we have had about training and its value—show that training raises awareness that the company actually has resources available. Training also raises awareness of the regulations and laws that are important for the company to be paying attention to. Training does not itself necessarily change conduct, but it is an essential component to remind people that there are standards, there are laws, and there are regulations.

A couple of other essentials that are there usually include a help line or a hot line, some mechanism to receive reports of misconduct from the employees, follow-up with that through investigations, disciplinary action, it is one of the measures that we see most often in an ethics and compliance program that is effective, employees believe very strongly that people are actually held accountable to the standards, so if you overstep the bounds of the code, if you are involved in some sort of incident that involves breaking the law, there is action taken by the company. A couple other things in-

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<sup>34</sup> FEDERAL SENTENCING GUIDELINES: CHAPTER EIGHT SENTENCING OF ORGANIZATIONS (2011), available at, [http://www.ussc.gov/Guidelines/2011\\_Guidelines/Manual\\_HTML/Chapter\\_8.htm](http://www.ussc.gov/Guidelines/2011_Guidelines/Manual_HTML/Chapter_8.htm).

clude, evaluation of an employee conduct, rewards, incentives, actually upholding the standards, and finally high-level oversight; you have heard Paul talk about it.

From the top down, there is a perception by employees that this company really cares about being a company with high integrity. The values are actually employed from the boardroom all the way down to the shop floor or various business units. When those elements are in place, there are a couple of things that happen. First, there is a reduction of the likelihood that misconduct will take place. Second, there is an increase in the likelihood that when misconduct takes place, the company will know about it and will respond appropriately. So, that in and of itself it is the reason that businesses that do a very good job of establishing these programs, they see that as the value. It is not necessarily to keep us out of trouble or to give us some sort of mitigation in penalties; it is because it is going to help the business do its business better.

So, let me just give you some numbers that actually demonstrate that. When a company has an effective ethics and compliance program in place, employees are 60% less likely to say that they feel pressured to break the rules or disobey the law in order to do their jobs. Observe misconduct, and the extent to which people see violations of the code or violations of the law drops by 66%. An employee's willingness to come forward and report misconduct to management when they see it increases by 84%. The results are dramatic. Companies that have good programs are actually collecting data to be able to monitor the extent to which those kinds of things are happening.

There are a number of other benefits of a good program. Employee engagement increases by 44%. Employees are better able to navigate some of the gray areas where there might not be a rule, there might not be a law, but it is a questionable thing. They know what to do. They know where to go to ask questions and they actually are willing to come forward and ask questions of management about some of those gray areas.

We are also starting to see some research that shows there is actually value to the bottom line. The ERC has done a study that has not been published yet on the ROI, of an effective program and some of the things that you see are less employee sick time, less disciplinary actions, there is less cost for the company in terms of a lot of the HR types of issues. But, there have also been some other organizations that have looked at shareholder value, and companies that have strong programs actually are generating more revenue than organizations that do not. So, it really does matter for a business to invest in these programs. As we have been saying already, there is certainly, from an enforcement perspective, a good argument for companies to have a program because it does help in terms of mitigation of penalties if you are able to demonstrate that you have a program in place.

But, there are some big challenges for companies and I want to talk about two of them. First, is internal in terms of how they are going about

implementing these programs. The other is external in terms of relationship to the government and enforcement officials. So, first, internally, from what we have seen in the work that we have done, only 41% of companies across the United States have a well-implemented ethics and compliance program. By that I mean that it is not a measure of how many companies have codes and training, help lines, and all the major things that they come forward and try to defend themselves by. But, only 41% of companies have employees who say I know my company has an ethics program; I make use of it, and I am also not observing a substantial amount of misconduct and I am rewarded for ethical conduct. When we put it all together, the vast majority of companies across the country have not achieved what we are talking about in terms of strong cultures and employees that are actually making use of the resources that the companies are investing in.

There are a couple reasons for that. First, codes and training and hotlines, while they are prevalent in a lot of companies, the larger the organization, the more difficult it is to actually implement that across the entire organization. For a multinational company, having a code of conduct that actually is rolled out globally, respecting diversity within a different country and cultural practices, and yet establishing a very strong standard about how a company will operate is a difficult task. Training has come a long way because there are lots and lots of vendors in the ethics and compliance industry that will help companies. But even getting employees to take training, to pay attention to it, and to absorb it can be a challenge particularly for companies that are trying to do it across a large employee population.

But, I think probably the biggest challenge for companies internally is exactly what we have been talking about in terms of leadership commitment. A company that has a program in place, what we have seen over time, is that the more they invest in the program, the more they communicate it, and the more they are talking about it with their employees, the more likely it is that employees say that they work in an organization with a strong ethical culture. Culture trumps compliance every day of the week, but it is a big challenge for companies to first of all systematically, comprehensively, and regularly pay attention to the culture of the organization.

In the business day, most of the things that get talked about are the bottom line, how are we doing in meeting expectations of our customers and our vendors, how are we doing with investors in some cases. Culture is a difficult concept to actually be rolling out throughout an entire organization, but once it is achieved and if you're able to maintain it, it has a huge, huge impact. So as I was saying, I was sharing those statistics earlier, a well-implemented program is also one that has achieved a strong ethical culture within a company and it is the culture that matters more than the program. But, the other thing is that for a lot of ethics and compliance practitioners, getting the top levels of the organization to invest in the program and continue to invest in it can be a challenge.

A lot of business executives see it as a check the box kind of thing. Have we implemented the things that are required of us, or are expected of us from some of the milestone things that Paul has talked about? Once we have done that, we have those elements in place, we are good to go. We should be okay, but as I was saying, the culture is what matters and employees get their perceptions of culture from two places. The first is the CEO of the organization, the top level. The second are the actions of the employees' direct supervisor. So, when the expectation does not come from the top and filter all the way down and become reinforced by a supervisor, employees will not really think that ethics actually matters in their company and to the same extent, compliance.

Compliance is generally communicated as, we need to obey the law, we need to pay attention to the regulations but without that expectation from the top down; it really makes a dramatic difference in employees' perceptions. I talked a little bit about company size. That is another challenge for companies in terms of their own internal implementation of a good program. As I was saying, for a large organization across many countries, it is difficult to implement a program and maintain it and monitor it but for a small organization, it is also a challenge.

Even if you take the Federal Sentencing Guidelines for Organizations and the elements that Paul mentioned, the seven elements of an effective program, codes, training, help lines, resources, high level oversight, if you are a company of a hundred employees or less, having an anonymous hotline can be a challenge because everybody knows who everybody is and if there is a report made to the helpline or report coming to an immediate supervisor, the risks of retaliation for reporting are higher so it presents a challenge for the company to have that. Also, resource can be scarce so for smaller companies, very often, an effective ethics and compliance program has those elements in some way, shape, or form, but it looks very different from a large company.

In terms of external challenges, I want to talk a little bit about the things going on outside companies that also impact how well they can implement these programs. The first thing is that the economy makes a difference. We have seen over time that when the economy is struggling, ethics actually improves within companies. It is an interesting finding but when the economy is strong, ethics gets worse and there is a reason for that. When the economy is poor, there is something about the behavior of senior executives and supervisors; they talk more about how they value their employees. They say things like, we need to stick together, and we cannot afford to get in trouble. There is a change in the behavior, the extent to which companies are taking risks changes, and the way they manage their employees overall communicates to those employees a sense that the company really cares about me maintaining its integrity during these times.

Even if they are laying-off employees, the remaining population hears from senior management that they are doing it for good reasons, that it is a

principled decision sometimes and they generally perceive that as a commitment by the company to strong ethics. The other reason that in tough economic times ethics tend to be stronger is that the bad actors are laying low. Every survey we have done of employees talking about the changes in your company during these economic times, a majority of the people say that the ones who are probably likely to be the rogue employees are laying low.

So, those are the reasons that during tough economic times, ethics tend to improve. The challenge in that though is as the economy recovers, most companies cut their ethics and compliance programs back when they need to cut their budgets. So, during tough economic times, when ethics are good, you can reduce your hotline calls. We are not seeing too many problems. We are feeling good about our culture. Our employees are not seeing much misconduct. We can shrink our budget. But as the economy changes, as things strengthen, behavior changes, people's expectations change, misconduct tends to rise, and most companies have reduced their ethics and compliance programs. They change the way they are approaching the culture and it makes a difference in the long run for that company.

The second major challenge for companies has to do with the enforcement community and the way that ethics and compliance programs are being looked at. So, as Paul mentioned, for the twentieth anniversary of the Federal sentencing guidelines, the Ethics Resource Center convened an independent advisory group to just spend some time talking about the impact of sentencing guidelines, and the remaining challenges. And, I think that there are copies of the executive summary of that report.

**KAREN CZARNECKI:** At the registration table.

**PATRICIA HARNED:** At the registration table, thank you. So, I would encourage you to pick that up. We convened a group of it. Paul's a part of it. Prosecutors, Federal judges, ethics and compliance practitioners, a couple former congressmen, academics who have been studying these issues, and the group spent approximately 18 months talking about what we know about the results of sentencing guidelines, and what are the challenges that remain. And, probably the biggest conclusion that came out of it was, first, the commission got it right. As we know, when companies actually take Chapter 8 and follow it, using it as a model to design their programs, they are more likely to be able to have an effective program.<sup>35</sup> It starts to change employee behavior. If they take it seriously, Chapter 8 is a very good standard for companies.<sup>36</sup>

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<sup>35</sup> FEDERAL SENTENCING GUIDELINES: CHAPTER EIGHT SENTENCING OF ORGANIZATIONS (2011), available at, [http://www.ussc.gov/Guidelines/2011\\_Guidelines/Manual\\_HTML/Chapter\\_8.htm](http://www.ussc.gov/Guidelines/2011_Guidelines/Manual_HTML/Chapter_8.htm).

<sup>36</sup> *Id.*

As we have seen across our industry, it really is the de facto standard that people go by to try to figure out if the company is starting with nothing, that is how they design their program. But the second biggest challenge is that very often it is unclear to companies the extent to which ethics and compliance programs factor into enforcement decisions. It has been rare that a company actually comes before a judge and has the criteria of their ethics and compliance program considered based upon Chapter 8 because most reinforcement decisions are being made with the DOJ or some other enforcement agent prior to coming into a courtroom.<sup>37</sup> The federal judges that served on our advisory group agreed with that and said often when they do have these kinds of cases, that by the time they see it in their courtroom, the settlement agreement has already been locked up. It has already been decided and negotiated; it is just there for their approval.

That is part of the reason why the DOJ especially, but also other reinforcement agencies, really have a tremendous amount of control over how enforcement decisions are being made. But, with that, there has been a lot of feedback from the ethics and compliance community that it is tough to know whether the extent to which ethics and compliance programs matter and also the extent to which companies were actually given credit for it. So, we did a survey of ethics and compliance officers across the industry and 84% of them said that when there is information from an enforcement agency about how an ethics and compliance program mattered in the enforcement decision, 84% of ethics officers take that and use it with their boards and their CEOs and their C suite executives to help make the case for continued investment in their program.

But, 86% of ethics and compliance officers are not getting that information directly. At the time the DOJ was one of the main focuses for that survey because there was not a whole lot of information about how the program actually factored into the decision. Now, the Morgan Stanley decision came out after that survey was done so and as Jeff was saying, a great deal of consideration was given to the program for that and that decision has certainly had a good impact on our industry.

Another challenge that companies face, in particular in working with the judiciary system and with the enforcement community, is that there is not consistency between agencies in terms of the criteria they are applying if they are applying any criteria at all for judging an ethics and compliance program. So, a company that is dealing with the DOJ and the SEC, or the Department of Transportation, or state judges, or wherever they happen to be, if there is more than one agency involved, it is unclear the extent to which different standards are being applied and very often, they are using a very different criteria so there needs to be more consistency across enforcement agencies.

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<sup>37</sup> *Id.*



When we did this advisory group report, we made a couple of recommendations largely to the DOJ, but also intended for that to be in the enforcement community. But, we also made recommendations to the courts. So, the first thing that we recommended and it applied to both is that the Federal Sentencing Guidelines Chapter 8 be adopted as the standard by which companies are judged in terms of the extent to which they have developed a good program.<sup>38</sup> It is not the be all and end all but it is, if a company can come in and say they have those elements in place, and in addition to that they can demonstrate that it has made a difference in employee behavior, they have made a very good case for reducing the risk that misconduct will take place.

**JEFF KNOX:** Sorry, it's hot up here.

**PATRICIA HARNED:** I know, it is hot up here. I am making you sweat?

**JEFF KNOX:** You are. It is the compliance talk.

**PATRICIA HARNED:** But, the second thing is judges should exercise their judicial oversight in the process of settlement agreements when the DOJ or some other agency comes forward with a settlement agreement, we encourage the courts to ask questions about the extent to which the ethics and compliance program was considered and also to be a second level of judgment about whether or not the company actually really did have a good program. Every company can come in the door and say we have the code, we have training, and we have a hotline. Those are the easy things to put into place.

Even Enron had a bang up code, but being able to demonstrate that they also established a strong culture, that they have mechanisms to receive those reports, that they actually get them from employees, that they respond, and that they actually hold people accountable, those are the harder things to measure but those are the essential elements that you should be looking for as well if you are looking at a case where a company has come in and said we have a program and it is factored into the enforcement decision.

I think with that I am going to stop and I think we have time for Q&A.

**D. BRUCE JOHNSEN:** Yeah, thanks, Pat.

**PATRICIA HARNED:** Sure.

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<sup>38</sup> FEDERAL SENTENCING GUIDELINES: CHAPTER EIGHT SENTENCING OF ORGANIZATIONS (2011), available at, [http://www.ussc.gov/Guidelines/2011\\_Guidelines/Manual\\_HTML/Chapter\\_8.htm](http://www.ussc.gov/Guidelines/2011_Guidelines/Manual_HTML/Chapter_8.htm).

**PAUL MCNULTY:** Okay, we only have a few minutes left. I would love to hear any thoughts, questions, comments you all have? Let's start over here please.

**AUDIENCE MEMBER:** As a former prosecutor, I appreciate the discussion. It seems to me like the best way to incentivize the culture of Morgan Stanley would be to create the standard for compliance with the matter of avoidance being the exception for prosecution. If there is an ethics compliance program X, Y, Z, or what the decision is worthless as opposed to being.

**JEFF KNOX:** So the question I heard, the statute will make this a statutory exception similar to what I was describing as what the U.K. Bribery Act has, or actually, would it be a defense that could be—

**AUDIENCE MEMBER:** Stronger than the defense, the exception should be that if unless the prosecutors have engaged in reasonable doubt then that means they prosecute.

**PAUL MCNULTY:** Well, Jeff, maybe before putting you on the really hot seat—

**JEFF KNOX:** Try to explain why prosecutors would not want that, I was saying that—

**AUDIENCE MEMBER:** It is the best way to incentivize—

**JEFF KNOX:** Yeah, no I agree. Sure. If you really thought that there was again sort of a theme here today, that there was going to be a real benefit that you could count on in your compliance program, it would certainly incentivize compliance, and so I think that is an interesting point. I will say that having spent eight years as counsel of the house judiciary committee that that legislation would be seen as a way of giving a break to corporate crime and probably would not go too far too fast so it would be a very difficult thing to actually enact.

Probably the more legal issue is the principle of a vicarious liability for companies and for the conduct of employees has been pretty well settled down for a hundred years, and so prosecutors and others count on that kind of presumption of liability. It would really be a very significant issue from a historical perspective on the accountability of companies to be able to have that essentially strong defense.

There is a lot of merit to what you are saying because certainly the more that you think that this is going to matter, the more incentive there is to make it happen. Any more comment on that? I—

**PAUL MCNULTY:** No, just that there has been a lot of talk about whether there should be a compliance defense written into the law, and when I think about it, it would be very difficult to litigate that issue because companies might be able to come forward, sort of like Siemens in the last three or four years of its conduct where you have a strong program on paper but the real question is how is it being applied? That is a harder issue to evaluate whether a judge is evaluating it or a jury is evaluating it, so I think you would end up left with kind of a trial within a trial. First, whether there is criminal liability and second, whether there was a compliance program not just in place, but operated in good faith and comprehensively. I think just in practice, it would be difficult to flesh out those issues.

**PATRICIA HARNED:** Just to add a thought to that, the DOJ has been really good about seeking the input of the ethics and compliance community as they are thinking about the FCPA guidance that is in development right now. That question came up: should there be a compliance defense? An ethics and compliance officer said no, and the reason for that was that as soon it has become a defense, and it is very spelled out, the worry for them is that it becomes a checked box mentality of the senior levels of their organization, so it is a tough challenge for them.

It is so easy for companies to start to say FCPA matters to the DOJ. Do we have everything in place? Okay, great, let's move on to the next priority. Maintaining that perception that it is not just being able to check the box, that you have got what you need in case you need a defense, but maintaining codes or maintaining commitment, encouraging employees to come forward, that is the biggest priority.

**D. BRUCE JOHNSEN:** There is another over there, yes, please?

**AUDIENCE MEMBER:** I think it is wonderful how the FCPA's global scope is helping improve business ethics throughout the world so my question is other than the U.K., what countries have similar laws, and has there been any criticism of this FCPA on the grounds that it reduces competitiveness of American companies?

**PAUL MCNULTY:** Yeah, the level playing field issue. Well, Jeff would you like to take—I'm happy to go to the global picture. Do you do you want to do it?

**JEFF KNOX:** Sure. There has been criticism that we have gone too far in FCPA enforcement and that we are harming competition. I think though, that when you actually look at the cases we have brought, it is hard to argue that we have been overly aggressive. Maybe there are one or two cases out there, and it is possible to bat a thousand I guess, but if look you at our track record, I think that it is pretty good and that the cases we bring are

those that should be brought. I would say that enforcement is increasing significantly around the world, not just in Europe, but even in higher risk areas like Asia, Africa, Eastern Europe, and Russia. I think this also has a significant impact on compliance by organizations because they are realizing even if their conduct escapes our notice, there is a good chance that some prosecutor in Europe or Africa may be looking at the same conduct.

I think the trend, in fact, there is no question, the trend is moving toward increased compliance, and from our perspective, the more enforcement there is, the less that companies could have an argument that we are losing businesses and competitors are getting it. As long as everyone is getting caught, then all companies I think have an incentive to do things ethically. It is only when someone acts ethically and follows a compliance program, and then their competitor, their corrupt competitor gets the deal but you have the argument. If the competitor is acting corruptly, and gets caught, then it is obviously going to be a worse position at the end of the day than the company that behaved ethically in the first place.

**PAUL MCNULTY:** Transparency International in the OECD, kind of monitors countries and does report cards and evaluations, and right now, the U.S. and Germany are kind of getting the best grade for their enforcement, but among the 38 countries of the OECD, they are all making improvements with their new laws. Then again, as Jeff said, in countries that are getting involved but probably on a monthly basis, we see a significant development globally in the either, development or the enforcement of some anti-corruption law so it is definitely changing. Yes, sir?

**AUDIENCE MEMBER:** I was with the Department of Labor. We found there was a major disconnect between the agencies that were responsible for enforcement of OSHA, FCCP, a whole raft of places. And the question I had was with regard to unions; there are violations the Department of Labor was not involved with that. The question I had is, what type of cooperation do you have with all the enforcement agencies. You go in there as a task force to put together something and you say, "Hey, we know how we found this, but we found this and blew a global whistle on that." In other words, a joint effort for all the enforcement agencies so that you work together. It did not happen back in the 1970s, I will tell you that.

**PAUL MCNULTY:** Well, in 2006, when I was deputy, we fixed all that. Oh, yes, working cooperatively together. Sure, that it is a major challenge and I want to say just two things about it. The first thing is that there are some efforts made to get agencies together. I think increasingly you see the IGs of departments and you see in certain themes such as the mortgage fraud issue or in my day it was more the accounting fraud cases after Enron where there is a collaboration with agencies among various authorities to team up and compare cases and try to, you know, look at it from a different

angle, so I think there are efforts and sort of fits in starts made in that way, but the other thing is to remember that when you have civil liability issues such as these agencies you mentioned, and the enforcement that they can do, they tend to be almost like strict liability.

You know, you violate that standard and we are going to impose this penalty. It is a civil issue; therefore, it is about how much money you pay as a penalty. The DOJ is bringing the criminal enforcement aspect into this. The criminal enforcement issue has a certain amount of extra harm and impact in the company, and so that operates in a kind of a different way in this issue of what mitigates or what are all the discretionary issues tend to be a little bit more significant yet a little bit more opportunity to argue them on that criminal side but it's a great point about—and goes back to Pat's point about the need to have the collaboration of standard. You must be giving me a signal of some sort.

Well, listen, it is wonderful to be here with you. Thank you for enduring the heat.

**KAREN CZARNECKI:** Good news, the next room is twice the size so it should be cooler in there.

**PATRICIA HARNED:** It has got to be 90 degrees in here.



EMINENT DOMAIN, MORTGAGE MODIFICATIONS &  
THE RULE OF LAW

*Walter E. Dellinger*

**D. BRUCE JOHNSEN:** Walter Dellinger is a partner at O'Melveny & Myers in Washington D.C., he is a member of their Appellate Practice. He has a long and very distinguished resume; he served as Assistant Attorney General and was head of the Office of Legal Counsel from 1993 to 1996. He was acting Solicitor General for the 1996-1997 term of the U.S. Supreme Court during which time he argued nine cases before the Court, the most by any Solicitor General in more than 20 years. He has argued cases involving such diverse issues as physician-assisted suicide, the line item veto, the Cable Television Act, the Brady Act, Religious Freedom Restoration Act, and the constitutionality of remedial services for parochial school children. He has argued various cases in front of the Supreme Court, not in his capacity of Solicitor General. He is published in the *Harvard Law Review*, the *Yale Law Journal*, the *Duke Law Journal*, and in non-academic venues such as the *New York Times*, the *Washington Post*, *Newsweek*, the *New Republic* and the *London Times*. He has visited various universities across the globe including Catholic University of Belgium, university facilities in Florence, Italy, Siena, Italy, Nuremburg, Copenhagen, Leiden, Utrecht, Tilburg, Mexico, and Rio de Janeiro. Please join me in welcoming Walter Dellinger who is . . .

**WALTER DELLINGER:** Let me begin by asking Bruce a question before he leaves the microphone, have you all discussed this issue earlier today?

**D. BRUCE JOHNSEN:** No.

**WALTER DELLINGER:** This is the session on eminent domain. All right, I just wanted to know where we were starting. I am happy to talk about the eminent domain issue and we will cover that, and answer any questions about it. I am not sure that takes up the full amount of time that we have available so I am happy to talk about what else is happening at the Supreme Court this term, what it is like to argue before the court, what changes are likely in the future of the court, anything you all want to ask questions about after we cover some eminent domain issues. I would be more than happy to discuss those other subjects.

Here is how the eminent domain issue arose. Everybody knows we have a very serious housing problem in the country. We over-borrowed on money and the housing values were inflated. There are a lot of counties in the country, many of them located in California, Florida, Arizona, other

states are particularly impacted in which the amount of the mortgage is greater than the remaining indebtedness on the mortgage, is greater than the value of the property. Many of those go into foreclosure. And there has been a very serious proposal put forward by a group called Mortgage Resolution Partners to try to do something to ameliorate this problem. The stated goal being to remove the blight that is causing neighborhoods where houses are underwater, the mortgages and the homes have been abandoned, and power of eminent domain should be used to do that. Now, I was retained to do a memorandum on this subject by the Securities Industry Association so that is how I have come to take a particular look at that issue.

The plan is simply this: to use the power of eminent domain, which can be used not just for real property but the eminent domain has been used in the past for some intangibles. The Mortgage Resolution Partners proposal, which has been under very serious consideration is San Bernardino County, California and Chicago and in other areas, would seize only mortgages where the homeowner is actually performing; is making payments on the loan, but to seize those and to pay as compensation for them on an amount equal to 75 or 80% of the current value of the home. So if there is a \$150,000.00 mortgage outstanding balance on a piece of property, if the assessed value is \$100,000.00 and if they would propose to pay 75% or \$80,000.00 in compensation to the mortgage holder with that additional discount being the fact that if the mortgage holder, the bank, whoever had to go through foreclosure processes, the transactions cost would be significant. So the mortgage holders got a note for \$150,000.00 they would get 75% or \$80,000.00 in payment for it, the Mortgage Resolution Partners would then resell it to private investors and the homeowner would be able to pay off the remaining indebtedness for \$100,000.00.

So they go to the counties, and they are able to say to the counties, this is sort of a win-win situation. A win-win situation in that the homeowners get a substantial reduction in the amount of their mortgage, the mortgage holder gets all they reasonably ought to be able to expect, and we can move this along. It is certainly a well-intentioned goal of doing something about the housing crisis. The question that arises is whether this is an appropriate use of the power of eminent domain. So the first critique that we made on behalf of the Securities Industry Association is that it is not clear that this taking is for a public use. It works only if you are actually not paying fair market value for the property, you are paying the mortgage holder less than the mortgage holder thinks the loan obligation is actually worth and then reselling it immediately to other private investors. So they take property from one set of private investors and transfer it to another is not itself going to be a public purpose. Now, is there an argument that it makes the community better? Yes. But so would any redistribution of property make the community better off, you could certainly argue that is a valid public purpose and if it were true here it would be true everywhere, but from the standpoint of the mortgage holders that's not fair mortgage value. They



have a contract; they're entitled to \$150,000.00. The security on that may not be worth that amount but to discharge that obligation for 75% or \$80,000.00 would not be beneficial.

The second problem is the valuation. The loans that are proposed to be taken by this process are performing loans; people are actually paying on them. So if someone is actually paying, the value may be the total value of the note. Now predictably you can think that people are not going to pay forever on a note where the security of the home is worth less than the amount of the note. But a lot of people are paying on those loans. But secondly, there is fairly subtle takings law that you are entitled to the whole loss and it is not just the individualized loan. What has happened to these loans is that they have been securitized into packages of loans. So if you go and you pluck out, seize that is, the performing loan, you have a problem that the value of the whole securitized package is diminished, and that loss could be considerable. And so I think one of the concerns that communities ought to have is that they may be responsible for excess liability. The plan is to take these mortgages by a quick take procedure where you take it first and then estimate the amount to be paid later.

But the law is pretty clear. I argued one takings case on the side of the taker actually. I argued the case in the U.S. Supreme Court—Washington Legal Foundation.<sup>1</sup> The only time I believe I represented judges as my clients; I represented the Chief Justice and the Associate Justices of the Supreme Court of the State of Washington. And in that case what was being challenged was the IOLTA programs with which I think probably all of you are familiar, that use the interest on lawyers' trust accounts to fund legal services for the poor. Those lawyers' trust accounts cannot earn positive interest on their own because setting them up just to hold the money for a brief period of time would not be worth the transaction cost but if you pool them all nationwide—at the time I argued the Washington Legal Foundation case nationwide it was generating about \$250,000,000.00 a year for all kinds of legal services for low income people by these programs. It was challenged by sort of property rights theory folks from the Washington Legal Foundation of Washington, D.C. was suing the Legal Foundation of Washington State, I know that got confusing; I think the court finally changed the name to *Brown v. Washington Legal Foundation* at the end to clarify the parties. Former Solicitor General Charles Fried argued, for the property rights side, that the court had previously held that this interest was the property of the client but had not yet addressed the question of whether it was a taking. And we argued that it was a dog in the majors; it is that the money was not of any value to the client because you could not effectively earn interest on it, that there was no taking of anything of value. It was a really hard fought case, but the Court, five to four, upheld these programs

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<sup>1</sup> *Brown v. Legal Found. of Wash.*, 538 U.S. 216 (2003).

for funding legal services of the poor saying that you measure the proper measure of compensation as the loss to the property owner and there is no loss. The challenger just wanted to stop the program and stop the funding of legal services because of this theoretical violation where there was actually no loss to the individual clients because of the transaction costs. But in that case the court was pretty emphatic that you measure the loss to the property owner, not the benefit that someone gains.

And this case, it turns out, that that position helps the banks or the investors who are holding these mortgages that are going to be taken from them and given to other private investors. Because they can argue that once you start plucking certain loans out of a securitized package, the loss of the whole package may exceed those individual amounts, so that there could be significant excess liability on the part of counties. Now let me say one other word, since I have honorable judges here. It was really a wonderful experience to represent judges. The IOLTA program in Washington was adopted by the state Supreme Court so they were the defendants and they were my client. And it looked like it was going to be a tough case to win because in an earlier case from Texas where the court held that the interest on lawyer's trust accounts was the property of the client, they looked like they were one step short from holding five to four that you could not engage in these programs and do the taking.<sup>2</sup> And I thought, what could be different about this case from the Texas case? Well, in the Texas case the Legal Foundation was the recipient of the money even though the state of Texas was the one actually doing the taking so it was property right advocates versus liberal do good people. And it was five to four—five property-rights, four do-good-liberal people. I wanted to emphasize this was something state judges had adopted on their own, that since I think Justice O'Connor was going to be the possible swing vote in this case it is very important to recognize that some deference to a state trying to deal with the problems of what you do with excess lawyers' trust accounts. It's not right to let the bank just reap the money or let the law firm just reap the interest; that gives them an incentive to delay, not that anybody would be expected to act on that. But there are some problems that are solved by aggregating into lawyers' trust accounts. And it was useful to have a Justice who might be undecided about this case who might have been a state court judge before going on the U.S. Supreme Court.

So that I wanted to make this case about tough judgments that were made by judges of the Supreme Court of Washington thinking that raises the deference level that ought to be accorded to the program in question. So I asked Chief Justice Alexander if he would come to the argument. I know it is a long way, he said he would be delighted to come to the argument. Then I thought, that is really good, the Chief Justice of the state's

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<sup>2</sup> Phillips v. Wash. Legal Found., 524 U.S. 156 (1998).

Supreme Court will be there and that will really make the point that this is about what state courts are doing. But then I realized, how will they know he is there? Right? They will not recognize him and I was struggling with that. I was out jogging when the idea hit me. I had to stop and find a pay phone—a few years back there were still pay phones—and I called the Honorable Chief Justice and I said, “is it possible that in your busy career being on the west coast you have never had the occasion to be admitted to the bar of the United States Supreme Court?” He said “no”, I said “yes, that is right, so I will get the papers ready, we are coming.” So when court opened that morning, right before the first argument, I got to stand up and say “may it please the court, I move the admission of the Honorable Gary L. Alexander, Chief Justice of the State of Washington, I am confident he possess the necessary qualifications,” and they all nod, adding the Chief Justices there. And I already knew that the first words out of my mouth were going to be, “the Chief Justice and the Associate Justices of the Washington Supreme Court, after long and careful study have adopted this plan,” so that was a sense of a way to make the court understand that states and state court judges have a lot at stake here and indeed we did prevail and with Justice O’Connor joining the majority.

But Justice Stevens’ opinion and the case made it clear that the private party is entitled to be put in as good a position pecuniarily as if his property has not been taken, he must be made whole but not entitled to more. Now, the “not-entitled-to-more” was what was the critical part in Washington Legal Foundation, and here in this case the other part it is that you’re entitled to be made whole as if your property had not been taken. So, if plucking one mortgage out of a securitized package is going to reduce the value of the overall package then the appropriate compensation may be the diminution and loss. And these packages of mortgages are now held by all sorts of pension funds, teachers association retirement plans, all sorts of state government plans; all these would suffer by it.

Plus there is the added question—when you think of seizing property by eminent domain you usually do not have any difficulty deciding where the property is. If it is a building that you want to tear down so Wal-Mart can build something fancier at least you know where it is, but here it is not clear when you are seizing the mortgage obligation that has been repackaged and resold, owned by the New Jersey Retirement Association, what you are seizing or where it is. Is there really jurisdiction on the part of the state or the county, say in California, over such an instrument? I think the memorandum we did on this may have stalled this. Since we did a widely circulated memorandum about what the legal issues would be and what the excess liability would be, no jurisdiction has moved forward, it is all on hold. Many are still looking at it but no one has actually adopted a plan to try to seize these mortgages.

The other issue goes back to the time of the founding in the sense that if you have a mortgage obligation and you are the mortgage holder it is

worth \$150,000 on its face, and it is not clear to me that you can use the takings clause and pay someone \$80,000 just because that is the current market value because you run into a contracts clause<sup>3</sup> problem in my view. At the time of the founding there were many circumstances in which indebted farmers had debts that could not be repaid and because of deflation they were actually paying back a lot more and state legislators were passing laws that said you can discharge loan obligations at \$0.50 on the dollar, for example. And the contracts clause is really put in to stop that from happening and to prohibit impairing the obligation of contracts. It is one of the really conservative property oriented provisions of the Constitution and intended as such and it even contemplated circumstances in which a loan obligation was for more than it was worth and in their judgment they tried to make those secure.

There is also a problem I increasingly think of, whether there is some federal preemption of this kind of regulation of what really are national and international securitized packages by a particular local jurisdiction. And here I think, to broaden the subject just a bit, we are looking forward over the next decade or two where I think a recurring issue for the courts is going to be the question of federal preemption. And that is because we have increasingly vigorous enforcement actions at the state level. One can argue quite vigorously both sides of the value of more vigorous state enforcement. Certainly there are those who will argue that lax regulatory authority by the SEC led to state attorneys general taking much more aggressive stance, certainly led to, in New York, Spitzer, Cuomo, and others. But around the country I think state attorneys general and other state Consumer Affairs offices have become much more aggressive in going after commercial transactions which appear to violate state law and to seek to regulate those activities. After the tobacco settlement, a number of attorneys general ran successfully for governor because AG's offices come to be seen as profit centers—if you can find the right litigation to bring and to sue malpractors and then others see it as a way to fill in for inadequate enforcement at the federal level. That is the sort of pro-state enforcement side of the argument. On the other hand there is the concern that we are moving towards having fifty-one different systems of regulation and that that poses problems for the national economy.

I have done a couple of debates at the Federal Society on the question of federalism and business where it is really not clear even to politically conservative policy advocates what the right answer is when federalism means lots of experimentation with national business enterprises. I know the General Counsel of General Motors said that he used to love to hear young conservative academics talk about the importance of states as laboratories of experimentation—a great goal of state's rights, states as laborato-

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<sup>3</sup> U.S. CONST. art. I, § 10, cl. 1.

ries of experimentation. He said then I realized my company was one of the laboratory mice and all of a sudden it seemed less appealing to me than it did before. Some people have suggested that on these larger preemption issues we have to be concerned about whether we are en route to trading places with Europe in the following sense. About the time I got out of law school, which was in the mid '60s, we were bearing the fruit. This is that period, post-World War II period where we are really bearing the fruit of the fact that the framers created in Philadelphia in 1787 the greatest common market the world had ever seen. It was really an extraordinary achievement in Philadelphia given the fact that a dozen years earlier in 1776 John Adams could write home to the remarkable Abigail and he wrote about we are 50 gentlemen, all strangers when they first met in Philadelphia.<sup>4</sup> We are fifty gentlemen, all strangers, not acquainted with each other's ideas, views, designs. We are therefore jealous of each other, fearful, timid, skittish. So they came to Philadelphia as defenders of histories accomplished, they did not see themselves as a beginning but as continuing traditions of independent rule and government. But what came out of Philadelphia at the end of the summer of 1787 was a truly extraordinary government, continental in scope. With the powers John Marshall was to say to raise armies and navy, to send treasure from the east to the west, to regulate from the St. Quad to the Gulf of Mexico, from the Atlantic to the Pacific, and it created through the Commerce Clause this extraordinary continent-wide common market.

Now at the time I was sort of learning and getting the sense of how that had led us into the American century post-World War II; what was Europe like? Europe was a vulcanized economy where one's image in the '50s and '60s of Europe of a commerce of Europe was fruit trucks and vegetable trucks backed up at the border between Spain and France with rotting vegetables while people were trying to fill out quadruplicate forms for everything—the barriers to getting French vegetables into Spain and Spanish wine into France, for example, while our economy was thriving. Now what is happened is, though they are struggling in the short term, Europe has created a 400 million person common market which is increasingly subject to a single regulatory system. So that it is a real challenge to American commercial leadership to have fifty-one different systems of regulation. And when I talk to Corporate Counsel they see preemption as a more important issue than virtually anything else affecting many industries; they want to be under a single system of regulation. So whatever it's guise I think you will see issues arising as we go forward about the very legitimate degree to which state governments want to protect their own citizens from practices that seem untoward and to make up for federal regulatory failures

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<sup>4</sup> Letter from John Adams to Abigail Adams (25 September 1774), in *Adams Family Papers: An Electronic Archive*, MASSACHUSETTS HISTORICAL SOCIETY, <http://www.masshist.org/digitaladams/aea/cfm/doc.cfm?id=L17740925ja> (last visited Mar. 22, 2013).

and at the same time. The other side of that equation, the need to have a single regulatory system in running a national business and trying to cope with fifty-one different regulatory systems, particularly if it comes to the areas of securities regulation and the free-flowing financial markets—it is a great challenge. So I see, without regard to any particular case, that over the next decade it's going to be one of the major issues that I think the Supreme Court will confront.

Now what I would like to do is take some questions on that or any other topic that you want, or comments. It is a lively term coming up, lively term last year, the Supreme Court, to put it mildly. And, another lively term coming up soon.

**D. BRUCE JOHNSEN:** Let's hear your idea of what is coming up soon.

**WALTER DELLINGER:** Oh, okay, what is coming—yeah, I will take one—first question, what's coming up soon? Next question?

**AUDIENCE MEMBER:** Me?

**WALTER DELLINGER:** Yes.

**AUDIENCE MEMBER:** You said any question, right?

**WALTER DELLINGER:** Yes.

**AUDIENCE MEMBER:** I'm from Alabama and the court could bring this week to take Voting Right Acts case up in *Shelby*?<sup>5</sup>

**WALTER DELLINGER:** Okay, good, *Shelby County*. I will begin by starting with the fact that *Shelby County* is huge and difficult. The issue is whether Section Five of the Voting Rights Act<sup>6</sup> is unconstitutional. Section Five requires that the covered jurisdictions—think basically the Southeastern Conference, and you'd be roughly close—whether the covered jurisdictions are required, before they make any changes in election law. To submit in advance those changes to either the Attorney General or to the District Court or the court in the District of Columbia for preclearance, and no changes can go into effect until that preclearance is done. It is an extraordinary remedy and an extraordinary time. And the question is whether it should be reconsidered. Now it was originally upheld in *South Carolina v. Katzenbach*.<sup>7</sup> I think my nominee for the most important piece of legisla-

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<sup>5</sup> *Shelby Cnty. v. Holder*, 679 F.3d 848 (D.C. Cir. 2012), *cert. granted*, 133 S. Ct. 594 (Nov. 9, 2012) (No. 12-96).

<sup>6</sup> Voting Rights Act of 1965 § 5, 42 U.S.C. § 1973c (2006).

<sup>7</sup> *South Carolina v. Katzenbach*, 383 U.S. 301 (1966).

tion ever enacted by the National Congress would be the Voting Rights Act of 1965.<sup>8</sup> For nearly a century the 14<sup>th</sup> and, in particular, the 15<sup>th</sup> Amendments had been a dead letter in whole sections of the country. We amended the Constitution to prohibit denial of the right to vote on the grounds of race and it'd simply been ignored through one stratagem device after another. And whenever one would sue it would invalidate one provision, another would be enacted. Whether it was that you had to pass all these tests, which people were exempt if they could prove that a grandparent had been a registered voter or endless other tricks and devices that meant that you had very few African Americans permitted to vote in the deepest parts of the South in pockets only in states like North Carolina. Throughout the '50s and '60s litigation had just been a failure, suing each registrar individually for refusing to register African Americans and then if you win that suit, a new rule is adopted and there is always another rule.

So what Congress did was really extraordinary and it was Lyndon Johnson's great achievement. The Voting Rights Act says we are basically putting this portion of the country under federal receivership, we are sending in federal registrars, and we are going to do this if you meet certain criteria which were, everybody understood, reverse engineered to identify the states where there was a problem. But if you had fewer than 50% of your eligible voters registered or fewer than 50% actually voting and you had employed a test or device other than age, residency, and citizenship, a test or device as a pre-condition to voting anytime in the previous five years, then you were a covered jurisdiction. And it wiped out all the literacy tests, poll taxes, etc. and said you cannot adopt anything new without going to Washington for permission from DOJ or from the court of the District of Columbia. And this was an extraordinary remedy, an extraordinary remedy. If you think of it at the time of the founding, the idea that states could not enact laws until they got permission from the national government, which seems striking—well, it should not be all together shocking. Madison proposed it across the board; Madison proposed that no state laws be able to go into effect until they'd been first submitted to Congress.<sup>9</sup> It was his idea of how to have a real national government. It may have been appealing to some in theory but in practice it was unworkable. They said, if Georgia has a problem on its borders and they need a new law, by the time they got it to Washington and back, it would not work practically, so the convention rejected that idea.<sup>10</sup>

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<sup>8</sup> Voting Rights Act of 1965, Pub. L. No. 89-110, 79 Stat. 437.

<sup>9</sup> THE CONSTITUTIONAL CONVENTION AND THE FORMATION OF THE UNION 116 (Winton U. Solberg ed., Univ. of Ill. Press 2d ed. 1990) (1958) (“[Mr. Madison] could not but regard an indefinite power to negative legislative acts of the States as absolutely necessary to a perfect system.”).

<sup>10</sup> *Id.* at 119 (“How can it be thought that the proposed negative can be exercised? [A]re the laws of the States to be suspended in the most urgent cases until they can be sent seven or eight hundred miles, and undergo the deliberations of a body who may be incapable of [j]udging of them?”).

So here at least in this respect you have this dramatic, dramatic remedy. You wipe the board clean; you send in federal registrars, you allow no changes without preclearance. And the Supreme Court allowed South Carolina to bring an original action in the U.S. Supreme Court to challenge to constitutionality of that. I had clerked two years later for Hugo Black, who was very troubled by it and thought the preclearance provision was unconstitutional even in light of enormity of it. But the court did it and it worked. I mean the transformation that rippled through over the next ten years where we now in the South have African Americans on juries, as prosecutors, as judges, as justices, a whole system was transformed by this act and it brought us, honestly, in compliance with the 15<sup>th</sup> Amendment.

But now times have passed and the original law was five years. It was reenacted and extended in 1970 and was reenacted again in 2006 and now it has been challenged again. So what is really being challenged is the 2006 law to extend the Voting Rights Act from its expected expiration date—yet again for another period of time going into the future.<sup>11</sup> And they're two challenges that are being raised by Shelby County, Alabama. One is simply that the burden is no longer justified, as it was in 1965. And it really does appear to me that they're five Justices who are sympathetic to that argument, and one thing that has happened since 1965 is of course jurisprudence has shifted in a much more deferential direction so that Justice Kennedy can speak of insults to the dignity of the states by having them have to go "hat in hand" to Washington to ask permission to change their law etc. Now I am not as taken with this concept of the dignity of the states as the majority of the Supreme Court is; I thought about writing an article about it called *Can a State Blush?* I mean sort of anthropomorphize the states here but I'm not on the Supreme Court and they are so I think there is a lot of sympathy to that.

The second question is, if you get past the first one and there's still justification for having some jurisdiction subject to the burden of getting preclearance for their laws, is whether the coverage formula has become irrational. What happened is the coverage formula has not changed. They are using 1970, not 1965, data but you are a covered jurisdiction based upon your 1970 voting figures and in the earlier argument of the Voting Rights Act case there was really a skewering of the Solicitor General as to how this was possibly rational and how it made sense not to use 2005 data instead of 1970 data; why not reopen the determination of what states and counties were covered?<sup>12</sup> Now this is a question where I think you are pitting theorists against pragmatists because there is no good theoretical answer. And some would say no good answer at all but I can see there is no good theoretical answer to the question of why you use an outdated cover-

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<sup>11</sup> Pub. L. No. 109-246, 120 Stat. 577 (2006).

<sup>12</sup> See, e.g., Mem. of Points and Authorities in Support of Plaintiff's Motion for Summary Judgment at 1, *Shelby Cnty. v. Holder*, 811 F. Supp. 2d 424 (D.D.C. 2011) (No 10-0651).



age formula. It was a very good practical answer of practical politics, which is that you could get even the southern delegations to go along and vote to extend the Voting Rights Act on the basis of the old formula without making a new judgment about who are current sinners. Reopening the coverage formula reopens the whole blame game; the current blame game that was going to make the whole process collapse whereas just using the historic formula about who historically had practices of racial discrimination was something you could get through.

Whether that is convincing to the court, I do not know, but that is the first argument and the Solicitor General will also argue that they're opt in and opt out provisions. Actually, very few people have done it; only 17 jurisdictions, like counties, have opted out. You can show that you shouldn't be covered any longer. And if a court finds active discrimination they can add a jurisdiction to what is practically the coverage so there's some opt in opt-out status, not a fix set, so it is not irrational. But those are the two questions. Is it now unduly burdensome, particularly in light of the fact that this court is very wary about burdens imposed by the national government on state governments and their dignity and two, even if it is, is the existing coverage formula not sufficiently rational since it has not been updated?

**D. BRUCE JOHNSEN:** They're just asking questions.

**WALTER DELLINGER:** Okay. That's the—yes, sir.

**AUDIENCE MEMBER:** The Supreme Court will do to Affirmative Action?

**WALTER DELLINGER:** I think the only question is whether it's going to end Affirmative Action in one step or two. That is to say the Texas case that is before the court comes out of Texas at a time when, in the Fifth Circuit, no consideration of race was permissible because of a Fifth Circuit decision which the U.S. Supreme Court did not review so the Fifth Circuit was under its own law.<sup>13</sup> Texas adopted this top 10% plan that if you're in the top 10% of a Texas high school you can be admitted to the University of Texas at Austin as well as the other campuses and then they have added to that some measure of consideration of race among a number of other factors because that 10% plan wasn't actually producing what the educators wanted to see in terms of diversity. I think the court is prepared to hold either that in light of the 10% plan that was producing some significant diversity in the student body there was not a significant justification for any further consideration of race or they're just going to overrule the Michigan

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<sup>13</sup> *Fisher v. Univ. of Tex.*, 631 F.3d 213 (5th Cir. 2011), *cert. granted*, 132 S. Ct. 1536 (Feb. 21, 2012) (No. 11-345).

cases or at least the Michigan Law School case.<sup>14</sup> It is really the replacement of Justice O'Connor by Justice Alito changes that so I think they will either do it in a small step or a large step. Yes, ma'am?

**AUDIENCE MEMBER:** What do you think is going to happen with the same sex marriage case?

**WALTER DELLINGER:** Oh, right, that is right. Those are big, those are coming up. They are two cases; they are two sets of cases coming up. One is the appeal from California on whether there is a federal Constitutional right to same sex marriage up from the Ninth Circuit<sup>15</sup> and the other is the Defense of Marriage Act cases.<sup>16</sup> The court is going to decide at the end of this month which cases to take. There are several cases under the Defense of Marriage Act,<sup>17</sup> let me first say that the California case is a mess. And it is a mess because I am not sure there is anybody who has standing to raise the best issues in the case, I really do not. A challenge was made on grounds of due process, equal protection—the case brought by Ted Olson and David Boies in California.<sup>18</sup> They prevailed in the district court and the state defendants did not appeal. The governor, the attorney general, and the registrars of the two counties where the suit was brought did not appeal. I think it was over when the time for appeal ran. There was a group of interveners who came in who were people who supported the referendum that restored one sex only marriage or whatever you call it, man-woman marriage whatever, traditional marriage, whatever you want to call it—was when that the people that supported the referendum they intervened in the case.

Now I think they arguably had standing on one issue only and that issue I think is not even a very good issue for attacking the state's restriction and that is whether there was something wrong with the referendum—they get to litigate the referendum process and nothing else. They appealed and the Ninth Circuit held that they had standing to appeal after referring the question to the California Supreme Court. But I think the reason Judge Reinhardt wrote an opinion saying I am only going to decide this on the basis that the referendum violated the rights of those who want to be married, the referendum violated their rights because perhaps the tone of the referendum and the fact that it took back a right that had been established—

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<sup>14</sup> *Grutter v. Bollinger*, 539 U.S. 306 (2003).

<sup>15</sup> *Hollingsworth v. Perry*, 671 F.3d 1052 (9th Cir. 2012), *cert. granted*, 81 U.S.L.W. 3075 (U.S. Dec. 7, 2012).

<sup>16</sup> *United States v. Windsor*, 699 F.3d 169 (2d Cir. 2012), *cert. granted*, 81 U.S.L.W. 3115 (U.S. Dec. 7, 2012).

<sup>17</sup> Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7 (2006) and 28 U.S.C. § 1738C (2006)).

<sup>18</sup> *Hollingsworth*, 671 F.3d 1052.

I just think that that argument is going nowhere. The argument, the straight up argument of equal protection I think is a strong one but not this argument—and I think Judge Reinhardt decided on that basis because he knew that was or felt that was the only issue that was properly before his court at the behest of referendum sponsors. They do not have a dog in the fight for the next fifty years of whether someone has a federal Constitutional right to same sex marriage. I do not know what the court's going to do but that case is a mess because the state did not appeal, and the defendants did not appeal. And they may hold that it simply was over at the district court and vacate the Court of Appeals decision which would mean that that case is literally only binding on the two jurisdictions where there were state defendants. But I can tell you that the state attorney general and the Governor of California are going to say we accept the District Court decision and we're going to consider the limitation against same sex marriage is invalid, we are going to accept that district court decision as a practical matter. Now some future governor or attorney general can change their mind but in fact they never will, they never will.

We all know where this issue is going; it is a one-way ratchet. I have never seen anything in my lifetime move as fast as an issue like this has moved, which is relevant to the other case, involving DOMA. DOMA was signed by President Clinton. The Defense of Marriage Act was enacted before any state had allowed gay and lesbians to marry but one state, Hawaii, the court had posed the question as whether there was a Constitutional right, that is all that happened. What DOMA did was to change federal law, which had basically for 200 years said that whenever federal law turns on whether someone is or is not a spouse; you answer that question by looking to state law. If you are married in the state in which your relationship is domiciled, that is good enough for the federal government. So, if you are an age of marriage which is younger than a lot of other states, you still get federal benefits or federal burdens as the case may be. There are a couple of thousand provisions of federal law that use the term spouse so it's a big deal. And it was theoretical only since at the time no state allowed same sex marriage but basically says if it does no federal agency is to recognize it. The *Windsor* case,<sup>19</sup> which is the case they'll probably take, the DOMA case, comes out of New York, a state that permitted same sex marriage. A couple, two women, got married, been lifelong companions, once New York legalized gay marriage. One of them died, Miss Windsor's partner died, and she had to pay the full federal estate and gift tax, which as you know when you die your estate goes to your spouse without having triggering federal estate and gift tax. So she is seeing this as a straight up case of "I'm married under the law of New York, New York recognizes my marriage, I'm married under the law of New York and like any other married

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<sup>19</sup> *Windsor*, 699 F.3d 169.

couple in New York I'm entitled to inherit from my spouse without having to pay estate and gift tax."

Now that is the Windsor case: nice, clean simple case and I think it would be a better step for that to be the next case. If you are a gay rights advocate, you would want that to be the next case because it is an easier step because state's rights and gay rights are on the same side in the DOMA case. The DOMA case has no consequence in Alabama or North Carolina or any other state which has not allowed gay marriage, has no consequence whatsoever. The DOMA law only has an effect now in the six, seven, eight—the number is going up—jurisdictions that allow gay marriage by overriding what the state has done. So it is a great opportunity for whoever argues to go after Justice Kennedy by bringing state's right and gay rights together and saying look, the state of New York<sup>20</sup> and now the state of Maryland<sup>21</sup> and the state of Maine<sup>22</sup> by popular referendum allow these people to be married and you, federal law that usually doesn't decide laws of marriage and divorce, it's really none of your business, you were right all along just to defer to whatever the states said, what business do you have overriding state judgment? So that's the strange case, gay rights and state's rights on the same side. Yes?

**AUDIENCE MEMBER:** I respectfully disagree that it does not matter to other states because if you are married in California and you come to Colorado to get your divorce, Colorado law says both in the state constitution and in DOMA that you cannot get divorced in Colorado because we do not recognize that you were ever married.<sup>23</sup> So I think, I think DOMA as well as many—some state constitutions really impact us.

**WALTER DELLINGER:** I am sorry. There are—it is Title three of DOMA that is before the court, what is not before the court is Title two. Title one is the title, used to be known as the Defense of Marriage Act. Title two says that no state is required to give full faith and credit to a marriage of people of the same sex from another state; that is not being challenged so what I was talking about, this does not affect that. And I always thought at the time, I was in the Office of Legal Counsel, that Section two was inconsequential in a sense that that already would be the law. I think it is fairly well accepted that a state does not have to give full faith and credit where it has its own social policy that differs from another state. So I think before,

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<sup>20</sup> N.Y. Dom. Rel. Law §§ 10, 11, 13 (McKinney Supp. 2012).

<sup>21</sup> Annie Linskey, *Maryland OKs Historic Same-Sex Marriage Law*, BALTIMORE SUN, November 7, 2012, at 1A.

<sup>22</sup> Susan M. Cover, 'A New Day for Marriage Equality'; *Maine is One of Four States Whose Electorates Support the Gay-Rights Issue at the Ballot Box*, PORTLAND PRESS HERALD, November 6, 2012, available at Factiva, Doc. No. PTPH000020121108e8b800006.

<sup>23</sup> Colo. Rev. Stat. § 14-2-104 (Supp. 2012).

during, and after DOMA, Colorado is not required to recognize a marriage from Maine or Maryland or New York or California. So the only issue up in DOMA is Title Three of DOMA which has to do with federal statutory law, social security tax, all that stuff. And that has no consequence in any state—the provision itself has no consequence in any state other than the states that have allowed gay marriage where their marriages will be recognized. Nothing changes in North Carolina if DOMA is struck down if Title three of DOMA is struck down.

**AUDIENCE MEMBER:** I still think it's an equal protection problem.

**WALTER DELLINGER:** Title three only addresses questions of federal law and not any question of state law is the point but—

**AUDIENCE MEMBER:** But, federal law impacts divorce significantly in terms of the tax consequences—

**WALTER DELLINGER:** Right.

**AUDIENCE MEMBER:** And all those kinds of things so I am not understanding why striking down Section three wouldn't matter.

**WALTER DELLINGER:** Because in North Carolina—if you are a gay couple in North Carolina you are not allowed to get married, right? And so you are not married for state purposes and you are not married for federal purposes before and after DOMA. In Maine now you are entitled to be married and if DOMA's struck down, federal law will have to recognize the validity of the marriage. Yes ma'am?

**AUDIENCE MEMBER:** My question is: does that mean that after *Loving v. Virginia*<sup>24</sup> all states did not have to recognize interracial marriage?

**WALTER DELLINGER:** The answer is before *Loving*, states did not have to recognize interracial marriage. After *Loving*, there was a Constitutional right everywhere. So after *Loving*, what's interesting is if the court were not to take DOMA—this is odd, not likely to happen—if the court held that there was a federal Constitutional right and invalidated state laws that limited marriage to opposite sex couples, DOMA would still be the law and would still say you are not married for federal tax or social security or any other purpose unless and until the court struck that down as well, which I think would necessarily follow from that. Yes sir?

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<sup>24</sup> *Loving v. Virginia*, 388 U.S. 1 (1967).

**AUDIENCE MEMBER:** I guess we have to use the mike. So let me move you off of same sex marriage for a moment and consider that last week two states voted to legalize “recreational” marijuana use.<sup>25</sup> Other states, several have passed—including mine—have passed laws allowing for the medical use of marijuana. Considering *Gonzales v. Raich*,<sup>26</sup> if—and also your comments about federal preemption in the business context, are we going to see some court—ultimately all Supreme Court ruling that all state laws with the respect to marijuana use at least or other forms of drug use are preempted?

**WALTER DELLINGER:** Yeah, I may be missing something on this. It seemed to me that what those two states have done is change state law, right? And so it is no longer a violation of state law in Colorado to possess marijuana and so but if it remains federal law, it is still a violation of federal law and that is unchanged by anything those states did. Now I guess the problem comes when the state is going to license retail facilities so the state licenses it and you’re immediately in violation of federal law, right?

**AUDIENCE MEMBER:** Or taxes it.

**WALTER DELLINGER:** What?

**AUDIENCE MEMBER:** Or taxes it.

**WALTER DELLINGER:** Or taxes it, right. So you are in violation of federal law. Federal law is supreme on that, I mean it is just a matter, I would guess, of prosecutorial discretion. I can see the attorney general at least addressing the question of whether U.S. attorneys should be told that they should not enforce federal criminal marijuana laws in states which have opted to remove the state criminal penalty but that was not the position that the justice department took that last time around. I suppose it is not even a really tough question for the Department of Justice; I do not know what you do unless until Congress changes the federal law. I guess it could be that you think the federal government has a lot more things to worry about and if the local Colorado police are not going to be hassling you, you’re unlikely to be hit by the FBI raid in your backyard, right? If you look at the U.S. Report—in the U.S. Reports there are lots of cases involving going after somebody with a small amount of marijuana so I do not know what is going to happen but on the surface of it all they have done is change state law and not the federal prohibition. Thank you all very much.

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<sup>25</sup> COLO. CONST. art. 18, § 16; Initiative Measure No. 502 (July 8, 2011), [http://www.sos.wa.gov/\\_assets/elections/initiatives/i502.pdf](http://www.sos.wa.gov/_assets/elections/initiatives/i502.pdf) (codified in scattered sections of WASH. REV. CODE titles 46 and 69).

<sup>26</sup> *Gonzales v. Raich*, 545 U.S. 1 (2005).

**D. BRUCE JOHNSEN:** Thank you Walter.

**KAREN CZARNECKI:** We have a 20-minute break and back in for the next panel.





## USING DISPARATE IMPACT ANALYSIS TO ESTABLISH DISCRIMINATION IN LENDING

*Andrew L. Sandler, D. Jean Veta, Cindy Collins, Paul H. Rubin*  
*Moderator: Satya Thallam*

**KAREN CZARNECKI:** Our next panel is directed toward the question of Disparate Impact in Lending, the extent to which you could draw inferences about discrimination from disparate impact. The moderator of our session is Mr. Satya Thallam from George Mason University. He is Director of Research and Policy at the Law & Economics Center.

He had been at Mercatus prior to that time which is in the same building as the law school. The Mercatus Center is a well-known center that is involved in a lot of different good activities. Satya was the Director of the Financial Markets Working Group.

He has also acted as advisor to such groups as Pulitzer Prize winner PolitiFact and Congressional Oversight Panel, and as a consultant to Continental Group and an affiliated economic expert with American Action Forum as well. He was a Senior Editor of *The Journal: Lombard Street*. He graduated from Arizona State University with a degree in Economics and then went to the doctoral program at Emory University, so I now give you Satya Thallam. Thank you, Satya.

**SATYA THALLAM:** I will keep this brief so we can get to the opening comments. This presentation is kind of the roadshow of disparate impact. We have discussed this topic in various settings with various combinations of this group at the National Press Club, for a group of Attorneys General and staff a few weeks ago; so it is something we have been thinking about quite a bit, and this is a group that knows quite a bit about the economics and law of disparate impact, especially in lending markets.

I do not want to steal too much of their thunder, and as I said, they know this issue quite well. Each one is going to speak for about 15 minutes, to set us up and give us a common language. And they will follow up with questions, and of course there will be time for questions from the group.

I just want to say in understanding this, talking to some of you, particularly with the AG staff I met with a few weeks ago, it is best to understand disparate impact as being the—disparate impact in lending as being kind of the stepchild of disparate impact in employment law, employment discrimination, probably something that most of the folks in this room are more familiar with. But it would be—with the new [adjustments to microphone].

There we go. Sorry about that. Everything I just said is really important. You should remember it.

But in this new financial regulatory world that obviously is still being implemented, the Dodd-Frank Act<sup>1</sup> was passed but there is still a great deal of the Act which is meant to be implemented. There is, of course, a new Federal regulatory agency, the Consumer Protection Bureau, which is very seriously taking a concerted look at the use of disparate impacts and unfair lending outcomes in the lending market. So this is something, no doubt.

And then, of course, the agreements on national servicing that was recently passed I believe by 49 states, and I believe Oklahoma had a separate agreement. So this is something that is clearly very timely. The fallout from the mortgage system is, from the subprime crisis is still upon us. We are still dealing with that. And so we have a variation on different experiences in both industry and academia and law and law practice and economics.

So with that why don't I hand it over to—I think we will start with Ms. Jean Veta; so please join me in welcoming Jean.

**JEAN VETA:** Good afternoon, everyone. As Satya was saying, disparate impact, particularly in the context of lending discrimination, is something that the courts in particular do not deal with very often. Just to get a sense, how many of you have dealt with employment discrimination, either Federal or State, and had cases like that in your courts? Okay, most. How many of you have had lending discrimination cases in your courts? Notice the difference.

These cases are less frequent, in part because the legal issues are difficult and second because typically banks are involved and it's very difficult to take the reputational hit of litigating a case that involves discriminating against a protected class of borrowers, so a lot of the cases tend to be settled. The case law that has developed is not quite as sophisticated as it is, for example, in Title VII.

But that said, it is nevertheless important for all of you, be you on the federal bench or the state court bench where I suspect many of your states have laws that are comparable either to the Equal Credit Opportunity Act<sup>2</sup> or the Fair Housing Act<sup>3</sup>, to have these basic concepts in mind.

So I am going to do two things today. First, I am going to give you a basic overview of what disparate impact means in the context of lending discrimination; and then second, I am going to talk about the jurisprudence that has developed through the litigated cases. And then I am going to turn it over to Mr. Andy Sandler, who is going to tell you then what has happened in the real world with many or most of these cases that have ended up being settled, typically with the Department of Justice.

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, § 1043, 12 U.S.C.A. § 5553 (2010).

<sup>2</sup> Equal Credit Opportunity Act § 701 et seq., 15 U.S.C.A. § 1691 et seq. (2011).

<sup>3</sup> Fair Housing Act, 42 U.S.C. §§ 3601-3619 (2012).

So as Satya was saying, disparate impact started off, and most of us are familiar with it, in the context of Title VII.<sup>4</sup> And as you know discrimination can be of two types. You can have disparate treatment, which is to say I do not want to hire you because of your race or your sex or something like that, or you can have a factor that has a disparate impact. In other words it looks neutral but it is applied very differently.

For example to be a fire fighter you have to be six feet tall. And whereas a number of men could satisfy that standard, very few women could satisfy it. So it was in that context that disparate impact really began to develop.

As applied to lending disparate treatment is obviously where there is discretion in pricing, for example, and a member of a protected class comes in and because of the discretionary pricing gets charged more than someone who is a non-minority. Disparate impact, however, is where there is a facially neutral criterion, for example, what is called a FICO score or your credit score. And if the bank says, "We are only going to lend to people with credit scores of 670 or above," then it will likely be that that neutral factor will have a disproportionate impact on protected classes, typically minorities.

Now all of the Federal banking agencies for years have taken the position that a disparate impact standard applies in the context of lending, and this dates back to 1994 when they all adopted the Interagency Policy Statement on Discrimination.<sup>5</sup> And at about the same time the Federal Reserve Board adopted an interpretation of what's called Regulation B, which implements the Equal Credit Opportunity Act<sup>6</sup> that again establishes that according to the Fed there's a disparate impact standard.

Similarly as Satya was suggesting the new CFPB has stated that they, or rather has adopted the Fed's position on ECOA for disparate impact. And HUD has a regulation pending that is a proposed rule that would outline the standards for disparate impact as applicable to the Fair Housing Act. And, of course, the Department of Justice, primarily in cases that have been settled but also to the extent there has been litigation, consistently has taken the position that there is a disparate impact standard under Title VIII or the Fair Housing Act.

Now as we all know the typical disparate impact test, there were basically two different tests. There was first the balancing test that was developed in *Arlington Heights II*, which was a Seventh Circuit case back in 1977, where there were four factors and you kind of balanced the factors to see whether they weighed in favor of the plaintiff or the defendant.<sup>7</sup>

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<sup>4</sup> Wall Street Reform and Consumer Protection Act § 5301 et seq., 12 U.S.C.A. § 5311 (2010).

<sup>5</sup> Interagency Policy Statement on Discrimination in Lending, 59 Fed. Reg. 18266 (1994).

<sup>6</sup> 15 U.S.C.A. § 1691 et seq. (2011).

<sup>7</sup> *Metro. Hous. Dev. Corp. v. Vill. of Arlington Heights*, 558 F.2d 1283 (7th Cir. 1977).

For the most part that has given way to a three-part burden shifting approach where first, the plaintiff establishes a prima facie case of a disparate impact; second, the burden shifts to the defendant who shows some level of business necessity or a business justification, depending on the court you are in; and then third, the burden shifts back to the plaintiff to show that there was a less discriminatory alternative available. In other words that for example the bank could have accomplished the same objective of preventing defaults on loans by adopting a criterion that also reduced the risk of default but at the same time had less of an impact on protected classes.

Now it is significant that the Supreme Court has never held that there is a disparate impact standard under the Fair Housing Act or ECOA. However, in fairness I also need to tell you as you probably already know, every Court of Appeals, US Court of Appeals, that has considered the issue has found that there is a disparate impact standard. But I think there are two cases that have been litigated in recent years that may suggest that the legal landscape is changing.

The first case that I think is suggesting that we may be seeing a shift in terms of whether disparate impact is appropriate under the Fair Housing Act is in the *Smith v. City of Jackson* case.<sup>8</sup> And you'll recall the Supreme Court decided that case in 2005, and it was looking at a disparate impact claim under Title VII.<sup>9</sup> And there the Court found yes, indeed, there is a disparate impact standard.

But if you take a look at Title VII it has two pieces.<sup>10</sup> The first part basically makes it prohibited to discriminate in hiring. But there is a second provision of Title VII that also prohibits an employer from taking any action that would deprive an individual of an employment opportunity or otherwise adversely affect the individual's employment status.<sup>11</sup> And it is this second prong where it has to do with adversely affecting the individual's employment status or the effects test that the Court in its plurality opinion said gave rise to a disparate impact standard under Title VII.

Now what is important here is that Title VIII, the Fair Housing Act,<sup>12</sup> does not have that second provision in it, so those of us who typically represent banks are of the view that a disparate impact standard is inappropriate as applied in lending because it does not have the comparable statutory language that we find in Title VII.<sup>13</sup>

The second case, again in a different context that nevertheless we think is informing the disparate impact debate is the *Wal-Mart v. Dukes*

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<sup>8</sup> *Smith v. City of Jackson*, 544 U.S. 228 (2005).

<sup>9</sup> *Smith*, 544 U.S. 228.

<sup>10</sup> Wall Street Reform and Consumer Protection Act § 5301 et seq. (2012).

<sup>11</sup> *Id.*

<sup>12</sup> 42 U.S.C. §§ 3601-3619 (2012).

<sup>13</sup> Wall Street Reform and Consumer Protection Act § 5301 et seq.

case.<sup>14</sup> And as you all will recall, that was the Supreme Court case where there was a nationwide class action lawsuit against Wal-Mart claiming discrimination against women. And the Court in that case said there were too many differences among the women who were hired by Wal-Mart among all of these stores across the country who were supervised by different people, and refused to certify the nationwide class.

Now the reason why that is important is there was a decision in 2011 out of the Eastern District of Pennsylvania, *Rodriguez v. National City Bank*, and in that case, there was a class of minority applicants for home mortgage loans who brought suit against National City alleging pricing discrimination.<sup>15</sup> The case settled, and the parties came into the Court to approve the settlement.<sup>16</sup>

But based on *Wal-Mart v. Dukes*, the District Court said, “Hold on a second. I am not sure I can certify the class because there are too many variables among all of these minority borrowers. They were, you know, handled by different loan officers and in different geographic areas, and so for that reason I am not going to certify the class.”<sup>17</sup> And obviously if the class is not certified, that would have a significant impact on the ability of the plaintiffs to raise the disparate impact standard.

So that class certification decision is now on appeal to the Third Circuit, which in fact is hearing oral argument in this case tomorrow as to whether or not there should be class certification in that case. So I think we need to watch to see what happens there.

We have also had an opportunity recently where we thought the Supreme Court was going to decide this. There was a case, *Magner v. Gallagher*, where there was a case pending before the Court where rental property owners alleged that aggressive enforcement of requirements in the City of St. Paul’s Housing Code had a disparate impact on African Americans.<sup>18</sup> The District Court had held in favor of the City, but then the Eighth Circuit reversed and held in favor of the property owners.<sup>19</sup>

And it was up on appeal, and I think it is fair to say there was serious concern among civil rights groups about whether the Court would uphold the disparate impact standard. And what ended up happening is shortly before the case was to be heard the parties reached a settlement. And in settling, the City withdrew its Petition for Cert and stated that it was confident it would have won if the Supreme Court had had the opportunity to

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<sup>14</sup> *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

<sup>15</sup> *Rodriguez v. Nat’l City Bank*, 277 F.R.D. 148, 150 (E.D. Pa. 2011).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Magner v. Gallagher*, 132 S. Ct. 1306 (2012).

<sup>19</sup> *Steinhauser v. City of St. Paul*, 595 F. Supp. 2d 987 (D. Minn. 2008), *aff’d in part, rev’d in part sub nom.* *Gallagher v. Magner*, 619 F.3d 823 (8th Cir. 2010).

rule on it, but that it could potentially curtail their civil rights activities going forward and so they were withdrawing the appeal.

And the property owners clearly had won in the Eighth Circuit, so they were not interested in moving forward in the Supreme Court, so that got taken away.

You may also note that in the context of that case some of the Republican members of Congress were quite unhappy with the Obama administration and the Obama Justice Department, saying that the Justice Department had basically entered into a *quid pro quo* with the City, agreeing that the government would not intervene in a False Claims Act *qui tam* action that was pending against the City in exchange for the City withdrawing its appeal.<sup>20</sup>

You know, I think I understand the politics of the situation. My sense is that the conduct of all of the parties on all sides of this was perfectly appropriate, and I think each one made a judgment call about what was in their respective interests.

But given that, we may well have a second opportunity, and that is the *Township of Mount Holly* case.<sup>21</sup> That is another case where cert is pending before the Court. The Court recently asked the Solicitor General's Office to weigh in as to whether cert should be granted or not. And as I said, the Justice Department consistently has taken the position that a disparate impact standard does exist under the Fair Housing Act, and so I suspect that is the position the Court will take in this case.

Now whether they say the Court should grant cert or not, because I think they may be concerned about how the case comes out, is yet to be seen, and we will have to wait until they respond to the Court's request on that. But the complication even in the *Township of Mount Holly* case is, we have heard, that the parties are in settlement negotiations there as well, so it is unclear whether, in fact, the Court will have an opportunity to rule on it.

So the short version is that while a number of courts have upheld the disparate impact standard as applicable to the Fair Housing Act, it really has never been formally decided by the Supreme Court, and there are very good arguments for why a disparate impact standard, while entirely appropriate under Title VII, is not appropriate under Title VIII, the Fair Housing Act, or under ECOA.

And with that I will turn it over to Andy Sandler who will talk to you about how it works in the real world.

**ANDY SANDLER:** Thank you, Jean. Good afternoon, Your Honors. May it please the class—it is not often as a practicing litigator and trial lawyer that I get to stand on the high ground and speak to all of you without any appli-

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<sup>20</sup> Evan Perez, *GOP Questions St. Paul-U.S. Pact*, WALL ST. J., Sept. 27, 2012.

<sup>21</sup> *Mt. Holly Gardens Citizens in Action, Inc. v. Twp. of Mount Holly*, 658 F.3d 375 (3d Cir. 2011).

cable rules of procedure or evidence. I will take full advantage of this unique opportunity this afternoon.

As Jean has indicated, disparate impact arises largely in the employment context. It has also been used broadly with respect to other statutes where Congress in its wisdom has seen fit to set forth the effects test as an alternative to intentional discrimination. Over the years, as you may know, the Federal Fair Housing Act and many state analog statutes have borrowed liberally from Title VII case law in terms of the legal theories that may be used in that context.

The use of disparate impact had become a fairly standard norm or use in many different kinds of fair housing cases, not necessarily lending cases where discrimination is at the very heart of the lending decision; discrimination hopefully not among protected classes, but discrimination as to credit risk as measured by a number of different factors.

Over a period of years the courts have therefore made decisions generally not in the lending context. The United States Department of Justice chose not to use the disparate impact theory until very recently in this administration where Tom Perez, the Assistant Attorney General, a very able civil rights advocate, who has a very clear agenda as is appropriate to expand civil rights protection just as far as the penumbra of the laws will allow, has deployed it to be much more aggressive in the Justice Department's program.

State Human Right Commissions, and so some of many of you who are State Court judges, although you have not seen it before, are likely to begin to see these cases. Many State Human Rights Commissions, a number of State Attorneys General, are also based on the investigations that we are now handling for our clients—and I am largely a defense lawyer—are using this theory to bring some or to explore some very aggressive cases.

And the problem and the frustration for defense advocates such as Jean and myself has been we have had a very difficult time persuading courts to focus on the specifics of this new use of disparate impact in lending cases versus Fair Housing Act cases generally in a context where virtually every Federal Circuit and other context have agreed that it's appropriately used.

And that frustration has been particularly acute since 2005 when the United States Supreme Court issued its *City of Jackson* decision that Jean referenced that many of us in the defense bar believe pretty clearly set out the Supreme Court's guidelines as to when disparate impact was appropriate and when not, meaning that when Congress intended to use the effects test language it knows how to put that in a statute; and when Congress does not do that then the clear reading of that statute should not be augmented to do so.

Nevertheless while I consider myself a relatively effective advocate in the courtroom, I have lost this issue more times than I think any other issue; but some judges have very much focused on it and have thought carefully about whether it is appropriate in its use. So as you, if you do, begin to see

these cases, let me share with you some examples of the way it has been used by the Justice Department to establish the common law of consent decrees.

As Jean noted, very, very difficult for a financial institution to stand up to the United States Department of Justice in one of these cases, and they almost invariably are settled. And recently I settled one significant case for Sun Trust Mortgage Company, and there the issue was very simple in the sense that the judge was focused, I'm sorry, the Justice Department was focused on the pricing of mortgage loans.

And they concluded that if you put all African American mortgage loans in one bucket, and white, non-Hispanic mortgage loans in another bucket, on average the cost to minority borrowers where discretion was permitted was higher. And that was without regard to taking a look at any of the factors like FICO score, loan-to-value ratios, debt-to-income ratios that one normally looks at in deciding risk in a loan. The Justice Department's view was because that was not on the price sheet and therefore was not properly considered after the fact.

Now in this case the loan price varied in some MSAs where minorities paid more on average. Some MSAs minorities paid less on average, but clearly more of the MSAs the average price to the minorities were more, and that could be as little as five basis points, which is 5 percent of 1 percent. Five basis points were sometimes the difference.

Well, when we appeared before the Federal Court judge for approval of the resulting consent decree, the judge said to my team, "Why is your client settling this case?" and we said, "Well, you know, Your Honor, we are settling this case for one reason and one reason only—not to be in litigation against the United States Department of Justice." "Are you sure your client wants to settle this case? I am not convinced. I want more information. Go back and find more information."

So there finally was the opportunity to litigate that case in a forum that was prepared to hear it in that context, but as is often the case the bank determined that it had reached a settlement agreement, it would live up to that settlement agreement, it wished to have the issue put behind it, it paid its \$21 million settlement amount to move on and get back to the business of lending.

Another context in which this has recently come up is another case that I settled with the Justice Department for a small California bank named Luther Burbank. There the bank was a multi-family lender, and its Federal Banking Regulator said, "You know, you are a little concentrated. We would really like you to do some residential lending to sort of spread your risk."

Bank said fine, was not really comfortable or knowledgeable about residential lending, but came upon this product which was a portfolio loan product; one it sold and kept, a nontraditional product, a nontraditional



product which had elements that we have all come to learn are very unattractive for low and moderate income and less sophisticated borrowers.

They were income only, sometimes negative amortization kind of products, the kind that one would be accused of predatory lending if you offered it to the wrong clients, but for the right, sophisticated group of high income, high net worth sophisticated borrowers who may like the idea of paying their mortgage meaningfully once a year, it is a perfectly fine product.

In order to insure that they did not sell the product to those for whom it was not a good product, they put a \$400,000 loan minimum. Every borrower who walked in—black, white, Hispanic—who qualified got the loan. But what happens when you put a \$400,000 minimum on a loan product often is that you will have proportionately fewer minority borrowers than you will with a, than will your peers who are offering traditional mortgage products including FHA products that are insured by HUD.

The Justice Department said, “Well, that is discrimination. It is not discrimination that you are not selling this product; it is discrimination that you have not come up with other products to sell that are more attractive to minority borrowers such that you can equalize or meet the norm in your community for the proportion of loans that should go to minority borrowers.”

Now where is the appropriate line between equal protection and affirmative action? What does the law of our land require? These are important questions that sometimes get lost in the disparate impact legal theory and its use in this context.

So while I applaud Assistant Attorney General Perez and the human rights groups and organizations and state agencies throughout the country and the consumer advocates and the civil rights advocates and the State Attorneys General who work very hard every day to bring to your court room cases where there’s a need to address discrimination, like all good advocates they sometimes push the envelope.

And this disparate impact theory which requires no evidence of intent can very often, and we are seeing it very often, overused in ways that I would assert actually undermine the credibility of the efforts of all of these good people—good government officials—who are righteously out there every day fighting against discrimination. And sometimes they need those of you on the judiciary to remind them of the appropriate lines between what is an appropriate use of a legal theory to advance legitimate interests and when a legal theory can be used in a way that perhaps overreaches.

And when you are considering these cases insofar as they come to you, understand please and think about the devastation to business executives and bank leadership, particularly in small community banks around the country, who are being accused of discriminating against their neighbors because particularly in this point in time they are trying to be careful and conservative about only making loans where the right risk profile applies

and where risk-based pricing is permitted to protect their institutions by aligning risk to loan pricing.

It is a devastating accusation. I cannot tell you how many CEO clients of mine literally—and I do not mean to exaggerate this—but literally almost in tears to hear that they are being accused of discrimination by the Department of Justice, and perhaps a Public Consent Decree is about to come out. What do their children tell their classmates, their minority classmates, about their mother or father against whom these allegations are being made in the context of their role in their financial institution?

I think as these theories are more and more aggressively used and as bankers are held in ever lower esteem in the media and in their local communities, the calculus is beginning to shift, and folks are beginning to say, “You know, I might as well defend myself because what is the worst thing that is going to happen? They are not going to like me?” Because while some of it is very deserved, much of the public opprobrium is not necessarily deserved equally across the board, especially in small community banks.

So I expect that you will begin to see some of these cases, and I hope that perhaps I have, you know, in these few minutes this afternoon I shared with you a useful perspective in terms of how you might look at them; and welcome all questions and thank you all for not exercising your normal prerogative to interrupt at all times whenever you think I am getting off course. Thank you very much.

**CINDY COLLINS:** Hi. I am Cindy Collins of Hibernia Corporation, which is a \$20 billion bank holding company headquartered in Mississippi.

I would like to say that my first encounter with Andy Sandler was actually, I was once upon a time a regulator, and Andy represented a bank that I was actually the compliance examiner in charge. And I would like to say to this group, I am now a banker but I was once a regulator for about 15 years, have been a banker for another 15 years, and I have seen all sides of the discrimination complaints and accusations. And I feel like I am a very experienced person, not just from regulatory banking but as a consumer and a minority, a double minority as well.

When I was a regulator, there was a bank, and I will not name the bank but the accusation by the regulators whom I worked for was that this bank unfairly directed the clients. There were two mortgage products, so if you wanted to purchase a money mortgage product, if you looked like Cindy according to the regulators you went to the retail product, which was higher priced and underwritten differently versus if you looked like somebody else on this panel you may have been directed to the mortgage product, which was underwritten differently with a lower price.

And I will tell you as a regulator I had a lot of difficulty just being very familiar with the bank that that was actually going on in that day and age. And I am just a very simplistic person. I say, “There has got to be an explanation for this.” Well, the bank eventually explained it, but clearly no

one was there directing people based on their race as to which product you should get, so my fair lending experience began, not as a personal consumer but as a regulator, that I just thought, "This cannot be."

And at the end of the day it really was not, so I am standing before a bunch of judges to say, when and if you are presented with one of these cases, please do try to understand the facts and the numbers behind it. Andy made a comment to the fact that lending is discriminatory. It is. I do not know how many of you have ever loaned money to either a family member or a friend, but for those of you that have. . .

And my dad taught me this long before I was educated. I mean as a young kid my dad said, "Do not ever loan money to somebody, do not ever loan an amount of money to somebody that you cannot afford to lose, because guess what? Some people are not going to pay it back." And I learned that probably at ten years old. So when you hear in court that lending is discriminatory, it is. So there is a group of loans based on credit scores, which tells us your willingness and your history of repaying other debt, and your debt to income.

I have not been in a bank ever where they did not consider your history of repaying other people and your debt to income, which tells us how much money, how much income do you have to service debt. And if you can do the basic math and you do not have enough income to pay all your debt and then live the lifestyle that you choose to live, then we are not going to make the loan, plain and simple. It does not matter whether you are blue, black or green, whether you are a woman or a man, we do not care. We want to get the money back. So do you, if you loan your money, or do you not?

I mean I have done it personally, but I remember what my dad said. He said, "Do not ever loan any more than you can afford to lose, because some people are not going pay it back." Whatever the reason. Sometimes they cannot, sometimes they just will not. Some people just live above their means.

Now as a banker, do I believe that there are situations where certain people are taken advantage of? Yes, and I am not going to stand here and say it is always the person that looks like me. Some people are just better negotiators, and they are more educated on what their credit looks like, so if you know that your credit score warrants a better price, guess what? We are not the only game in town. And that is what I often tell people that look like me that complain to the bank that either I was declined or I was charged a higher rate.

A lot of people just do not even educate themselves. They do not get a copy of their own bureau. They will not be honest with themselves that I am living above my means, and the reason I could not pay that banker is because I had all these other things I had to take care of. But yet as a banker when I am sitting there with my safety and soundness examiners, mean-

ing are you putting good quality loans on your books so you do not have to charge it off and then maybe one day your bank becomes a failure.

As a banker we are confronted with both sides of this. We have to comply with the law, and I do not want anybody to misunderstand me in that I think banks should discriminate on a prohibitive basis. No, I do not believe that is fair to anyone. It is most unfair to the bank. Why would I as a banker if you qualify for a loan based on your debt to income and your proven track record that you pay other people back, why would I not want to make the loan? We are in the business to make money. If we do not make loans, we are not going make money. It is the major asset of a bank.

So sometimes I just do not understand in some of these cases some of the basic premise that either examiners or others view just as data that says, this bank is discriminating. There is a report that banks are required to file. It is called the HMDA Report, the Home Mortgage Disclosure Act.<sup>22</sup> And several years ago the Federal Reserve—I forget which district it was—based on the decline ratios, it led the world to believe that most banks were discriminating.

Well, I do not know how many of you understand credit bureau reporting, but banks can do something called a prescreen, meaning they can go to the credit bureau in a certain market and give them criteria that says, “Give me every person that fits this criteria.” So they give them a credit score, and they may give them several criteria. One time we were challenged as a bank, the exam started out saying, “Your disparity in the lending rate, you decline blacks twice as much as you decline whites.”

And I said, “Okay, so what does that mean? Are you concluding we discriminate?” There is a lot that goes into a lending decision. Most, I would hope that nobody is doing it based on somebody’s race or sex, but one of the most significant contributors or significant contributors to a lending decision is your credit score and your debt to income. Do you have enough income to support the level of debt, including the proposed debt that you are asking us for?

And then your credit score tells us how well you have paid others. Again, I ask this audience, how many people are you going to loan money to time after time that will not pay your money back? I would not do it. I have done it several times, and you know what else my dad told me as young kid? He said, “But let me tell you about the people that you loan it to that do not ever pay you back. You do not have to worry about them because they cannot come back and ask you for a loan again.”

You sit there and laugh, but it is the truth. That is what a bank is faced with. You know, I cannot keep lending you money if you do not pay me back or you have not paid other lenders back. And that is the piece that I think people in your positions need to just understand the basics of how this

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<sup>22</sup> Home Mortgage Disclosure Act, § 302 et seq., 12 U.S.C.A. §§ 2801-2809 (1975).

works as opposed to some big broad number that says X banks declined black applicants twice as much as they decline non-minority applicants. You cannot just go and assume that there is discrimination based on that number.

Now in my opinion as a banker, lots of times in a lending process there are places where people use discretion. You know, the most common thing that I see is banking relationship. What does that mean? Does it mean that person's dad and their fore-parents banked at the bank? That is one of those things that I think is very loosely used, so in the disparate impact theory I think that could present a problem because did my dad bank at the bank that I banked at 50 years ago? Probably not.

So I would probably be at an unfair disadvantage if you use something as simple as a prior banking relationship. And if you are going to use that type of criteria, you have to be very objective as to what that means. So if I have a banking relationship you need to define what that means. Does it mean I have other maybe investments? Have I had a loan with you before where I performed and I can go on your word that you are going to pay me?

Some people fall upon hard times, they have medical situations and they are well intended but they just could not; and so there are some cases where banks do use some level of discretion that is not purely objective. So it is my job as a compliance officer to look at all of our lending processes; and to the extent we allow the officer or the underwriters to use some level of discretion that is not clearly articulated in the policy, my job is to make sure that that discretion is applied consistently, to avoid maybe not intentionally.

My experience is people are using that discretion for either someone they know or someone they have gotten comfortable with. And how many of us are not more comfortable with people that look like us? That is just a given. I am sorry, that is just the way of the world.

And I often tell bankers, when we are going to use exception authority, we need to make sure that the ones that we are making exceptions for I am going to purposely go look for somebody of the opposite race that looks like that person on a piece of paper, and you are going to have to explain to me as a compliance officer why you did this one and not that one.

And my job simply is to make sure that we do not back ourselves into a problem. Do I believe bankers intentionally do it? By and large, no, but on another hand that there are some lenders whereby to the extent there is a lot of discretion, bankers a lot of times are incentivized based on the volume of loans that they make. So when it comes down to pricing, if you do not know any better and I can charge you ten and you really qualify for five, then I do think, in some cases, people are taken advantage of.

But I often tell people that look like me, that go to my church, that say, "I was discriminated against," I say, "Well you should know better." If you do not know and understand your own credit and what you are credit worthy of, and you do not take some time to shop around for yourself, I think

there is just a certain piece of it that we have to ourselves be responsible for. And there are probably a lot of people in this audience that just do not agree with that, but I am sorry, that is the way life is.

You know, we did, one of the banks at, we tried to do an analysis on indirect lending. Indirect lending is like when you go to an automobile dealership, and then they farm out your credit to different banks. So banks buy that paper, right?

I do not know how many of you buy cars and still have to negotiate the price of the car, the price of your loan. It is just the biggest headache that I have ever encountered as a consumer. I do think automobile dealerships will rape you on the price, they will rape you on all the add-on products; they will rape you on the rates if you do not know any better.

So what we did is we did an analysis based on male versus female, and to my surprise and to everybody else's surprise, because a female is a prohibitive basis that you cannot discriminate against on pricing, right, or on lending decisions. Well, the analysis showed that women were getting a better price than men. Well, I went home and I told my husband that. I said well, that works in this household because every time we go to buy a car it is like my husband will negotiate to some point, but at some point he wants the toy and he wants to get out of here.

That to me is like it tells me, too, that a lot of it depends on whether you are willing to negotiate. You, the consumer, need to know that you have every right to fight the dealership on the price of the car. There is too much information out there on what they pay for the car. So when I go buy a car today I know exactly how much they paid for it. I already know what my credit is like, and no, I don't need you to farm it out to another bank. I got my financing in order before I came here.

And so I try to teach people what they need to educate themselves on as opposed to when I get declined for a loan or if you feel like my pricing was too high. You need to arm yourself and teach yourself and find out what kind of rate should I be getting. What is the rate today for car loans? You need to know that before you go buy a car.

And so I guess I see it from a different standpoint, and personally I have loaned money, have not gotten it back, but I remember what my dad said. Do not ever loan any more than you can stand to lose, because some people just won't pay it back no matter what the situation.

So I cannot speak to the disparate impact theory as a banker. But it is a very scary theory because there are lots of things in banks that we do that could have a disproportionate adverse impact on a certain group of people. For loan amounts, a lot of times, we have a minimum loan amount. And people need to understand that a bank just does not operate for free. It takes money; it takes people to process loans.

In today's world, the compliance world that we find ourselves in, lots of compliance people like me. I mean we have had to triple the size of our compliance staff because of all the new regulation that has come out. So

maybe you say well, good job security for you; but it costs money to run a bank. So we do not just pay you a little bit on your deposit and charge you this exorbitant rate. There are a lot of expenses that come out in between.

So, as a set of judges, I just hope that when you are presented with a discrimination in lending case that you really try to understand just the basic fundamentals of what goes into a lending decision, and it is not simply what you look like. Thank you.

**PAUL RUBIN:** I am an economist and not a lawyer and not a lending officer, and if you know economists you will know that I find Cindy a tough act to follow. But I will do the best I can, and I will say that much of what she said is, I am going to agree with, although I start at a theoretical position rather than at the position of a practicing banker.

I am going to take a pretty strong view that in the area of lending—bank lending—economic theory would indicate that there is probably no discrimination that goes on. If you use a method that finds discrimination such as disparate impact, you are probably doing something wrong.

And the theory of discrimination—economists have a well worked-out theory of discrimination, goes back to Gary Becker who was a Nobel Prize winner in Economics a few years ago at the University of Chicago, and for his doctoral dissertation he wrote what became a book, a well-known book on the economics of discrimination.<sup>23</sup> And Becker defined discrimination as being willing to pay to avoid some group.<sup>24</sup>

For example—and the three forms of discrimination he talked about were consumer discrimination, worker discrimination and employer discrimination. And rather than saying either/or, Becker said we have a continuous measure of how discriminatory someone is; it is how much they are willing to pay to avoid contact with some group.<sup>25</sup>

So I will use the example, I think it is true, you know better than I. I think people with piercings are not yet a protected category. Is that correct? So I will say I might prefer as a customer not to eat in a restaurant where the wait staff has lots of pieces of metal coming out of their face. If I am willing to pay more to go to a different restaurant that doesn't have that characteristic, then you would say I have a taste for discrimination with respect to people with piercings.

If I am willing to pay \$1.00 more, then my measure of discrimination is \$1.00. If I am willing to pay \$0.50 more, then I have a lower measure of discrimination. But the measure of discrimination is the amount that someone is willing to pay to avoid dealing with members of a racial group or a behavioral group or whatever group it might be.

Worker discrimination would be the same thing. A worker has a taste for discrimination if the worker will accept a lower wage to avoid working

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<sup>23</sup> GARY BECKER, *THE ECONOMICS OF DISCRIMINATION* (1971).

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

alongside people with certain characteristics. Employer discrimination is when an employer will pay a higher wage to avoid hiring people with certain characteristics.

So we have a measure of discrimination and we have agents in society that may engage in discrimination. Totally outside of the law, this is simply behavior that Becker was looking at.

In lending none of these characteristics apply. A lending officer is out to make money. There is no reason why the lending officer may have an ongoing relationship with a client, but it is not a day-to-day relationship. Every once in a while he will see a client, but there is no reason a lending officer would have any incentive to engage in discrimination in the form of charging a higher price or being less willing to make a loan to someone because of their race. So there should be no reason to expect it to happen and a lot of reasons to expect it not to happen.

If a lending officer did behave that way, he or she would make fewer loans, would have not as good a record. As Cindy tells us, it is the record of a lending officer, how many loans you make, that determines how well you do; and lending officers would not have any incentive to do that.

Moreover there is competition. If one lending officer or one bank did behave that way, we have in the US 8 thousand banks, which is about 160 banks per state, and interstate banking is now possible, so even if one bank did behave that way—again, as Cindy's told us, what do you do if you are customer? You go to another bank. You found a competitor who was not going to behave in that way.

In the economics of banking essentially, if you discriminate you are leaving money on the table. Banks do not want to leave money on the table, and in today's world especially, they do not want to leave money on the table, and so you would not expect to find, the theory would indicate you would not find behavior that is discriminatory.

If you do statistically if you think you have measured discrimination, as Andy said, maybe you made a mistake by throwing all the loans in one pot without looking at relevant variables. You have probably made a mistake, and the bank is probably doing the best it can to make as much money as it can, which means not engaging in discrimination. And if you find it, it is probably based on some error.

What is the effect of disparate impact? Well, it scares me. I talked to Jean before, and she says I am needlessly scared. But it scares me because if this theory becomes widespread, if government looks intensely for disparate impact, looks for discrimination with no evidence of behavior, simply looks for cases where there are differences, then someone is going to put pressure on banks to relax their underwriting standards to make loans that they might not want to make in order to avoid being examined, being accused, being convicted, and paying large fines.

And we have seen that world, right? We have seen that world where banks made loans that they should not have been made, and we have seen



what happened and it was not pretty. And I would hate to see us go back to that world with liar loans and loans based on undeclared incomes and all the bad things that got us in the mess we have been in for the last several years.

I would hate to see us go back to that world, coming about it through a different mechanism but still putting pressure on banks to make loans that they find not worthwhile. And as I say, we know where that can lead us, and it leads us to places that we really do not want to be.

The economics I think reinforces what you have been hearing. Sometimes economists come up with different answers and probably we are wrong, but here the economics enforces what you have been hearing from the people in the business, that it is unlikely, very unlikely that we would have any substantial amounts of discrimination in this market. And it is an error to look for discrimination where there is no overt evidence of actual discrimination. Thank you.

**SATYA THALLAM:** We have time for questions. I will start out, but we have a couple microphones in the middle of the room. We will be happy to call on you if there are some questions.

But let me start out. Jean, you were talking about the Wal-Mart case, which weighs heavily on this insofar as there is a doctrine that is being developed and as the Supreme Court will possibly further hear on this case.<sup>26</sup> But does not the outcome of that case—so this was that the—again to refresh the class, the class was women who alleged that they were being discriminated against by management, not being allowed to advance and were being disparately treated.<sup>27</sup>

Policies were resulting in a disparate impact for females that worked for the Wal-Mart Corporation.<sup>28</sup> But the Court said that they could not certify the class because there were so many differences among the class.<sup>29</sup>

Does this not imply going forward for any court that is going to hear or use *Wal-Mart* and in the context of the three-part burden shifting test that for the agency or the borrower who is alleging discrimination, does *Wal-Mart* imply a higher burden of proof going forward for establishing class and disparate impact? Especially in borrowing where, as you said, there are a thousand different factors that could go into any group in separating them out.

**JEAN VETA:** Right. Well I think the private plaintiffs' bar will think hard before they bring class action suits alleging lending discrimination. I mean, just in terms of doing the economic analysis and the likelihood of hitting

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<sup>26</sup> *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

the jackpot, I think they are hard cases to bring, especially as private plaintiffs they do not have access to a lot of the information on the front end that would let them evaluate how good their case is.

Now it is very different, however, when you are dealing with either a State Attorney General's office or the Department of Justice, which obviously has the power to subpoena the information from the institution and to do the analysis beforehand. So I think there is still a serious risk of those cases being brought by the government enforcement agencies.

What I hope will happen is that some disparate impact cases are shall I say more credible to bring than others. I think the kind of unsophisticated, rudimentary bucketing approach that Andy referred to that was used in the Sun Trust case is extremely troubling.

And conversely my experience has been, and Andy and I do very similar work, that sometimes you can persuade the Department of Justice, although they start off with an investigation and they think they can establish a disparate impact, that they are just plain wrong. And if you do a sophisticated economic analysis, you see that there are other factors, other nondiscriminatory factors that are driving the results. And the problem is that there is typically a very high correlation between low and moderate-income borrowers or people with impaired credit and protected classes.

It is really hard to de-couple those to figure out what is really going on, but we have had some success, as I am sure Andy has, by having the Department open formal investigations and really sitting down with them, engaging them in a dialogue and ultimately persuading them that if they were to bring it to your courts they would lose, and then to have them back away from it. But it is getting harder.

**ANDY SANDLER:** Just an observation. In terms of what you all are like to see in terms of private litigation, agree with Jean that the hurdle has gone up quite a bit with Wal-Mart in terms of bringing discrimination class actions. What we have seen historically and likely will see more of in the future is to the extent that your jurisdictions permit mass actions you'll see more mass actions.

You will see consumer and civil rights groups filing cases based on organizational standing where they think they are entitled to stand under the statute in some *parens patriae* kind of position. And you will see, and we are already seeing and have been seeing, municipalities file cases where they claim damages from the fact that bad loans were made to minority borrowers that have led to foreclosures, vacant housing and a host of problems around that.

In the Federal court system they have a very difficult time surmounting *Iqbal* and *Twombly* type of standing kinds of problems in state jurisdic-

tions to a varying degree that have those same problems.<sup>30</sup> But we are starting to see more of those kinds of cases, and I expect some of you will see all three of those kinds: the mass actions, the organizational standing cases and the municipal cases.

**SATYA THALLAM:** We have a question in the back?

**AUDIENCE MEMBER:** Yes, my name is Philip Batton. What is your experience with redlining neighborhoods? My experience has been that that happens a lot where certain neighborhoods, if a loan is originated for a house in a certain neighborhood it is going to get a higher interest rate regardless of the demographics of the borrowers. Is that still going on, has that diminished, or is that still a problem, or what?

**SATYA THALLAM:** Cindy, I think you?

**CINDY COLLINS:** I have not had any direct experience with redlining, but I do follow a number of cases where banks have been accused of redlining. I was speaking to another gentleman earlier, and he asked me the question, “when are banks going to start loaning money again?” And I said, banks really do want to loan money. I mean, to the extent we do not loan money, we cannot make money. That is how we make money.

And just like the HMDA report,<sup>31</sup> people really need to understand what the term redlining means. For a lot of years as bankers we got into this, we were doing all types of mortgage loans. There is a regulation called the Community Reinvestment Act, where we have to delineate our community and we have to make sure that we do not draw the line right where there is a minority neighborhood.<sup>32</sup>

But what has been happening throughout the United States is that housing prices have come down substantially. So, when we underwrite a loan, we need to first, make sure that our primary source of repayment, most times it is your income, we have a primary source of repayment. Our secondary source of repayment is typically the collateral. And what you are finding in today’s economy is when you go to certain neighborhoods where there have been lots of foreclosures, when they go to appraise the house in that neighborhood the value of that house is based on recent sales.

If there have been a lot of foreclosures that has driven down the prices of homes in those neighborhoods. And what neighborhoods are more affected than others? It just happens to be high minority neighborhoods. So when you look at the value of the housing in those neighborhoods—now

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<sup>30</sup> See *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007); see also *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

<sup>31</sup> Home Mortgage Disclosure Act, § 302 et seq.

<sup>32</sup> Community Reinvestment Act, § 802 et seq., 12 U.S.C.A. § 2901 et seq. (1977).

you will probably sit there and say, well, they did that because it is a black neighborhood. Well, the value of the housing has gone down so much until we don't have a secondary source of repayment.

So, if you are trying to borrow \$100 thousand on a house that is only worth \$50 thousand, for a bank, that is not going to work. But to the average consumer that does not understand what all goes into making a lending decision, I take you back to my father's example. There are going to be some loans that simply will not pay back. Well we are not going to start off in a position of making a loan where we can't see where we are going to get repaid, either through the income from the borrower or from our collateral.

**ANDY SANDLER:** I am not going to sit here and tell you that there are legitimate redlining cases, the traditional hole in the doughnut where somebody lends all around minority neighborhoods. And maybe for, because of expectations about what property values or collateral might be makes a lazy decision and decides we are not going to do any lending in that community, and that is not right and appropriate or allowable. So yes, I am sure there are those cases out there and I have probably seen several in the last 20, 25 years, more years ago than recently.

But a lot of what you see today, and the Justice Department brings a lot of redlining cases, are not that kind of case but rather a bank is beginning to expand and is moving towards a city community but is not quite there yet, and the Justice Department or somebody else takes the view that if they are moving in that direction they need to be all the way in.

A bank does not do residential lending or does not do a certain type of lending, or what we sometimes see, and I had one famous redlining case focused on the City of Chicago. You have not made, Bank, any loans in the following eight majority/minority census tracks. Well the problem was there was not any owner-occupied real estate because they were stockyards and a few rental units.

So redlining is clearly a legitimate place for use of the Fair Housing Act to attack intentional discrimination, but the accusation of redlining is sometimes thrown around in a way that is not justified.

**AUDIENCE MEMBER:** Yes. I was wondering if you expected there would be a Congressional hearing on the Department of Justice action in the *St. Paul Housing Enforcement* case?

**JEAN VETA:** I think the Republicans tried to get a hearing on that, and Andy may have more recent information, but I think it sort of. . .

**SATYA THALLAM:** Could you explain the *St. Paul Housing* case briefly?

**JEAN VETA:** Sure. In that case property owners were alleging that the way the City of St. Paul's Housing Code was being implement was having a

disparate impact on minorities.<sup>33</sup> And as I said, the City won in the District Court.<sup>34</sup> But then the Eighth Circuit reversed and found in favor of the property owners, and so then it was going to be taken on appeal to the Supreme Court.<sup>35</sup>

And I think it fair to say that the Justice Department and the civil rights community were very concerned about what this Supreme Court would hold with respect to the applicability of a disparate impact standard under the Fair Housing Act, particularly with respect to the issues it was being presented with.

And so, you know, they decided—and I think in fairness the City was receiving a lot of pressure not just from the Department of Justice but from civil rights groups to drop the appeal because they did not want to make bad law where there could be repercussions not only for them but for all municipalities and the civil rights movement more broadly if the disparate impact standard weren't upheld.

**ANDY SANDLER:** On the Congressional, yes, the House seems to be very interested in pursuing this further. Whether they will successfully obtain hearings or not, I guess they probably have the power to do that and likely will because they see it. Or at least they have articulated in a letter their view that it was a *quid pro quo*, drop the False Claims Act case against the City of St. Paul in return for dropping the Supreme Court appeal.

But let me just raise another issue about this for you. What does that say when the United States Department of Justice goes out of its way to avoid the Supreme Court clarifying the state of the law as it should be applied? And I do not just mean that as a criticism of the Justice Department. What does that say about the Justice Department's view of the Court?

And whether that is legitimate or not legitimate, many of us would have different views on that, but it seems like we are in a really bad place where whether it was entirely appropriate as Jean has suggested or not appropriate as some Republican members of Congress have suggested, that is what has to happen, that it is viewed as something that is appropriate and necessary. You know, maybe we get past this in some new era of comity. I am going to be an eternal optimist.

**JEAN VETA:** Well, and actually just to sort of make it interesting let us have a little disagreement on the panel. I think, although I take Andy's point when he says, you know, what does it say about the Justice Department in not wanting the Court to clarify the law on this, you all know both from your positions as judges hearing these cases and the cases that come before

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<sup>33</sup> *Magner v. Gallagher*, 132 S. Ct. 1306 (2012).

<sup>34</sup> *Steinhauser v. City of St. Paul*, 595 F. Supp. 2d 987 (D. Minn. 2008), *aff'd in part, rev'd in part sub nom.* *Gallagher v. Magner*, 619 F.3d 823 (8th Cir. 2010).

<sup>35</sup> *Magner v. Gallagher*, 132 S. Ct. 1306 (2012).

you that sometimes bad facts make terrible law. And certainly we as advocates make those judgments all the time.

So I think it is entirely appropriate, especially for the Department of Justice that is supposed to be acting in the public interest, to make those kinds of judgments and to figure out where they want to spend their resources. So I mean that is one point.

And then this other point about this *quid quo pro*. I mean my understanding was the False Claims Act case was a private qui tam case that had been brought by a relater, and the question was whether the Department of Justice was going to intervene in the case. And again for those of you who are familiar with False Claims Act cases or have your own kind of mini state versions of those cases, the government often does not intervene in those cases because it concludes that not worth the investment of resources.

And I firmly believe, although I am not in the Justice Department and have not been for a number of years, and when I was in it was as a political appointee, that, you know, they made the decision based on the merits of the case, informed obviously by the broader objectives and resources in the Department.

**ANDY SANDLER:** And Jean, I just, we do not disagree on it. I agree with you that bad facts can make bad law. I would suggest, however, that the Justice Department is determined under any fact scenario to get this case to the Supreme Court if they can avoid it at all, and it was in that context that I was raising the point about the disconnect between our judiciary and our Justice Department, which I find unfortunate both ways.

**JEAN VETA:** Yeah. I think it will be interesting to see what the Solicitor General's office does in responding to the Court's request on the pending cert petition in the Mount Holly case.

**ANDY SANDLER:** I will bet you a beer that I know, even though the facts are better for the Justice Department.

**AUDIENCE MEMBER:** I have a question for Paul Ruben. If I wanted to read up on somebody who is a peer of yours who has comments to say on the other side, give me a name that I can Google or something like that. Because I mean obviously the Justice Department speaks for the legal side of it, and so—but you are talking about economic expert support for the presentations at the trials that do not happen because the case is settled. Who are the economists that would be on the other side?

**SATYA THALLAM:** He is asking you to discriminate against your own view.

**PAUL RUBIN:** Remember the name of the fellow from Syracuse who was at the first one of these things?

**JEAN VETA:** Well, and Alan.

**ANDY SANDLER:** Alan White. Alan White is one, and actually he recently wrote a book that is specifically on this issue, on disparate impact in lending and discrimination in lending. Takes a different view than Paul.

**PAUL RUBIN:** And Alan is a very experienced and very thoughtful guy. Many of us disagree with him, but he certainly does a very effective job laying out that side of the argument.

**SATYA THALLAM:** Let me follow up with that question now in that—so that Paul and then Cindy, I would like you to jump in, too. The idea that a lender or lending institution that would have, would exercise its taste for discrimination would be costing itself, and so it has to impose a cost on itself and therefore competitively they wouldn't do that or someone else would get that business.

But does not it assume that perhaps in certain neighborhoods a competitive marketplace maybe does not exist or search costs could be prohibitively high? Or Cindy, as you say, information is required on the part of the consumer.

**CINDY COLLINS:** Well, one of the things, and I mentioned this earlier, banks are subject to a number of rules and regulations, one of which is the Community Reinvestment Act.<sup>36</sup> And the Community Reinvestment Act requires us to delineate our community, and we have to explain to regulators to the extent there are certain areas in that community we are not loaning money to.<sup>37</sup>

Then we may not get a good CRA rating, and if you do not get at least a Satisfactory CRA rating you cannot continue to grow and expand. So if you want to grow by merchant acquisitions the regulators will decline that request.

So we have lots of reasons to do the right thing for the right reason, but from a regulatory standpoint if we do not do right by loaning the money from the areas that we are taking deposits from, the regulators have another stick to beat us with. So we have to do right. And so there are lot of eyes out to make sure we do right, but I still, I guess I been a banker longer than I was a regulator.

I see no reason in the world why a bank would not make a good loan. But a lot of people do not really understand what a good loan is, and lots of times, most times; it has nothing to do with the individual unless that individual for whatever reason chooses not to pay.

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<sup>36</sup> Community Reinvestment Act, § 802 et seq.

<sup>37</sup> *Id.*

**ANDY SANDLER:** But there is no question that there is inadequate access to credit in certain communities in the urban core, particularly where Cindy noted earlier, property values have declined significantly. And you know, the public policy question is, what is the right way to address that very real problem? Is it by accusing lenders of discrimination for not affirmatively bringing credit into those communities, or might there be better ways in terms of what we do for those of you who focus on mortgage issues with the GSEs, with government guarantees, with other kinds of mechanisms to address it.

So I mean nobody should leave this room with the view that it is not a very, very real problem. The question is, when is it discrimination and when is it something else?

**PAUL RUBIN:** And do you want to make the banks bear those costs or do you want—if you think there’s a social problem then maybe some other agency should do it. Whether banks should be the agent of bearing the costs of the fact that there’s bad—some people have trouble borrowing, but whether you want to impose costs on banks. Seems to me we have gone down that road, and we have seen that it is not a good way to handle it.

**SATYA THALLAM:** I think we have time for—I guess we will have these last two and then wrap up.

**AUDIENCE MEMBER:** Thank you. I think some of us are still seeing the hangover from a period of time in which those originating the loans did not retain the risk. And then Professor Rubin’s analysis of why it does not make sense to issue this bad loan did not work at all because you could issue a bad loan, you could take it off your books very quickly. And so I am not sure that any of you are addressing what many of us in our State Court systems continue to see, which was an era when loans were made that did not consider the risk of repayment because they were not going to be held on the books.

A similar issue that we see sometimes, Professor Rubin, in a perfectly competitive market where the consumer understands where he or she can go for credit, one might go into the bank, be offered a very expensive loan and say, “Well, no, I am going next door where I can get a better product.”

But if the bank is preying on a more unsophisticated borrower who appears perhaps not so much merely by color but by education and so on, who has a decent track record in repayment and income to loan values get offered a product which is more expensive than somebody else with the same economic characteristics would be offered but who seems perhaps more knowledgeable as Ms. Collins suggested one should be when you take out the loan.



In other words, if you posit a perfectly competitive environment in which the bank accepts all of the risk and the consumer knows what to do, then all of your economic theory works. If it is not that perfectly competitive environment perhaps it doesn't work as well.

**PAUL RUBIN:** Then you have to ask the question, is having poor bargaining power a protected class? If some people are not as good at bargaining is that a protected class under—and as I understand I am not a civil rights lawyer, but I have not heard that that is a protected class.

**AUDIENCE MEMBER:** Well then you look at secondary characteristics and whether or not people in that particular position of being not particularly knowledgeable have some other characteristic that tends to suggest a disparate impact.

**JEAN VETA:** Right, and actually although I am perfectly comfortable disagreeing with Andy I am a little less comfortable disagreeing with a judge, but let me see. I have wanted both to follow up on Paul's point but also to address your point about, you know, well bankers made these horrible loans because they were laying off the risk. And I take your point there.

On the other hand we have to remember what was going on at the time. You know, in 2000 and up through 2006 or 2007 we had a number of things going on. We had both, you know, we had a Democratic administration and then we had a Republican administration, all of which were promoting the expansion of home ownership and saying that banks should figure out ways to make loans to people who didn't have traditional credit profiles. That is point one.

Point two is at the time the economy kept expanding, and so Paul's colleagues at least, including the guy who was the president of whatever it is called, the American Association of Economists or whatever, was saying we have got this expansive economy. We have beat depression. We will no longer have depressions. We figured out how to have an ever growing and expanding economy.

And the third point is while banks were laying-off the risk, they were laying off the risk to Wall Street. And while banks may be pretty sophisticated, I assure you that the credit modeling that was going on by the investors who were buying these things, they too thought they were buying good loans. Nobody saw the recession coming. What happened was that we, lo and behold, found out housing was in a bubble, and when the bubble burst property values went down, and all of the assumptions people had been operating on was this ever-expanding economy.

So anyway, if people had known they were risky, lousy loans, then they couldn't have been sold in the secondary market or to whatever kind of suckers there are at the end of the line because the suckers at least in this game were all pretty darn sophisticated.

**ANDY SANDLER:** While I find it best to always agree with Jean as well as judges, I will observe that I do not disagree with the point that was made because given the choice between Jean and a judge; I'll always pick the judge.

But what I would suggest is to the extent that there were originators out there that did not have adequate regard for the repayment potential of a loan because they were not going to hold it, they were not acting out of discriminatory intent. They were equal opportunity in the sense that they were looking for anybody, right, who they could make a loan so that they could create the, keep the machine running.

And when discrimination is used as the predicate to go after that kind of conduct because it is so patently an inaccurate accusation it undermines the ability to really address the issue. And I would submit in some respects the regulators at the time were so focused with very extreme pressure from Barney Frank, Maxine Waters and others to focus on the minority issue that they—I defended cases where all I had to prove was that the bank was unfairly treating all borrowers, not just minority borrowers.

I would submit that the regulators and the plaintiffs and the courts should have been focused on whether people were being treated fairly in that lending process. And so I just think it's very dangerous to take that very real issue and make it a discrimination issue.

**SATYA THALLAM:** I am sorry; we are overtime so we have got to stop there. Thanks Cindy, Paul, Andy and Jean.

CENTENNIAL OF THE COUNCIL OF BETTER BUSINESS  
BUREAUS: THE IMPORTANT ROLE OF SELF-  
REGULATORY ORGANIZATIONS

*C. Lee Peeler, Linda Sherry*  
*Moderator: Jodie Z. Bernstein*

**D. BRUCE JOHNSEN:** All right, so I would like to introduce our speaker for the next panel, which is entitled the Centennial of the Council of Better Business Bureaus: The Important Role of Self-Regulatory Organizations. And our session moderator is Jodie Bernstein, who is a counsel at Kelley Drye & Warren.

She is a well known, long time participant in and advocate for consumer protection. She is respected by many consumer protection groups, industry organizations, and the private bar, and is one of the country's leading lawyers. Jodie held a position as the Director of the Bureau of Competition at the Federal Trade Commission, as the General Council at the US Environmental Protection Agency, and as General Counsel of the Department and Human Services, where she accomplished much. And having said that, I will hand things over to Jodie to moderate our panel. Thank you.

**JODIE Z. BERNSTEIN:** Thank you very much. And I'm not here at the Centennial because I am one-hundred years old, but it does seem appropriate since I was very much involved in our topic, which is self-regulatory programs of national advertising, and in a particular one that we are focusing on today, and that is the one that is run by the Council of Better Business Bureaus.<sup>1</sup> This has been in existence since the early seventies, created in response to serious criticism about the role of advertising and its impact on consumers. Before I introduce our very distinguished panelists, I would just note that every commission, and indeed members of Congress, have noted over the years, the very effective role that self-regulation can and has played, as a complement to federal law enforcement.

So with that, let me tell you who our speakers are. The first one is C. Lee Peeler, who spent many years at the Federal Trade Commission ("FTC"). His and the other biographies are in your materials, so I will not go into the specifics of it, in part because I know everybody wants to get to the bar. And they have been warned. But Lee Peeler is the Vice President of The Council of Better Business Bureaus, and CEO & President of the

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<sup>1</sup> *Council of Better Business Bureaus*, BETTER BUSINESS BUREAU, <http://www.bbb.org/us/cbbb/> (last visited Jan. 30, 2013). CBBB is the network hub for BBBs in the US and Canada. *Id.*

Advertising Self-Regulatory Council. David G. Mallen is the Deputy Director for Legal Affairs of the National Advertising Division (“NAD”) of the Council of Better Business Bureaus.

And to critique our self-regulators, Linda Sherry is—I am not going to forget the name, Linda—is the Director of National Priorities for Consumer Action, which is a very distinguished consumer organization that has been on the job critiquing self-regulation, I would say, for a number of years.<sup>2</sup> So Lee, take it away and tell us about your self-regulatory program. We will have plenty of time for questions, and I would encourage them.

**C. LEE PEELER:** Thank you very much for the introduction Jodie. Thanks to all of you for giving us a chance to talk to you about industry self-regulation. As Jodie said, it is really a complement to law enforcement work, but it is a process that is been developed, and I think can be very effective if it is done the right way. So you know, whenever anybody talks about self-regulation, this is the image they have, of the fox guarding the henhouse. And part of my retirement plan is to get a nickel for every panel I am on where someone says they are just the fox guarding the henhouse. What I want to do is talk to you about a model of self-regulation that tries to respond to that criticism, and it is really focused on advertising and advertising related issues.

There are really six programs, the early of which was created in 1971, as Jodie described, that look at truth and accuracy in national advertising claims. The most recent of which is a program created in 2011, to look at the data collection that supports online behavioral advertising, and basically, that is a process of tracking where computers go in order to serve tailored relevant ads to consumers, and it has been a big driver in the success of the internet marketplace. So we tried to construct a system of self-regulation that meets three primary tests.

The first is independence. It needs to be administered not by the industry groups that create it, but by a neutral third party. The second is transparency; reporting the results publicly of the self-regulatory inquiries. The third is accountability; having some real consequences if companies don not participate or don not follow the guidelines. Regarding the need for independence, we are administered by the Council of Better Business Bureaus, which is now a one-hundred year old organization. There are 114 bureaus located around the country. They have two primary missions, they provide business ratings and they have a place where consumers can go to find out about businesses and the business’ ratings from A to F.

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<sup>2</sup> *About Consumer Action*, CONSUMER ACTION, <http://www.consumer-action.org/about> (last visited Jan. 30, 2013). Consumer Action is a nonprofit organization that has championed the rights of underrepresented consumers nationwide since 1971. *Id.*

It is an ambitious undertaking to do that, and the Council does a good job of it. They also are famous for being the place that you can go with consumer complaints. In fact, last year more than a million consumers went to the Council with consumer complaints. This will show you some of the primary areas of complaints which are probably similar to what the State Attorneys General and what the local consumer protection agencies deal with. And again, the model is that the Council gets the complaints from the consumers and it goes to the business and tries to get a satisfactory resolution for the consumer of the complaint. These are examples of the business ratings. Here is an example of a company that is an accredited business. It also has an A+ rating.

There has been controversy about how the Better Business Bureau (“BBB”) provides its ratings, but I can tell you that whether you are an accredited business or not, is not necessary to get the highest rating. What is necessary to get the highest rating is a business model that respects consumer trust and resolves consumer complaints. Here is an example of a business that is rated as F. This is a company that called consumers to try to collect on debts that consumers did not owe. They were sued by the FTC, and they are now under investigation by the Justice Department,<sup>3</sup> so a well-deserved F. That is the independence part.

Regarding transparency, there was a struggle about whether to report self-regulatory decisions. The idea was that companies would be more likely to participate voluntarily if they were not publicly reported. The industry decided that they would publicly report them, and now the results of every case that we bring, win, lose, or draw are publicly reported, and we actually have a database that provides access to that information. And finally accountability; there has to be some consequences. When the system was started, we decided that if companies did not follow the recommendation, that we would publicly refer them to the FTC.

This is an example of a case where a company was making a claim that their vacuum cleaner would kill ninety-nine percent of germs through ultraviolet light. We looked at the substantiation for that claim and decided it was not substantiated. They did not change their claims, were referred to the FTC, and they ended up paying a \$750,000 fine;<sup>4</sup> that is the broad overview.

David Mallen is the Deputy Director of the NAD, which is the oldest of our self-regulatory organizations. I want to turn it over to him to describe to you just exactly how the process works. David?

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<sup>3</sup> *Court Halts Alleged Fake Debt Collector Calls from India, Grants FTC Request to Stop Defendants Who Posed as Law Enforcers*, FEDERAL TRADE COMMISSION (April 11, 2012), <http://www.ftc.gov/opa/2012/04/broadway.shtm>.

<sup>4</sup> *FTC Settlement Requires Oreck Corporation to Stop Making False and Unproven Claims That its Ultraviolet Vacuum and Air Cleaner Can Prevent Illness*, FEDERAL TRADE COMMISSION (April 7, 2011), <http://www.ftc.gov/opa/2011/04/oreck.shtm>.

**DAVID G. MALLIN:** Thank you, Lee. It is a great pleasure and privilege to be here, and to tell you about the work that we do, about the work of NAD and self-regulation, and the process by which advertising is reviewed by this entity, and the way the disputes are resolved. I think one of the really interesting things about it, about this group, is that it was not originally set up to resolve disputes. It was set up because there was a need. This industry recognized that it had a problem and there was an interest in self-policing to preserve the integrity of advertising, and to restore consumer confidence in the companies that advertised.

But over time, what happened was this review process, companies began to appreciate and utilize as a cost-effective means for actually resolving disputes. And in fact, about two-thirds of the cases that we look at come to us by virtue of competitor complaints. And probably about the third that are not competitor complaints, we look at in the areas of health and safety, and the kinds of advertising that really impacts consumers where there may be consumer harm, or where there is a real need, where it looks like advertising has run amuck a bit.

We have—and I think this is something that we are very proud of—a success rate of ninety-five percent. And what that means is, when we make a recommendation to a company, when we ask them to change their advertising, they do comply. Approximately ninety-five percent of the time, it is a voluntary process, and yet they comply. And they do it for two reasons. One, is there are teeth in the system in this respect. If a company does not comply, it does get referred to the FTC. Those complaints are taken seriously by the government agency. They provide tremendous backup and want this system of self-regulation to succeed.

But more than that, companies are stakeholders in this system. They want the program to succeed because of the benefits it provides. It provides a level playing field. It provides a means by which they can hold their competitor's feet to the fire, and ultimately preserve the integrity of their brands in the marketplace. We look at all kinds of advertising claims and all kinds of advertising issues. Health and nutrition, I mentioned, is a really important one, and we will look at an example of that. We look at consumer surveys a lot. Very often, the issue that is before us is whether or not there is an implied message, whether or not an implied communication is false, or whether it is actually substantiated.

One of the things about this process, you do not need to come in with a survey. You do not need extrinsic evidence that an applied claim is being communicated, as you might if you were to go to court under 43(a) of the Lanham Act<sup>5</sup> under a false advertising lawsuit. The hurdle is not as high as it is for a plaintiff, or as we call it, a challenger. Nevertheless, we often do

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<sup>5</sup> Lanham Act §43(a), 15 U.S.C. § 1125(a) (2012).

see survey evidence. It can be very important in our decision making process. We look at product testing. Very often, the ultimate issue for us is technical claim substantiation. That is, does the company have a reasonable basis in support of their claims that they are making to consumers. Endorsements and testimonials of course, are a very important part of advertising, and we look at those to make sure that they are in adherence and comply with the guidelines presented by the FTC.

We look at puffery a lot, and that is always the advertiser's defense. I am not really making a claim, I am just puffing. Well, as you know, there is some well-established jurisprudence in this area, but we have—we try to provide consistent guidance to companies on what is and what is not puffery. Disclosure is an issue that comes up a lot. Obviously, if it is material, it needs to be clearly and conspicuously disclosed. We are looking increasingly at green marketing or environmental claims. The process by which we look at these advertising claims and our review, it is an informal one, and yet it is governed by a set of procedures. And companies can write a letter. They can set forth their complaint, and they set forth why their competitor is engaged in advertising that is not substantiated.

We have two rounds of evidentiary submissions, and significantly, we have a meeting with each party. It is an *ex parte* meeting, where we have a frank discussion about the issues in the case, and sometimes it is about science, and sometimes it is about marketing. And at the end of the process, NAD looks at the evidence and makes a decision. It is a simple process of saying okay, the advertising is either substantiated or it is not, in which case, there are recommendations that we make. Sometimes these recommendations are very detailed. And over time, we have understood that companies have valued this process, and for some companies, it is an alternative to litigation. It is cost-effective and it is of relatively short duration.

From start to finish the process is usually about four months, which is certainly a long time if you are a candidate for emergency injunctive relief. But for some disputes, it is actually quite quick and cost effective, depending on what the company is looking to accomplish. One of the real differences, of course, is the burden of proof. And the approach that we take is in following with the FTC law;<sup>6</sup> we understand that companies do have the burden of having substantiation for their claims. And they have to have that before the claims are disseminated.

And so, again, a company that wants to bring the challenge does not need to prove the falsity. It is incumbent upon the advertiser to show that they have substantiation for the claim, and that is consistent with the consumer protection mission. I mentioned that surveys are not required, yet we do see them quite a bit, but there is no formal discovery, there is no sub-

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<sup>6</sup> 15 U.S.C. §§ 41-58.

poena power. Whether this is a good or bad thing may depend on exactly where you stand in terms of whether you need subpoena power. Companies are expected to provide the evidence that is relevant to this case. And we work with the companies, and we have frank discussions when we think there should be evidence and there is no evidence.

Confidentiality is an important part of this process. Companies can, if they are being challenged, submit material to us in confidence, where we can look at it, but the challenging company cannot. We are careful that the process is not abused and exploited as a fishing expedition. Nevertheless, we encourage companies to disclose information and we do want to make sure that it really is proprietary information if they are declaring that it is confidential. Companies choose this process though, mainly because of the time and the cost. And to be sure, there are limitations to this process. We do not have the court order at the end of the day.

We do not have the ability to award money damages or emergency injunctive relief. But at the end of the day, we are making recommendations that companies change or modify their advertising when it is not substantiated. And they do that ninety-five percent of the time. And so it is something that has, again, been praised by government agencies, and even by some consumer groups, as being very successful in that respect. When we are looking at advertising, we are looking at what are the claims that are being made here, what are the express claims, what are the implied claims, and what is the support for the claim?

The starting point is to see whether the advertiser has a reasonable basis for their claim. That involves looking at the evidence, and sometimes there is a battle of the experts. I think the best thing and the best way to illustrate the approach and the analysis that we do is to look at some of the actual cases. And so I will just quickly run through a couple of examples to just share with you how we approach these, and what some of the results have been. I mentioned that health and nutrition is an important part of our review, and this is one that was a challenge. This is a fortified water product, Fruit<sub>2</sub>O Essentials, and you can see the claim that is being made right there on the label, right there on the packaging, five nutrients equal to two servings of fruit, or in the case of the other variety, four nutrients equal to two servings of fruit.

This was challenged by Campbell's, and this is a claim that was literally truthful. The company said look, we have nutrients that are equal in amount to two servings of fruit. The problem in this case was that the nutrients were nutrients like potassium and magnesium. They were not the nutrients that are the reason why you need four servings of fruit. I mean so it was not vitamin C, it was not fiber. So it was a case, and we see this a lot, where the claim is literally truthful. But in our view it implied a different message. And added to that fact is, you have to remember, the location of this claim on the front of the label. This curves around, and what you see on the store shelf is two servings of fruit. And of course, without the calo-



ries, as this is just fortified water. So this was one where we thought that the claim had to be discontinued or significantly modified. The company agreed to do it and they actually changed their packaging and embraced the spirit of self-regulation.

Sometimes it gets really technical, and we have seen a lot of challenges and much activity in the area of telecommunications, and here for example, we have 3D televisions. Four out of five people choose LG Cinema 3D over Sony and Samsung for overall 3D experience. So this is one where you have a company making this claim of superiority. Basically, our technology is not only superior to our competitors but four out of five consumers say so, or choose our technology. This is the kind of claim where we look at very technical substantiation. And we looked at reports from color scientists.

We looked at all kinds of testing, including consumer testing, survey testing, and field testing. We had—I mentioned—we had all kinds of reports from color scientists as well. And the challenge here is that 3D technology is an area where you do not have a consensus industry standard. So, the challenge of coming up with a reasonable basis is a serious one. The technology is evolving more rapidly than any process for developing industry standards.

In this instance we had a battle of experts, and we took advantage of these *ex parte* meetings to really talk to the experts about the studies in this case. In this case, the support for the claim was problematic because although it was very technical, and it had a lot of explanation for why the science behind the claim might be true, the real test for us is whether it is consumer relevant. For example, the experts did a side-by-side test, but they had the consumers sitting at a distance where they could not tell the difference between the different televisions. It was not really a consumer relevant scenario, so that ultimately is really going to be decisive in our cases. There were also problems with the statistical analysis.

Ultimately, what we found is that the four out of five consumers were really reacting not to the picture quality, but to the 3D glasses, which were more impressive, I guess, for one company than the other. But this resulted in around a thirty-page decision, which is a little long by our standards. But it was resolved in less than six months, and the company agreed to make the changes.

We also do some monitoring cases.

This next one is probably the case that has received more press and publicity than any case that we have done in the past five years.<sup>7</sup> The primary reason is the cover girl that you see is none other than Billboard Artist of the Year, Taylor Swift. And the claim that is being made here is two

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<sup>7</sup> Lyneka Little, *Procter & Gamble Pulls Photoshopped Taylor Swift Mascara Ad*, CBS (Dec. 19, 2011, 1:42 PM), <http://abcnews.go.com/blogs/business/2011/12/procter-gamble-pulls-photoshopped-taylor-swift-mascara-ad/>.

times more volume for the mascara. Now you can appreciate—I think we all can—that there is a lot of puffery in cosmetics advertising. We do not really expect that you are going to look like Taylor Swift, and certainly not that you are going to sing like Taylor Swift. The problem here is that you have the claim two times more volume, and then you have this in the small print disclosures. Lashes enhanced in post-production. This was problematic from our point of view, and this was one that we looked at on our own initiative because of that disclosure. It is one thing to have an enhanced image of beauty but it is another to make a specific claim, two times more volume, that this is what you are going to get. And then in the fine print say, well, not really.

So this again is one that we looked at and we recommended changes. They agreed to make them.

Finally, one of the real challenges for us is in the changing nature of media itself, and so we are looking more and more at social media and communications and digital formats, where there are real serious questions as to what is advertising, and what role does a company have to support claims in those kinds of places. This is Facebook, and for those of you on Facebook, you may be familiar with what is called a like-gated promotion. What that is, is if you like us, if you click that like button, we will give you something for free. And in this case, it was Postal Contacts claiming that if you like us, we will give you free frames for eyeglasses. Now you can do that.

That is a legitimate kind of promotion, but the question is, number one, are you disclosing all the material terms, for example, such as the fact that there are only 5,000 free frames, that you have to maybe pay for shipping. So, often, there is this issue of disclosure that we make sure that companies are complying with. The other interesting issue is what does it really mean to like someone on Facebook? Is that making an endorsement or testimonial? And that is really the difficult issue that we looked at, and our own conclusion was that it is not an endorsement in the sense of “oh, I tried this product and I think it’s great.” We did not think that consumers took away that impression. Nevertheless, to like something on Facebook conveys a kind of social endorsement, and if it is fraudulently obtained, it is a problem.

We are going to ask companies to make changes. Navigating this space is definitely a challenge. I think it will keep us busy for quite some time. I am hopeful that there is time for questions at the end, and it has been a great privilege to speak with you here today. Thank you.

**JODIE Z. BERNSTEIN:** Thank you, and just a couple of comments, Linda, before we start. Two things that I would add to David’s excellent presentation, I think there were two important points that convinced, at least the FTC, to add its endorsement to the program. The first is that the decisions are made public. That has been an important element of it. And the second

is that there is an appeals process. It is not used very often, but there is an internal organization separate from David's organization that will entertain and make decisions on appeal from his decisions. Are there any questions from the audience, and if there are, right now could we take a couple of—I think we have time. If you would like to address questions to Lee or David, please go to the microphone.

**DAVID G. MALLEEN:** The one thing that I would just add to that if I may, the decisions are public, and they are available to companies—they provide important guidance to companies on some of these claims substantiation issues. And when a case is decided, there is a press release, so everything that we do is transparent. And I think that is an important part of why certainly regulators have confidence in the system, and why the public does as well.

**JODIE Z. BERNSTEIN:** Yes, and it is widely covered by the media, I would say, by the newspaper reporters who cover business and business issues. Yes, there is a question from the audience.

**BILL MONROE:** Hi, Bill Monroe out of California. David, I have two questions. First, did you get your free frames?

**DAVID G. MALLEEN:** I did not get my frames. What was actually rather important to our own thinking is everyone that did hit that like button got frames, so that was important to us.

**BILL MONROE:** The second half of my question is, where do most of your complaints come from, the competition or the public in general?

**DAVID G. MALLEEN:** Most of the complaints come from the competition, probably about two-thirds, some years as much as seventy percent. And then of the remaining thirty percent, some of those come from our own monitoring program, where we are charged with the responsibility of having a look at the marketplace and bringing cases on our own initiative. And we do that especially, I think, in areas of health and safety, and very active in particular in dietary supplements, where there are many claims in the marketplace, and of questionable substantiation. And then on occasion, we do get complaints, challenges from consumers or from public advocacy groups. The majority though, do come from the competitors, and in some ways, they are in the best position to know if things are false.

**BILL MONROE:** And just to add, the organization that administers this system is the BBB, and the BBB is very active in addressing individual consumer complaints, and again, it handled about a million last year in the 114 Bureaus that are around the country.

**JODIE Z. BERNSTEIN:** So with that, let us go, unless there are other questions. Oh, there is one, I am sorry, please.

**AUDIENCE MEMBER:** Always wanting to inject some economics into the situation. There is a standard economics model about advertising, which goes something like this. It is not so much the content of the advertising that is important in conveying a message to consumers. It is the fact that the manufacturer advertised, that it spent \$40 million to hire Tiger Woods. Why would that be relevant? They could have dumped the money in the ocean in essence, is the claim, as long as what they do is post a non-salvageable performance bond, okay. So let us say Nike makes this implicit promise to consumers that it is going to produce high-quality sneakers, and not only that, but innovate high-quality sneakers. And you can stick with Nike and we will always be there for you as your needs change and so on and so forth. And we make this commitment.

The problem is the commitment is not in any way contractually binding, etc. So the way Nike bonds its promise to do that is by dumping forty million dollars in the ocean, and telling consumers we will charge you an extra five dollars for every pair of sneakers you buy, and if you ever catch us cheating, you terminate us and we do not earn a normal return on the bond we posted. Now what kind of bond would we post? Well, we post the bond that has the highest possible value to consumers.

So dumping it in the ocean is not as good as giving it to Tiger Woods because for some reason, people identify with Tiger Woods, okay, so I am just curious, David, if you take these kinds of considerations into your analysis. For example, the eyeglasses, that is basically a way of telling consumers, we paid consumers a pair of eyeglass frames every time they say they like us on Facebook, and the point is we spent a bunch of money doing that. And we would only do that if we expected that we were going to be around to provide you with high quality product. So if you have a moment to say something about that, I would love it.

**JODIE Z. BERNSTEIN:** I think they would, but in order not to run out of time, can we postpone that one?

**KAREN CZARNECKI:** If you want to answer quickly, David.

**DAVID G. MALLEN:** Let me take a shot at answering that. Yes, the whole idea of self-regulation is that—and the FTC’s approach to advertising regulation is that advertising is pro competitive, and that is if it is truthful and substantiated, it is of great value to the consumers, and that is validated by the Supreme Court’s Commercial Speech Doctrine.<sup>8</sup> Now I think Paul Ru-

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<sup>8</sup> *Valentine v. Chrestensen*, 316 U.S. 52 (1942).

bin would argue with you that they are not adding an extra five dollars onto every pair of Nikes, that most of the economic studies show that advertising lowers prices.

That is particularly true in the regulated professions, on the studies of lawyer advertising and dental advertising, which showed that states that allowed advertising had in general lower prices for consumers than other states. And finally, there is a great deal of information in advertising. I mean the prescription drug advertising area is a very controversial area, but in areas like depression, there are lots of studies showing that the advertising has conveyed information to consumers that makes them more willing to use those drugs and to seek counseling and help if they are experiencing depression problems. But the basic answer is yes, we are very sensitive to the economic models underlying advertising.

**JODIE Z. BERNSTEIN:** Linda.

**LINDA SHERRY:** Thank you. Hello. I am Linda Sherry from Consumer Action, and I am here to sort of play the devil's advocate, I suppose. And I just want to say that I am not here to attack the BBB because I think it is actually doing a great job. It has had a few problems over the years with some chapters and things, but they quickly took care of those things and then moved on, and really have a very—a model that is worth watching and worth knowing about with the public results that they display and allow everyone to read. So we are very pleased with that innovation at the BBB.

I work with a consumer group, a 501(c)(3),<sup>9</sup> Consumer Action, forty-one years old this year. We do a lot of things. One of our target areas is moderate income and minority consumers. We do a lot of our educational efforts, free of cost to the end user, and to the community groups that use training materials that we create and provide. And our mission is really to help consumers prosper financially, and to have a leg up in the economic system, so that they are not one of the—you know, stay one of the forty-seven percent forever, and that they can have a shot at being one of the one percent someday.

We advocate for consumers in the media, so we are very active speaking with the media. They call us a lot to get reaction to different things, before lawmakers, to advance consumer rights, and to promote industry-wide change. Some of the things we do, I have mentioned we have the multiple languages or publications. We have a hotline where people can call or email, and that is one of the places that we very often end up referring people to the self-regulatory organization such as the BBB because

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<sup>9</sup> I.R.C. § 501(c)(3) (2006) (exempting from taxation organizations “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes. . .”).

they are there to help, and a lot of the government agencies actually cannot handle the individual complaints.

Those that do, of course, we do a lot of referrals to the Attorneys General (“AG”) and the new Consumer Financial Protection Bureau (“CFPB”), etc. We also give free materials and training support to a network of non-profit organizations and community-based organizations, almost 7,500 of those organizations. We have a great website,<sup>10</sup> and I will not go through everything that it offers, but if you want to take a look sometime, please do. We have daily updates of consumer news. We have all of our publications. We have sub sites on a bunch of different topics, and it is, I think, a great job that we do to keep consumers informed, to come back and visit us. So basically, what I want to point out here about being the devil’s advocate for this issue is that in general, consumer advocates run in a large pack.

Since I have been in Washington D.C., since 2004, very often twenty-five of us will show up at a regulator’s office to talk about X, Y, or Z. It could be almost humorous in a way. But what we find is that of the consumer advocates, such as myself—I am a lay consumer advocate, not a lawyer—we end up going in and we end up hearing a lot from companies, as well as from Congress and other regulatory bodies, that the voluntary self-regulation is a great way to go because it avoids much of the rule-making, much of the perhaps unintended consequences that come with some legislation, and other things that they wish to avoid, that might cause more trouble than they are worth.

But unfortunately, those of us in the consumer advocacy field really feel overall that self-regulation is not the greatest model, when you can have a good law to protect consumers. Some of the pros and cons, as I see them, are while the government consumer protection agencies have a lot of specific tools, such as laws they can enforce, and enforcement mandates and budgets to some degree—I know the budgets are not always there—they have the cooperation of Justice Departments, etc.

Sometimes the Self Regulatory Organizations (“SRO”), you know, they still cannot do much. And the SROs are valuable because they really do serve an additional place for consumers to seek assistance. Business owners will sometimes listen more to their peers than they will to others, so that is a great advantage. And I think we are seeing that, as we hear about it from David and Lee about some of the issues. When your peers come down on you, you are perhaps more likely to be concerned that your competitor is giving the industry a bad name, or getting an unfair leg up, that kind of thing, so that can work well to bring businesses in line.

Sometimes with jurisdictional issues, such as international types of things, and I know the FTC really struggles with this on terms of fraud, you know, transporter fraud—it can really be hard to coordinate exactly, the

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<sup>10</sup> *Consumer Action – consumer education, advocacy, financial literacy, and consumer protection*, CONSUMER ACTION, <http://www.consumer-action.org> (last visited Jan. 24, 2013).

laws are different, etc., and they have to work very hard on that. A self-regulatory organization can actually have more of an advantage there because they are not subject, perhaps, to the exact laws of one country or another. And if it is a voluntary SRO that was created by the different players in the different countries, it can work very well.

We also think that the—a letter of the law is a strong enticement for the industry to avoid consumer abuse, and solve unfair and deceptive practices. And so I think that in some cases, with the third party oversight, say the government oversight, these things would work a lot better and have shown to be more effective, or at least with the participation of the government, the endorsement or the participation of the government. As far as drawbacks, I would say that some of these companies are really not legally responsive—some of these organizations, I should say, are not necessarily legally responsible if someone really did want to in the end, bring an enforcement action against them.

They can refer them to organizations, but of course, they do not necessarily have that power themselves. And we also think that catching bad actors either for a government agency or an SRO can be remarkably tricky, so it can be close to impossible for an SRO to actually catch the people who are not part of its membership, and work with those people because those people are determined to defraud consumers. So they are outside of the realm of that whole effort.

Also, I think that another pro that I wanted to mention, which might work in some cases, was that some of the SROs being there for consumers do keep some of the disputes out of court, so that might be a good thing, too, in the end. The key elements to the success of these programs are really the inclusive stakeholder design process, so I would say that people really need to put their heads together, and who is involved in the design process? And they should have not only businesses be involved in that process, but states and consumers as well as consumer organizations. And we have noticed sometimes that in the efforts to put this design process together, to put these SROs together, that the consumer voice is often missing.

So then, compliance and third-party oversight, I think that can really help with the issue that Lee mentioned, which is the fox guarding the henhouse issue, because if somebody is responsible for overseeing the SRO, it can be a stronger one I think. And I think evaluation is key to everything that we do today, so a means to evaluate whether the self-regulation is working and is open to public scrutiny, as obviously the BBB's is, then that can really result in a good program. Some of the danger that we see with these SROs, with SROs in general, is that it may be difficult to maintain impartiality.

They can be seen as kind of old boys' clubs inside, or simply marketing ploys by companies to say look, I am gonna do this, and then when all attention is turned, I am going to—you know, go back to business as usual.

The pay-to-play, we have seen it happen, you know, pay us and we will give you a good rating type of thing. It is not pretty, but there is the potential that could possibly happen. And then I think that non-membership entities, who do not want to pay the dues or become part of the organization may question the evaluation process or the effectiveness of the evaluation process. And there is also something—I hope I can explain it, but consumer confusion can really be something you have to deal with.

I mean I know a lot of consumers call Consumer Action to get—we give advice and referrals to different agencies, people that can help them on their different topics, and that is a free service that we do. But sometimes the consumer will have very high expectations about what we are actually there to do. And if they are not happy, they will get very disgruntled about the process, and they will say well, but you are a government agency, which of course we are not. So the consumers themselves get very confused about the different SROs, I think, and they assume that maybe it is the FTC they are talking to, or somebody with the ability to actually go into court and do something in the end.

And that is not always the case, so we hope that—this could end up disenchanting some consumers, I think in the end. Why do they exist? Well, they obviously exist because there is really a lot of industries propose them when they think that they are going to be subject to regulation, and they assume, and maybe know rightly, I do not know, that regulation will add great costs and bother to their business model, and then they will not be able to necessarily do as much of their own business as they should be doing. So a lot of them do it—would prefer it to regulation, and that is a lot of the ones I have seen happening in Washington today, actually, where they are proposed.

These companies really want to avoid regulation. There was a recent anti-cramming measure by the FCC.<sup>11</sup> Cramming is when you have things on your phone bill that you did not really order. And the companies went to lobby the FCC to have more of a loose-ended, open-ended system where they would follow rules and do self-regulation as opposed to the opposite side of it. And they are also sometimes sparked by crisis. Something will happen and up will pop a call for banning together and doing a better job in the future, instead of bringing down the law on the companies.

And governments themselves, we see this all the time, Congress and other regulatory agencies, they actually prefer to work with a self-regulatory model. In the long run, I think there are situations where you really need regulations to protect consumers because you know, there is no doubt that substantive regulation works better in some cases. For instance, one of the situations in which I have personal knowledge is the Credit Card

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<sup>11</sup> 47 C.F.R. § 64.201 (2012).



Act of 2009.<sup>12</sup> For many years, we tried to get the credit card industry to clean up its act. And they kept saying, oh, we will do that, and then when Congresswoman Carolyn Maloney of New York became very interested in looking at the industry and saying, what are you doing to stop these unfair and deceptive practices that are happening to consumers in your industry? And they all said, we will self-regulate, we will change everything, everything will be fine.

But the problem with that industry is, it was a follow the leader industry, so what ends up happening is one company would adopt a bad practice, but a profit-making practice, and then others would just adopt the same practice because they wanted to make the same profit. So the Card Act passed in 2009, signed by President Obama, and in my opinion an example of where substantive regulation has really worked. It has reduced the costs to consumers of owning credit cards, and it has reduced a lot of the unfair practices. So please call me at Consumer Action any time you want. Go to the website, you can reach me at the Washington D.C. office, and I would be happy to talk to you anytime about consumer issues, consumer rights or consumer protection. Thank you.

**JODIE Z. BERNSTEIN:** I was going to ask Linda whether or not that last claim was substantiated, but I assume it was. We have a few more minutes if there are additional questions from the audience. We would be happy to and your panelists are available to answer questions.

**AUDIENCE MEMBER:** I am just curious, in terms of these reports from the self-regulated organizations, have there been any cases that have dealt with the admissibility of those reports in possible state court actions alleging unfair or deceptive advertising practices?

**JODIE Z. BERNSTEIN:** Of your decisions, I think in subsequent litigation.

**AUDIENCE MEMBER:** As compared to public reports that may be admissible and become a basis, I mean I am just wondering, is this something that helps consumers or actually hinders consumers?

**C. LEE PEELER:** It happens on occasion that following in any decision in a finding, there can be litigation down the road, whether it is action under a false advertising statute or a consumer protection statute. But it is unusual. Most often, the decision hopefully resolves the dispute, but sometimes there have been cases where companies or consumers have brought lawsuits, and the issue of NAD's reports and specific findings come into play or may appear in the pleadings.

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<sup>12</sup> Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (2009).

I am not aware of any situation where a NAD finding was admitted into evidence in a judicial proceeding. But some courts have given some deference to the NAD process, and have recognized that the mechanism is a good one for resolving disputes. There was one instance in the southern district of New York, where litigation was actually stayed, pending the completion of an NAD proceeding, which is a little different from the question you asked about the admissibility of reports.<sup>13</sup> But certainly, the NAD reports do not themselves create a private right of action. And I am not aware of actually them being given that status.

**DAVID G. MALLIN:** And there actually are one or two cases where plaintiffs have alleged that the NAD decision should be given precedential value, and the courts in those cases have correctly, in my opinion, held that no, this is a self-regulatory process, so we are happy to have the NAD decision, but it should not be looked to as binding precedent. And you know, because it is self-regulation, and because it is voluntary, I think that is probably the right place for people to come out, and I hope I am not engaging in *ex parte* communications with any of you.

**JODIE Z. BERNSTEIN:** Yes, and would you go to a microphone please? It is being recorded.

**AUDIENCE MEMBER:** Is Consumer Reports Magazine<sup>14</sup> as squeaky-clean as they claim to be?

**JODIE Z. BERNSTEIN:** Well, let me take a crack at that since I know a good deal about the organization, and how it does its reports. I think they have a very, very good process for evaluating the products that they evaluate. It is also open, and subject to a great deal of scrutiny—I am not on the board. I am not a paid employee of Consumers Union, but I think they have established that they have a very good squeaky clean reputation, and it is deserved. Are there any other comments on that?

**DAVID G. MALLIN:** And so we look at commercial advertising, you know, we do not look at advocacy—consumer advocacy ads, and we do not look at political speech.

**JODIE Z. BERNSTEIN:** Or charitable, do you look at charitable?

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<sup>13</sup> *Russian Standard Vodka, Inc. v. Allied Domecq Spirits & Wine*, 523 F. Supp. 2d 376, 387 (S.D.N.Y. 2007) (ordering the lawsuit stayed until the completion of the pending NAD investigation).

<sup>14</sup> See *About Us*, CONSUMER REPORTS, <http://www.consumerreports.org/cro/about-us/index.htm> (last visited Jan. 25, 2013) (characterizing itself as “an expert, independent, nonprofit organization whose mission is to work for a fair, just, and safe marketplace for all consumers and to empower consumers to protect themselves.” *Consumer Reports* is produced by the Consumers Union).

**DAVID G. MALLEEN:** There is an organization called the Wise Giving Alliance that is run by the BBB, that reports very comprehensively on charities on about fifteen different measures, so there is a lot going on in that area also.

**LINDA SHERRY:** I would just like to say that I am incredibly familiar with my colleagues at the Consumers Union, which publishes Consumer Reports, and I think that a sign that they are very—or strive to be very impartial, is that when they make a mistake, they admit it. And I think that's a real sign that somebody is doing something—mistakes can happen. Obviously, they are looking at a lot of products. They buy all the products themselves, so that is something right there.

There is a competitor out there, and I will not name it, but it is a magazine that purports to compare products, and they get the products given to them, which surely must be against the endorsement rules of the FTC, or at least subject to disclosure, I should say. So I think that Consumer Reports is doing a darn good job. I think where they get maybe fingers pointed a little bit is they do have a progressive viewpoint on consumer rights, and I think they should, because companies have a lot of power. Companies are the Goliath to the David, and so David can use all the backing he can get.

**DAVID G. MALLEEN:** So we have some testimonials.

**LINDA SHERRY:** It is worth the subscription price, I would say.

**JODIE Z. BERNSTEIN:** Do any of the three of you want to make any closing remarks before I let these people go and have a drink?

**C. LEE PEELER:** I guess the closing remark that I would make is I am sorry if you were hoping for a more heated debate. I think there are more agreements than disagreements about the value, and to be fair, the limitations of self-regulation. The one thing that I would add in terms of the pros, and the things that self-regulation can accomplish is its flexibility and relative speed. One of the hot issues in advertising for example, is environmental and green marketing. And there is a process, and FTC is very involved and engaged in this process, but it takes a very long time for guidance and regulation to come along.

And so while consumers and companies were waiting for FTC to revise its recent green guides, we were doing cases, both on our own initiative, and challenges, where we were advising companies, educating companies, hopefully raising the bar and getting companies to advertise more responsibly and more accurately. And so I think that is worth mentioning.

**DAVID G. MALLEN:** And so I would just close by saying I think what we are—I know, first off, we are delighted to be here, and you know, I know a lot about the state court and federal court trial system, and you know, the job that you guys do is just incredibly important and difficult. The role of self-regulation is not in any way a substitute for what you do, but in terms of the busy and crowded dockets that you have, and that the State Attorneys General have, and that the federal government has, self-regulation is a way of really extending resources to companies that are very interested in a level playing field and truthful marketplace.

**JODIE Z. BERNSTEIN:** As I said initially, I think we all view self-regulation as a very effective complement to law enforcement that heaven knows, needs a lot of help at every level, federal and state. So with that, may I thank my panelists, who have done just a superb job. Thank you for your questions and your attention.

## THE ECONOMICS OF PRIVACY AND DATA SECURITY

*Anna H. Davis, Nuala O'Connor, Matthew Fitzsimmons, Lisa J. Sotro*  
*Moderator: James C. Cooper*

**DANIEL D. POLSBY:** So I was actually chagrined when Bruce Johnsen upgraded for failing to brag enough about our Law School. So I hereby brag about it, and I mean I am actually very proud of the program, but I don't want to bore you with the kennel boilerplate either. All Deans say that about their law schools it is just most of them are lying. So I came over here this morning, and most of you were staying in Mason, if not all of you, and so you may have seen the weather, but you haven't actually experienced that it's filthy out there. It's cold and it's raining; it's actually going to clear a little bit later. But it impressed me as I walked in here that it is a wonderful day to have an indoor job and which we do and, come to think of it, most days are wonderful days to have indoor jobs.

I have a couple of other points to make, and I will be very brief. One of them is you all need to hire our graduates as law clerks; you will be very happy campers if you do and you will be unhappy campers if you don't. So, I mean, that is a great deal so keep us in mind as you need law clerks; we have at the law school, at the median, 90th percentile law students and it is a very, very strong competitive group of kids and we call them favorably to your attention. The final point is I actually should have welcomed you when you got here instead of towards the end of your stay. But I was teaching torts yesterday morning and I could not, in a timely fashion, express my gratitude that you are able to be here.

As a number of you are not on administrative leave, but you are actually taking annual leave or vacation time to be here, we are sensible of that and we appreciate the investment of your time. We hope that the program that we have pulled together here or another program that we do is fully justifying and compensates you for the sacrifice that you made in your schedule to come here. And we thank you for that, and even though it is tardy, I very warmly welcome you and thank you for coming.

**JAMES COOPER:** Thank you, Dean Polsby. All right and good morning and welcome, I'm James Cooper. I'm the Director of Research and Policy at the Law and Economics Center and I'm really pleased today to be kicking off this morning with a panel on privacy. Well, privacy—the right to privacy—is famously referred to as the right to be let alone. Brandeis and Warren wrote a famous Harvard Law Review article in 1890, which began to lay the foundations of legal framework that we have today, and was prompted by new technology. As the authors noted, let me read this to you:

“Instantaneous photographs and newspaper enterprise have invaded the secreted precincts of our domestic lives.”<sup>1</sup>

Numerous maniacal devices threaten to make good the prediction that what is whispered in the closet shall be proclaimed from the housetops. Well, technology again is serving as a catalyst for new discussions about privacy. We all live much of our lives online today. Here are some facts—and I know that they are true because I found them on the Internet—that for instance 80% of Americans use the Internet regularly, online retail sales are over \$170 billion and they have grown at an average annual rate of about 17% since 2002. Facebook claims over 900 million users worldwide, and a recent Pew survey shows that about two thirds of adults use social media like Facebook, Twitter, and Myspace.

Forty-five percent of adults and two thirds of those between eighteen and twenty-nine have a smartphone, and the number of smartphone owners that use their mobile device as a primary conduit to the Internet has doubled in the last three years. Of course these online industries are lying; consumer data, for example, add networks to track our online habits—be it cookies and other devices, and then advertisers bid to show us ads based on our likely interest in what they are selling. Not surprisingly this increased trade—the increased trade data for content has led to a vibrant debate over the proper balance between consumer privacy and information flow.

On one hand, sharing information clearly benefits consumers— consumers have access to volumes, reviews and other valuable information about products and services they are interested in. As we all know, increased information makes markets work more effectually; reducing information asymmetries makes consumers smarter and make better decisions in the market place. Targeting ads and sites like eBay help and also help markets work more effectually through better matching of buyers and sellers. Social media allows us to stay connected and reconnect with friends and family. And it’s not just commercial markets that have improved, online dating services, right, and I remember when I worked at the FTC when they did an audit of unauthorized website traffic— dating services were the number one.

That’s your tax dollars at work, right? So dating services just like other online markets help facilitate romantic matching. And finally the transmission of health information among different providers has the potential to improve health outcomes. So, on the other hand, however, some express concern over the amount of info—amount of data collected. Echoing Brandeis and Warren’s concern that the private details of one’s life are going to be proclaimed from the rooftops, some are fearful that vast reservoirs of personal information are just waiting to burst, causing catastrophic damage.

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<sup>1</sup> Samuel D. Warren & Louis Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193, 195 (1890).

More subjectively, people complain about a general creepy feeling that comes with being tracked online. And some also worry about the increasing porous wall between the private sector and the government sector when it comes to data collection. Currently there's a patchwork of state and federal laws that handle privacy. At the federal level, several laws such as HIPAA<sup>2</sup> and the Fair Credit Reporting Act<sup>3</sup> address privacy specific to a sector of the economy. [inaudible] protects children; Section Five of the FTC Act generally prohibits deception and unfair acts or practices,<sup>4</sup> and it applies across a wide variety of industries although there are some important exceptions.

The states have a plethora of consumer protection laws as well, many of which are modeled after Section Five of the FTC Act.<sup>5</sup> And future states have led the way in enacting data breach notification laws. But some worry current legal framework is inadequate for the task. To move forward in a reasonable way requires addressing some serious questions; for example: to what extent do markets adequately protect consumers right now? That is, is there really a crisis? Is there a need for new Federal Relegation? Should we pursue a harms-based approach or a more top-down regulatory approach where we mandate taking certain actions? And how do we handle non-monetary harm like the creepy feeling of being tracked online, and what about preemption? We talked about the vast array, the vast patchwork of federal and state laws. Should federal law preempt state law, and how did government-imposed privacy and data security requirements affect competition, and to what extent if at all does privacy domain affect the antitrust discussion? For instance, some have suggested that privacy should be treated as the price that we pay to access things online in the antitrust analysis. Well, we are lucky today to have a distinguished panel to discuss these topics. In order of presentation, first we have Lisa Sotto. Lisa is a partner of Hunton & Williams, and she is the head of its privacy and information management practice.

Next up we have Matt Fitzsimmons, Matt is an Assistant Attorney General in the Connecticut Attorney General's Office where he chairs the privacy taskforce. And finally, Anna Davis. She is an Attorney Advisor of Commissioner Maureen Ohlhausen at the Federal Trade Commission. She has also served as head of Congressional Relations and Public Affairs of the Federal Trade Commission. And she at one time, and this is when I met her early in my academic career, she was the Associate Dean of Career Academic and Alumni Services at GMU Law School. So without any further

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<sup>2</sup> Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936 (codified as amended in scattered sections of 42 U.S.C.).

<sup>3</sup> Fair Credit Reporting Act (FCRA), Pub. L. No. 90-321, 84 Stat. 1128 (1968).

<sup>4</sup> Federal Trade Commission Act, 15 U.S.C. §45 (2006).

<sup>5</sup> *Id.*

ado, join me in welcoming the panelists as I look forward to a lively discussion.

**LISA SOTTO:** Good morning and thank you for welcoming this panel. Privacy and data security is an area that is evolving so quickly that those of us that do this often can barely keep up with the area. Everybody uses the information; every organization uses data and maintains data, whether that's customer data or HR data, there is personal information about individuals maintained by every entity everywhere around the world. And, as we will talk about it a little bit later, data is not contained by country boundaries, so laws in this space are actually very difficult. When you think about data residing in sixteen different places at once—here you have the very same data elements, the same data sets, residing in those sixteen different jurisdictions, how in the world do you apply a single country's laws or state's laws to that data set?

So, these are very interesting and difficult questions. I am going to give you an overview of what's going on in the U.S. and a little bit about overseas. And then we are going to hear from the regulators, from Matt and Anna, who are the people who really make my clients quake in their boots. So let's go ahead and talk U.S. before we get to U.S. generally. I would like to just start with some definitions. When we think about data privacy we think about the rubric that also encompasses the state of security. But it is worth spending a minute teasing those two apart because they are different concepts, although they're two sides to the same coin. Data privacy is a culturally based phenomenon—when you go to different countries and you speak to an anthropologist about what is privacy they will tell you that privacy differs depending on the culture and depending on the demographic. So my teenagers think of privacy very, very differently from the way I think of privacy, the way that you think of privacy, and the way Singaporeans, Indonesians, or those in Japan or China or Europe think of data privacy.

And just to give you a sense of this the word, I'm told for privacy in Mandarin, there is no word for privacy; it is two words that are put together, and when those two words are put together it's actually privative. So privacy is the negative concept, and still in China they're working their way towards putting in place a comprehensive data protection law. So when we think about privacy here in the states, we think about consumer expectations. What do consumers expect with respect to the uses of their data and those expectations are often are imbedded in law? HIPAA is a very good example of that, and you have all gotten HIPAA notices.

You all know about HIPAA because we all go to physicians and get privacy notices from our health plans. HIPAA is the federal health privacy law, and HIPAA was enacted after years and years of grassroots outcry



over the use of personal health information for marketing purposes.<sup>6</sup> Data security is almost the flip side: where privacy is subjective, data security is objective, maintaining the security of data, keeping it safe, maintaining confidentiality, and making sure that data is not used in untoward ways. So how do we define personal information in the states? This is a very interesting question because, in fact, we define it so many different ways that it's almost hard to get your arms around this term.

In Europe there is one term—personal data—and it is defined in a set way in every member state plus the G3 nations. I've looked and seen Iceland and Norway plus Switzerland all define it exactly the same way. Here we have literally hundreds of definitions for this term that we are trying to get our arms around. So we see a definition in HIPAA; we have a different definition in the Gramm-Leach-Bliley Act,<sup>7</sup> which regulates financial privacy; we have in the states literally hundreds of definitions, and the state laws, in large part many of them define personal information as the data elements that can be used to commit identity theft or account fraud.

So only those data elements that are the most sensitive like social security number, credit or debit card number, or bank account number, or driver's license, and that's a subset of state laws, the data breach notification laws, and I will talk a little bit more about those. The FTC defines this term in a very, very broad manner and, the FTC's definition has actually evolved quite a bit over the years. So the definition FTC uses is probably the best one to look at because it serves the broadest industry sector or sectors. So they define personal information as any information that can be used to identify a human being.

And then they give examples, and those examples include name, address, email address, telephone, social security number, going down the list, more sensitive credit and debit card number, financial account information, and to more recently the list has gone on to include IP addresses. So what does the IP address identify? It identifies a device; it doesn't identify a human. And the last element's most recent definition is location information. So the fact that I'm here and the latitude and longitude that I'm at right now would be deemed by the FTC as personal information, which is very heavily regulated.

So it is very interesting to see that shift in definition. The other thing that the FTC has done is that they recently, in the last couple of years, made the pronouncement that data really can't be anonymized, so, to the extent data is anonymized, they consider that data to be useless and therefore almost mandates that anonymizing data doesn't really make data anonymous and there are statisticians and others who could in fact re-identify that data.

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<sup>6</sup> Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936.

<sup>7</sup> Gramm-Leach-Bailey Act (Financial Services Modernization Act of 1999), Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C.).

So there is a shift in the manner in which we are talking about anonymity and then this brooding of the definition of personal information to really widen the area of jurisdiction that the FTC has over this particular area.

And just to note, the FTC has now just stopped altogether using the term “personal information.” Because they said we are not going to debate anymore whether or not IP address is personal information, we are just going to call it “covered information,” and this is what we are covering and it’s this very broad universe of data. So in the United States we have what is deemed by others outside the United States to be a sectorial resume for privacy, meaning that we regulate by industry sector and by data types, so just quickly go through the plethora of it, really, of laws in this area and there are far fewer at the federal level than at the state level.

HIPAA is the law that regulates health privacy in this country. There are three types of covered entities: health plans, health care providers, and health care clearing houses. The Gramm-Leach-Bliley Act (GLB)<sup>8</sup> regulates financial privacy; so you have all seen privacy notices from your banks you don’t get those out of the goodness of their hearts. You get that because GLB is in existence. The Fair Credit Reporting Act (FCRA)<sup>9</sup> was really a very early privacy law. We didn’t think of it as such; it regulates data maintained by consumer reporting agencies so we didn’t really think about privacy when FCRA came into existence.

In the mid-1970s we thought about this as a law that regulated credit-reporting agencies, but in fact it really is a very early privacy law. The COPA<sup>10</sup>—the Children’s Online Privacy Protection Act that is—that was a reasonably early law that was in acted in the 1990s that is being rejiggered right now because there is so much change in how children provide data; they don’t provide data online anymore. Very few of our children actually go online to provide data; they use their devices, they use all kinds of other media to provide data to operators. CAN-SPAM<sup>11</sup> was enacted in 2004; CAN-SPAM regulates the sending of commercial email.

The Video Privacy Protection Act (VPPA)<sup>12</sup> is a very good example of what we do in this country in respect of privacy laws. We enact laws where there is a perceived harm. And here, if you all remember when Judge Bork was nominated for the Supreme Court, the Democrats sought his video rental records and the Republicans followed with the VPPA. The Drivers Privacy Protection Act (DPPA)<sup>13</sup> similarly was enacted in a way of a murder: a

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<sup>8</sup> Gramm-Leach-Bailey Act (Financial Services Modernization Act of 1999), Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C.).

<sup>9</sup> Fair Credit Reporting Act (FCRA), 15 U.S.C. §1681 (2006).

<sup>10</sup> Children’s Online Privacy Protection Act of 1998, 15 U.S.C. §§6501-6506 (2006).

<sup>11</sup> Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, 15 U.S.C. §§7701-7713 (2006).

<sup>12</sup> Video Privacy Protection Act of 1988, 18 U.S.C. §2710 (2006).

<sup>13</sup> Driver’s Privacy Protection Act of 1994, 18 U.S.C. §§2721-2725 (2006).

young woman was stalked by her high school sweetheart and the private investigator who he hired was able to find out her social security number and figure out where she worked and then he was able to find her and murder her.

So this was the result of that harm, the Telephone Consumer Protection Act,<sup>14</sup> TCPA: do not call registry—is anybody not on the do-not-call registry? You’re all too embarrassed to raise your hands; good job, thank you for being honest. The do-not-call registry has more people on the registry than there are registered voters in this country. The Privacy Act of 1974<sup>15</sup> was similar to the DPPA and VPPA, which also was enacted in the wake of harm called Watergate in 1974. Let’s talk a little bit about enforcement, and Anna’s going to elaborate on this the primary enforcement vehicle in this country, Section Five of the FTC Act. Section Five prohibits unfair or deceptive betrayed practices.

So the FTC started using this very, very broad authority in the late-1990s to tag companies that had done something untoward with data to say, “You promised you would do X and you did Y,” so for example, “you promised that you would keep data safe, you said in your privacy notice, ‘We will ensure that your data is safeguarded,’ and in fact there was a data breach and it wasn’t safeguarded so you were [inaudible]. You broke your promise,” so the FTC started, based on the deception principle, shifted in 2002, using fairness as well. But if you maintained data and you don’t use it in ways that are expected by the consumer or if you don’t safeguard data.

In particularly sensitive personal data that is fundamentally unfair, the FTC went after entities under Section Five. So these cases often result from putting this into four buckets, putting the enforcement actions into four buckets where a company makes a statement and does not abide by that statement with respect to its information practices. Second, where a company fails to take steps to protect data and that data is subject to theft or some other unauthorized access. Where an annuity fails to dispose of data properly, we have people in our security.

Known in our little world as dumpster divers, are people who go in back of drugstores and banks and other businesses and they dive for data. Because data is very valuable, you can make a lot of money off of data. You don’t have to collect bottles anymore; you can just look for data. Other enforcement actions have pinged off of the misappropriation with respect to the use of data where a company says, for example, “We will not share your data with third parties,” and then the company does in fact share data with third parties. There have been a number of enforcement actions that have resulted from that sort of practice.

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<sup>14</sup> Telephone Consumer Protection Act of 1991, 47 U.S.C. §227 (2012).

<sup>15</sup> Privacy Act of 1974, 5 U.S.C. §552a (2012).

Similarly, in the health data arena, the HIPAA as amended by the Hitech Act,<sup>16</sup> in 2009, February 2009, as part of the stimulus package the Obama administration passed, really changed the landscape here. There had been very, very few enforcement actions under HIPAA until 2009, and it was after that, that HHS<sup>17</sup> and specifically the Office for Civil Rights, which is the enforcement arm of HHS, really stepped up to the plate and said, “That’s it, it’s over; anybody that has had a free ride until 2009, no more free ride. We are enforcing with vigor.” And we have seen that kind of activity because HHS now has more tools.

One, they have the ability through the Hitech Act to now use state Attorneys General, and Matt will probably talk about that, to go after alleged HIPAA violators. And second, in 2009, under the Hitech Act—the Hitech Act law expanded HIPAA to apply not only the covered entities that I named earlier: health care providers, health care clearing houses, and health plans, but also portions of it, but now applied directly to what are known as business associates so service providers to health care industries also now are responsible for complying with what is called the “security rule,” which is the set of regulations that impose very stringent security standards on business associates and covered entities.

In addition, HHS started an audit program last year, so last I checked, which was now a couple of months ago, they had done 115 random audits to check on HIPAA compliance. And of course what they found, there was very little of it, or a lot that needed to be reinforced anyways, and there have been a number of actions ending in multimillion-dollar fines. Just to give you a sense, before 2009, the highest fine that could be levied against a company was \$50,000; after February of 2009, it was \$1.5 million per incidence. So this is really a hefty new level of fining ability. I am not going to go through these proposed laws, but just to give you a sense of the immense amount of activity around this area.

We are—the first bullet says that our regime in this country is under pressure; there’s no question about that. Because we are very much out of step with the rest of the world, the rest of the world is enacting quickly. One after the next after the next, and we are seeing them now weekly on the bus: comprehensive data protection laws. We do not have that in this country; we have this patchwork quilt of laws, and there have been a number of proposed laws that have tried to right this ship. In some way, we are stuck with the regime that we have. We are not going to do away with it at this point; it’s just too far down the road.

But there have been a lot of efforts to enact, in some cases, comprehensive privacy legislation, and in other cases pinpointed privacy legisla-

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<sup>16</sup> Health and Information Technology for Economic and Clinical Health Act (Hitech Act), Pub. L. No. 111-5, 123 Stat. 226 (2009) (as codified in scattered sections of 42 U.S.C.).

<sup>17</sup> United States Department of Health and Human Services (HHS).

tion. For example, The SAFE Data Act<sup>18</sup> was all about securing data. Where the Kerry-McCain Bill<sup>19</sup> was much more comprehensive, on the bus, data protection bill. The states, this is where the real action is. The states in the privacy area are really leading the Feds by the nose. So when you think about trying to put the hundreds and hundreds of state laws that are out there in the buckets as I've listed them here, and I will go through very quickly these buckets. So some of the key buckets are there, are a few states with data security laws. Now this is a real problem, and we will talk a little bit about the presumption later, but what do you do when states have different data security requirements? There's virtually no customer relations management database that contains the data of only one state's residents. There are multi-state-multi-country databases. So it is very difficult when the states come along and enact specific and diverse agent security requirements. There are now in forty-six states and four other jurisdictions, Guam, the U.S. Virgin Islands, Porto Rico and DC, state data breach notification laws. Many of you I know have received data breach notification letters.

These are laws that require that [inaudible] that suffer data compromises to inform the individuals whose data was potentially compromised that there has been this sort of an event. There are health privacy laws. There are thirty-five states that have restrictions on the use of social security numbers. There are some that deal with marketing restrictions. There are child protection registries down the line. On the state side, we've seen a huge increase in activity by state attorneys in general when we get a letter. From that we get a little bit nervous, and I see those a lot. Matt's been very busy. We also are seeing the plaintiff's bar enter into this arena with gusto; they really love this area, and we are seeing the dikes starting to fail.

Because at first these actions really did not succeed because there were no damages, so very rarely in these breach cases, for example, are there damages. But there are new theories that are being developed, as the plaintiffs' lawyers are, as you know, quite creative. Just to give you a quick sense of what is happening in the rest of the world, and then I'm going to sit down. The white shows where, those countries where there are no privacy laws in place, so I've been speaking for about fifteen minutes and it's about no privacy laws in our country. The red shows pending efforts and the blue shows where there are comprehensive data protection laws in place.

Take this with a little bit of a grain of salt as November of 2011, and there have been at least half a dozen new laws passed globally since then. For example: Philippines just passed a law; Malaysia passed a law not long ago. We are seeing them fast and furious now in Latin America, in Asia in particular; Europe is already well advanced in this area. So with that I will turn to Matt.

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<sup>18</sup> SAFE Data Act, H.R. 2577, 112th Cong. (2011).

<sup>19</sup> Commercial Privacy Bill of Rights Act of 2011, S. 799, 112th Cong. (2011).

**JAMES COOPER:** Thank you Lisa, Matt.

**MATT FITZSIMMONS:** Thank you, it was done perfectly. Lisa gave a pretty good overview of the many laws that operate in this area, and I think that my role here is to give you some details. What the laws look like and what they say from a state enforcement perspective, what it is we look to, what kind of matters we're concerned about, and how to resolve certain informant actions. In our office this is such a big deal that the Attorney General last year created the privacy task force, which I led and has four attorneys that work with me, and we handle all privacy matters for the state of Connecticut through the Attorney General's office.

Because before we would get a consumer complaint or notification about a data breach or a HIPAA complaint it just went to the various departments and health care fraud, finance, consumer protection, and everybody handled them somewhat differently; there was no uniform procedure for it. And I think our Attorney General felt that this is a big enough deal. We really need to centralize our efforts; so he created the task force that I led and it has been just over a year. I think that we have had probably a dozen data breaches investigated; we haven't filed any lawsuits yet. But I wouldn't be surprised if one may be coming.

So, we are talking about the economics of data security. I think that it's important to know on both sides all of the companies that Lisa represents have a lot of resources devoted to protecting the data because as she said it is really valuable. On the state side, and I am sure as Anna would say from the federal side, everybody thinks it is just as important and there are a lot of resources devoted to protecting consumers from harm as a result of data breaches and making sure that companies have adequate privacy policies. So turning to the first Connecticut law, and obviously I will only be talking about Connecticut, I probably could talk about a lot of other laws, but I guess I am only qualified to talk about Connecticut laws.

The first one is our breach notification statute. It is not that dissimilar from many other state breach notification statutes. I don't know if anybody here has come across one in their courts. The definition of personal information, just as Lisa mentioned, it's basically initial last name, first name, last name in combination with the persistent identifiers like social security number, driver's license number, credit card number, and I have it bolded in quotes because you will see a couple slides later, and just as Lisa mentioned, the different definitions. In Connecticut, we have more than one definition of personal information depending on which statute you're looking to and what it is you're talking about. In terms of breach notification, this is what legislature felt was the most important combination and definition of personal information. When we get to our statute you will see that the definition is much broader and encompasses more of what the FTC defines as now covered information. A lot of their consent created what they

think personal information actually is. Couple of things that I would like to mention when we are talking about our breach notification statute is the unreasonable delay language. And pretty similar to a lot of different states, if you have a breach you are going to have to notify the consumers who are affected. Some states have particular set days within which you have to notify; our state says it has to be done without reasonable delay.

What exactly does that mean? Nobody knows. It isn't defined by statute; the way we view it is really a lasting concept and it really depends upon facts and circumstances of the case. If anybody had read about the Sony breach, I know it was mentioned in one of Lisa's slides, they were criticized by our Senator from Connecticut, Richard Blumenthal, for waiting a little over a week to notify. And he said that was outrageous and should have been done a whole lot sooner. And I think that some people make a question whether or not that was really the case. But what is reasonable was really going to depend on the facts and circumstances, and you are going to see these kinds of cases I imagine.

In Connecticut there is no private right of action of our breach notification statute, but it also doesn't prevent plaintiff's lawyers from bringing in cases under our Unfair Trade Practices Act<sup>20</sup> using the breach notification statute as the public policy under the FTC cigarette rule that the companies supposedly violated. So you may see cases like this even when there is no necessary private right of action coming across. And the other thing that I would like to mention to is that last bullet right there, which is some states have a harm analyses built into their breach of notification statute where you don't have to notify if there is not going to be any risk of harm to the individuals.

Some states don't have that. We have kind of a hybrid of both; if you have a breach as defined by statute the default is that you're going to have to notify. Unless the consultation with relevant Federal and State and local law enforcement you make the determination and that harms are not likely the results. And in our experience what that means is you do your risk analyses; you know a business, they have a breach, they look at the situation and figure out exactly what it is that happened. And if that analysis leads them to believe that there's not going to be a likelihood of harm before they make the unilateral decision not to notify, they have to basically notify us and other relevant law enforcers. To explain that, basically this is for us to see if we disagree or if we have any questions about it. And I think that this is important because, well, it hasn't happened in our state at least that I know of. I do know of a situation where the company had the risk analysis done and didn't like it because it said people are going to be harmed by this, you can't get out from notifying the statutes, so they fired that company and

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<sup>20</sup> Unfair Trade Practices Act, CONN. GEN. STAT. §36a-788 (2013).

hired another one. Who they got the right answer, which was, “No, don’t worry about it, you don’t need to notify.”

And obviously regulators look into that and see—that’s not something that the federal agency, in that case, really wants to see from the company. That doesn’t put you in the best light, but really highlights the need for language like this in some of these statutes. And again, I think fairly unique to Connecticut, I don’t know of many others that have the same type of setup, at least formally by statute.

The next subject, I would like to talk about, again Lisa had mentioned, restriction on publicly posting, displaying social security numbers—it seems like common sense. You shouldn’t be posting a list of social security numbers outside on the wall of your store, but when I was in college we had a professor who listed grades outside his office by social security number. Because he didn’t want to embarrass students by putting their name next to their grade. Also when I was in college, my freshman year, what comes under number two here, my student ID had my social security number right underneath my picture. And these are the sorts of things that at least instructionally aren’t as likely to occur these days. Because I think there is a lot more awareness of social security numbers but we do see this coming up a lot under paragraph one.

There, the publicly posting or displaying is on the Internet. I mean, how many people out here have Googled their names? I don’t believe any of you; okay, thank you, some more than others, I’m sure. Especially in this room, no offense, and when you do that and it’s usually a few pages down because it’s a search result it’s a hit that is not likely to a lot of people to click on, and when Google runs our searches it will be a little bit down towards the end, but you will see your name there and your social security number sitting next to it. And you click on it and what it is, is an excel spreadsheet with your name, your address, your social security number along with the same information dozens, hundreds maybe even thousands of other people.

And this has happened more than once, just that I know of in Connecticut, where it at least involved Connecticut citizens. And it is obviously a big deal, so what do you do in that situation as a regulator? It is already out there; it has been out there for who knows how long open to the public. So all we can do is make sure that it’s taken down, try to work with the search result providers, search engines like Google and Yahoo, to hopefully have them clear that cache so at least it goes away, although nothing ever goes away. But then we really get down to it with the business and say, “How the heck did this happen?”

And a lot of things that we look to, and you’ll see in Attorneys General cases that maybe come through your courts, you’ll see there is always a lot about employee training that comes up a lot; HIPAA, it comes up a lot; and our HIPAA investigations, there was a big part of our case against Health Net, which was our first suit, I think the first state Attorney General suit in



the country, it was under HIPAA. The high tech authority and its employee training is really important.

And the instance that I was just talking about with the Google spreadsheet which was literally the file name of it was Dave's Book of Business, and it was an insurance agency's entire book of business—all of his clients, all of their personal information, just out there for everybody to find. So we looked into the employee training about the company and found it was a pretty robust system; it was a very large company. They had a lot of very detailed training, but there wasn't anything specific about social security numbers, about restricting access to them, about not posting them to the Internet spreadsheet, and that was one of the things that we worked into our settlement agreement with that company was there had to be a specific reference to this statute for hearing in Connecticut.

Because even though it seems like common sense, even though everybody laughs when you think of just posting a list of social security numbers outside of your office door in a college, it still happens and it's starting to happen kind of on a smaller scale or at least in less likely places. Because who would have expected an insurance agent to post his entire book of business online? And there is one thing I wanted to mention about this statute, which is what I think, and at least talking to other states, I think maybe the roots. Civil penalties under this statute, while it can also be a crime, civil penalties under this statute go into especially dedicated fund the privacy protection and guarantee and enforcement account.

And it works much the same way as home improvement guarantee funds where a home improvement contractor harms consumers and they have to pay to get work fixed; they can't recover from the contractor so they can access the guarantee fund. And it works much the same way in the data security realm as well. Under this account that company had paid \$10,000 which we now have in the account to reimburse consumers for losses if they go out and pay for their own credit monitoring for instance if the company doesn't offer it. And they can't recover any of that from the company; they can access this fund to get some of that money back and, more importantly for me, we can use it for enforcement as well.

Because I think, as everybody knows, the way state budgets are these days, every little bit of extra money helps and an account like this that is specifically dedicated to these kinds of areas can be very helpful for us. The next Connecticut specific statute is our general safeguarding laws. Again, Lisa mentioned lots of states have these. Pretty basic, if you are going to collect information you have to protect it. As I mentioned before the definition here is broader, much more like what the FTC uses and certain states do. This information capable of being associated with an individual, it's not just first name, last name, and social security number or credit card number.

It's a much broader concept, so the idea is, I think, although they are different definitions and it probably wasn't intentionally, so I think the idea

with the law like this is to really make sure that folks that are collecting information are protecting it. And make sure when they get rid of it they do it in the right way because the dumpster diver is a real scenario we have had several just in the state of Connecticut. A lot of time we find out about them because the person who dumpster dives contacts the bank and basically demands money to turn the records back over. It's kind of an extortion regime that a lot of these folks because they don't know where to sell it when they go online.

They just figure that they will try to sell it back to the bank, which obviously we in Connecticut frown upon. And the other piece of this statute although deals with social security numbers, if you are going to collect them, you have to have policy in publicly posted. And this is important: I think these days if anybody walked up to you in the street and asked you for your social security number I would hope that nobody is just going to give it to them. But in the context of the commercial transaction you are at a store and it's just one of the pieces of information that you are filling out on a form. Most time consumers fill it out without really thinking about it, without thinking why do they need it, what are they going to do with it, and what happens if I don't give it to them.

And this came up with me recently in Connecticut; I went to the music store to rent my oldest daughter a violin and as I am paying for it, I look at the rental form that just happened to be sitting there on the desk, which is a little different than the one that my wife had signed, a new box, so new forms not left over from kind of an old regime there. And it had a spot for social security number on it, and I asked them what they need that for. He said I don't know, maybe for collections, I said okay. Maybe that's a reason, what do you do if nobody gives it to you? He said, "I don't know, nobody has never filled it out." I said, "Really, what do you tell people when they ask why you need it, or what do you use it for?" He said nobody has ever asked. And I asked him how long he had had these forms, and he said, "Oh, years." So for years they have been collecting social security numbers and not a single person has ever asked, at least to this guy's knowledge, there was not a single person that didn't give it to them. So then I ask, and I was a little worried that what he might say because I could see where this was going, and I said, "Well what do you do with them?" He said, "Oh I have a file cabinet in the back they are all in there."

I said, "Okay, how often do you get rid of them?" He said, "Oh we need them forever because what if they come back they want to rent another instrument for another kid?" So there is this file cabinet in the back with information about who knows how many consumers, and not just a social security number but all the information on a nice tidy form, handwritten, that's all right there so you don't have to do any work if you want to steal somebody's identity; you don't have to do any work to try and piece any data points together. It's all right there. So this at least to me, I think really highlights the need for not just laws like this but some real education in the

small business community on what it is they need to do in terms of protecting this data.

I only have a couple minutes left. We really want to get the questions; I think that's where it's a least more fun for us up here. HIPAA, I don't know how often a lot of you at least on the bench run across it, certainly not in court, judges, but it's a big area for state attorneys general now, ever since the Hitech Act,<sup>21</sup> State Attorney General enforcement over HIPAA, although we have lower civil monetary penalties cap, only \$25,000 as opposed to, in contrast to HHS it's still a big tool and I think that a lot of different Attorneys General are really using it to go out and see now that we actually can what the medical profession.

And what the medical profession, and what covered entities and insurance companies, these providers are really doing to protect the information they are collecting from their patients. Because a lot of times it can be some really significant and important information, and under HIPAA, information can also, it doesn't just have to be personal information in a normal sense, it can be information that can lead to reputational harm. So a folder left on a train in Boston with information on HIV patients that company I think got \$1.5 million fine not because it was only sixty something people but because the kinds of information that was included in those files. I think with that I am not going to go on to these, I hope we can get some of your questions and maybe if Anna gets here and gets out of traffic she can jump in and add the FTC's prospective as well so thank you.

**JAMES COOPER:** Thanks a lot, Matt. Well we will kind of hold a place for Anna here and let her jump into the conversation when she arrives, but let me, and I want to leave plenty of time for you all to ask questions. I'm sure that you have had lots of panels but let me take advantage of being the moderator here, and I'm kind of a big picture quest here, we hear a lot about privacy crises, we see news reports, Wall Street Journal, New York Times all of the time, but how much data is being collected? Clearly in Lisa's presentation we saw that there's this big push for legislation at the federal level. So big picture question here for two people who are in the trenches and are staying in doubt: is there really a crisis? In my opening remarks you notice that there doesn't seem to be any shortage of people going online and doing things so. So everyone has a Facebook account, ecommerce is verging continues to, so is there really crisis? And do we really need more government action in this area or are the laws in the books sufficient to take care of it? So I will open up too.

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<sup>21</sup> Health and Information Technology for Economic and Clinical Health Act (Hitech Act), Pub. L. No. 111-5, 123 Stat. 226 (2009) (as codified in scattered sections of 42 U.S.C.).

**LISA SOTTO:** We have been talking a lot in our world about the term “big data.” Big data is a fiscal term to describe the enormous collection of information to be analyzed and mined and reinitialized so that for so many different uses, but think about how companies can market to you better in more tailored ways using data. So with the advent of big data and the statistics are astounding, I won’t quote them to you because I haven’t memorized them, but it is something like in the last two years we have collected as much data as we had from two years till the beginning. Since the beginning of time or the written word, so it’s enormous proliferation of data, so do we have a crisis?

We do have a crisis in that we have no earthly idea how to manage this volume of data and this asset that is so very valuable. So we are, I think in twenty years, we are going to look back and just think that we were so rudimentary in our management of data in the year 2012. Because we had no understanding of how data would continue to proliferate different devices through which we could collect data and how we might actually use data to create incredibly valuable ways to promote security, so with the value comes some danger as well.

The second thing that I’ll just note is cyber-security incidents: the world of cyber warfare is just beginning; we are seeing huge economic espionage being conducted through cyberspace, so we have no idea I think as a society how to manage cyber-security issues.

**MATT FITZSIMMONS:** Yeah, I think that I would just echo what Lisa said and I think as you got from what I had said with my comments before, I think from that perspective what my attorney general is really focused on is education. Everything from educating kids, what not to share on Facebook, educating businesses, particularly the smaller businesses, like the music store that I had mentioned. About what the legal requirements are, and even not even getting into the weeds of the specific legal requirements, but really getting folks to appreciate the sensitivity and the value of the data.

You know sometimes you will see in some insurance policies although they are changing now somebody loses a laptop, typical commercial liability insurance might pay for the cost of the laptop and not the value of the hundreds of thousands of consumers personal information that was on the laptop. So I think in a lot of ways a lot of folks need to really kind of change the way we look at a lot of this stuff and how we view the information that everybody’s giving online and on their smartphones these days. And really kind of take a step back from there and try to think about what it is we can do to limit the information we are giving and what it is we get businesses to appreciate about the information that they are collecting.

**JAMES COOPER:** Welcome Anna. Anna Davis, by the way we’re moved to the panel discussion part here Anna, but what we are talking about is sort of the big picture question that we hear a lot about this crisis we, Lisa’s pres-

entation showed a lot of federal purposed, federal inflation, so I know in your presentation, and I think I know where Commissioner Ohlhausen is on this. Is there, number one, really a crisis and is it one that calls for new federal legislation. The laws on the books say it is affection to deal with that and you can use this as a subway to talk about Section Five of the FTC Act and how that—whether or not that is up to the task.

**ANNA DAVIS:** Good morning, and first of all I apologize piously for being so late. Washington always has one of the worst traffic days. I have lived here thirty years and this commute will be near the top of that list. So yes, there is a sense in the policy particular in Congress. Congress has one tool to address an issue, and that's pass legislation. And I think often we jump to the gun and say, "Well there's a problem," rather than looking at the tools that we already have. In our arsenal saying we just need to pass another law and not looking at whether or not the laws on the books do justice. So James, I will answer in two parts in terms of general face line privacy legislation.

I do not personally feel, nor does the commissioner I work for feel, that you need any additional legislation to get at the harms. And the reason is that the FTC has a very powerful framework, which has existed for many, many years: Section Five of the FTC Act, that is extremely broad in its coverage, it covers unfair deceptive acts or practices and unfair methods of competition. And so you can use that framework to get at a whole lot of the harms that you want to get to. In the early-1980s, actually 1984, there was a sense that the previous administration, the previous commissioners at the FTC had gone too far and had interpreted as too broadly, and so at Congress' request there were several statements that were released. One specifically on fairness and one specifically on deception that talked about types of activity that this section would be reached by the FTC going forward. For deception it's really pretty simple: a deception basically is a lie in most cases at least in the privacy case. So the company says we are going to collect your data and we are going to do this with it. And if they do something different, then we will sue them even if that underlying activity might not be actionable, but because they made a promise that they were going to treat collection of data in a certain way, and they breach that promise, that can be a violation.

If you are looking at unfairness in the context of unfairness you don't have to have a broken promise, but what you have to have is tangible type of harm and it has to be a specific, articulated type of harm. And the types of harms that the FTC will pursue include monetary, financial, medical, safety and you see this most often in the context of the Children's Online Privacy Protection Act, COPA, but you can also see it. There have been some privacy cases that had to do with stalking and physical harm to people and that could be addressed by that as well. What you don't want to cover under fairness is speculative harm. "Oh that felt a little creepy," or "that

made me uncomfortable,” emotional harms, because when you get into that area it is far more subjective. And people have different expectations of privacy in that area.

I will briefly touch on a recent case that we brought, *DesignerWare*, it was *DesignerWare*, was a software company that did one thing: they developed software for rent to own stores.<sup>22</sup> They rented computers to consumers, and as part of that they came up with something that they called a detective mode, and there was a legitimate purpose for detective mode if it were in a computer and it was stolen, or if a renter stopped making payments you could flip a kill switch and stop that computer from working. It also had a geo location so that they could physically track where that computer was to recover it if it was stolen, or retrieve it if it was just not being paid for. So far all is well and good, but detective mode did additional things and the FTC sued it.

One of the things that it sent out was the designer/software company sent out a fake registration form, and the consumer that rented the computer couldn't use the computer until they filled out this registration form. That form asked for personal identifying information. Well there was no software registration; it was just that they wanted to be able to get that information. That was a deception account under unfairness. In addition to having the kill switch it would take screen shots of the computer and it captured very sensitive medical and functional information of consumers.

And it had a camera, a web cam, and a lot of consumers kept their laptops in their bedrooms and it captured a lot of intimate personal information as well. None of this was disclosed to consumers. No one, none of them knew it was going on. So this was a case that the FTC brought under its standard Section Five of analyses using both deception and unfairness discounts. Now this was a recent case we brought this in October and it seems very, very simple and when we were first talking about developing the case the staff wanted to put in additional further reaching harms on emotional and kind of that creepiness.

And we pushed back and said there is absolutely no reason to do that, you can get to that actually using the core of the Section Five authorities; we always have. So we, my commissioner and I, and her staff, if there needs to be additional authority we have to fill a specific identifiable gap we should be able to get to this behavior and we can't currently. So you identify that gap and then you can barely craft legislation and that's been done in the past several times: you have Gramm-Leach-Bliley, FTC helps enforce; you have COPA eluded to earlier, that we enforced, so it is not to say that there never will be additional legislation needed in this area, but right now there is no evidence of there being a gap. It's relevant because last March the FTC released a privacy report, a broad-reaching report, that

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<sup>22</sup> *In the Matter of DesignerWare, LLC*, FTC File No. 112 3151 (2012), available at <http://www.ftc.gov/os/caselist/1123151/designerware/index.shtm>.

had a lot of good information in it and much of what my commissioner agrees with.

But the Commission called for majority of the commissioners, three of them called for additional based on privacy legislation but interestingly didn't say what it would look like, what harms it needed to be able to address that couldn't be achieved with current authority. It just said there ought to be a law.

**JAMES COOPER:** Thanks, Anna. I want to follow up on that. Anna's remarks suggest that we should be very careful about where we go with addressing what kind of harms we address. So I just, number one, Matt and Liza, if you would like to talk about that, how do you think we—how or if your state or federal regulations should address these sort of creepy harms? The idea that someone found out my political affiliation or something on-line where there's no monetary harm, and Lisa, I also wanted to follow up on something that you talked about in your remarks related to this: is the private bar getting into the act here and their clever way to get around the normal harm requirement in under court law?

How that's happening? And again, Matt, if you want to talk about that too because you said that there's a private right of action, then I think that under your Unfair Practices Act, and I think that's kind of common in a lot of states, so open up to you guys, to Lisa if you want to start off.

**LISA SOTTO:** I can start us off. The harm that Anna was referring to that is being really discussed, I think everywhere around the world now is the harm to human dignity. That's what the catch phrase is. It's a very difficult issue to get your arms around, but it's really squashy. How do you define that, and what is the reasonable person standard with respect to harm to human dignity. It's virtually impossible to craft any kind of enforcement action around that. There has been a lot of discussion by various FTC commissioners sort of pushing the envelope, pushing the jurisdiction envelope I think past where Section Five traditionally has been.

So the plaintiff's bar, they are bringing actions wherever they can right? Because many of these laws state laws don't have private rights of action built in, so what they do is they look to the neglect standard, they look to many states that have inclusions and when inclusions are available they look to the state unfair deceptive trade practice acts. So they look to all of these things they shape their case around these various claims. Most of these cases are thrown out, they don't linger for long; there are few that are making their way. However, one of the theories at least is that seems to be catching a little bit of momentum is the likening of this area to medical monitoring where you need to monitor your credit over long periods of time because the criminals might use your data ten years down the line. So just like you need to monitor for mesothelioma, if you have been exposed to asbestos you won't also need to monitor you credit because your data has

been exposed to criminal activity. So we will start seeing, I think, more of those cases succeed.

**JAMES COOPER:** Matt.

**MATT FITZSIMMONS:** From a regulator perspective, when you are talking about trying to fill these gaps, and what cases are worth bringing or not, I kind of mentioned you have to really think about what it is you're doing, what harm you're trying to address. Because I think the last thing—I shouldn't say all regulators—the last thing at least my boss wants to do is really hinder innovation when you are talking about technology companies in particular. You don't want to over regulate an industry or a particular practice in response to a single incident or series of incidents.

That may unnecessarily hinder innovation and kind of steer companies away from, in some sense, pushing the envelope in a lot of ways can be a really good thing. As long as there are checks and balances that go along with that. So I think as a regulator one of the real challenges is, yes maybe we could make out a real claim under the various laws that we can make claims under, but is it really necessary to do that? Do we want to push the envelope, and what are the practical effects of us doing that? What harm down the road is going to come from us doing this one business or making a claim and possibly winning a claim against the one business? What kind of ripple effect will that have down the road, particularly in the technology field?

**JAMES COOPER:** Well thanks. Anna, you look like you wanted to say something?

**ANNA DAVIS:** I will add just a little bit to that. One of the things that I think the FTC can play a role in: I mentioned the deception standard is generally actionable when there has been a broken promise. And so to the extent those companies now are beginning to compete on privacy and the fact that they protect privacy more than other companies. And if they hold to those promises that can give them a competitive advantage, there's a company, it's either Go, Go Duck, or Duck Go, Go. It's Go, Go Duck that started

**MATT FITZSIMMONS:** It's Duck, Duck Go.

**ANNA DAVIS:** Duck, Duck Go.

**MATT FITZSIMMONS:** I think that's right.

**ANNA DAVIS:** Okay.



**MATT FITZSIMMONS:** It's one of those three.

**ANNA DAVIS:** I started a couple of years ago, and it started just a few years ago, and in 2011 it was selected as one of the fifty best new tech companies by Time Magazine, and its growth has just been phenomenal. Because it doesn't even collect, you know part of the issue with "do not track," does that mean do not track or do not collect and track? And it doesn't collect anything at all, and for people who want that, for people who are here, privacy sensitive, they can select and seek out those companies that will give them the level of protection they want.

And those companies will benefit from that as long as they keep to the promises that they make. So that's a way that the government, FTC, by leveraging, if you don't keep your promises we will sue. You can encourage innovation that consumers can seek out.

**JAMES COOPER:** Thanks, Anna, and we have about fifteen minutes or so left, and I want to, and I'm sure that you have lots of questions, so I want to open it up to the floor. Professor Johnsen.

**D. BRUCE JOHNSEN:** Yes, I just want to get the thing started on the economics of this. It appears that what's happened over the years then is we have gone from kind of one liability rule regime where people who want to know about you are free to go and dive in dumpsters and do whatnot, collect cookies on you and so on and so forth. Is it a different liability regime, and I want to know exactly what that liability rule regime is or what the structure of property rights—is it that now we are moving into a world in which I own my personal data? Or is it somehow out there in the ether hanging around? The main point being that somehow I'm being protected because somebody else can't get it.

I would like to know if it's the former, if any progress is being made or even considered on just, on improving the ability of consumers to contract with respect to their privacy rights. Maybe there's a non-contractor ability problem that is: suppose I want level of security or privacy three on a scale of ten or a level seven on a scale of ten, that is maybe I don't care if people have my social security number or this and this. For X, Y, Z purposes is it plausible to make this, you know, agreements over those matters.

**MATT FITZSIMMONS:** Do you want to start? No, go ahead.

**LISA SOTTO:** So I don't know if that's really clearly defined. I do not think that I have a property right in all of that information that is out there now under the current regime. And I don't think we'll ever quite get there. That's more going to be the European model, yet you know what comes to my mind as I think about this: is there now the concept of privacy by design that companies should think about privacy that they construct their business

models? So that it's emplaced and embedded in everything that they do, and we miss the boat on that and in so many ways.

That it is hard to know where exactly we fit into the personal rights to our own information, and again, the fact that there's a lot of subjective views out there about, "Do I care about that?" I'm five feet three and I have blonde hair and blue eyes and if I disclose that on a site do I really care that that be kept private? Probably not. If the company tells me that they are going to protect it, I want them to protect it. But that doesn't mean that I own it in that way, so it's very much muddy area as far as I see it.

**MATT FITZSIMMONS:** That's right when you are talking about consumer expectations, I mean, it really varies by the transaction in which the information is being shared. I know—I think if you're online and you're buying something from Target, I don't think anybody would object to having to put in your address so they can ship you the item. But if you're on a different site and they are asking you for your address for no apparent reason and they are not necessarily making any claims to why they need the data or how they are going to protect it, that's a different story. And the issues of privacy policies, generally is a persistent issue that I don't think is going away. Anybody that's read a privacy policy knows that it's nearly incomprehensible, and if you have ever tried to read one on a smartphone it makes it even worse.

Because it is so much smaller and there is only so much space on a smart phone, how can you make sure that you get all of the right information to a consumer there to make a good choice about whether or not you share information or do something online when the physical screen size you are looking on is so small?

**ANNA DAVIS:** And I'm the one who writes those, and comprehensible privacy just to embellish a little bit. Data ownership is an interesting question; the preamble to the European Data Protection Directive says that privacy is a fundamental human right. We don't think of privacy that way in this country; we think of it as the consumer protection interest, but there it is, a fundamental human right. And that stems from the very negative uses of data. If you think back to the use of data and dossiers kept about people and the lists in Communist regimes and Nazi Germany, that data was used to put people to death.

Here we market people to death, so that's the difference in this country the—we, certain laws have the term "data owner" in them. What that refers to is the company that holds the data, and if that data owner loses the data, if it is compromised in some way, then they have responsibility. So we don't think of data owner in this country as the data subject or as the individual, whereas in Europe they do think of the data owner as the data subject person whose data it is. One other thing to think about: we do think

about trading value for our own data, and if you think about Facebook having 900 million users.

People have actually voted with their feet; they voted to stay on Facebook and provide that data because they think there is value to be gained in return for providing that data.

**BRUCE JOHNSEN:** All right, other questions?

**AUDIENCE MEMBER:** My apologies, Professor Johnsen, if I divert from the economics for just a moment and in fact divert perhaps from the designated topic because you all are the privacy gurus of the world, probably, and I imagine that I like many of the other judges spent a lot of time trying to escape the world of having our addresses on the Internet so that disgruntled parties and prisoners can find it more difficult to locate us. Is that a complete waste of time in the current world? Should we not even bother doing that because it has no chance of being successful?

**MATT FITZSIMMONS:** I'm not a technology expert, but it's, I think I would be comfortable saying that it's basically impossible to get your information off of the Internet. To the extent that it's out there I don't think it's necessarily a fool's errand to try because, particularly when you are talking about—did some case for our public safety department representing department of corrections. Some of the inmates aren't the most sophisticated. They may not be able to do a lot of the digging; they may need to do if you at least try to keep your address private. But at the end of the day I don't know of anybody who can't be found on the Internet.

**JAMES COOPER:** Of course this is really what Europeans are dealing with, this right to be forgotten. At least you may know more about that, where you can, I don't know if it has been acted that or where it is, but the idea that you—if you have something online and then you decide later you don't like—you don't want that you can join, it is almost like the property right regime that Bruce was talking about, before you can enjoin people from publishing data that was previously put online. They have to respect your request and take it offline.

**LISA SOTTO:** In addition to the alphabet soup of acronyms we also have these great catch phrases, and I talked about privacy by design, and James just mentioned the right to be forgotten. This is a big concept; we are going to be reading about this a lot over the next few years. This concept is actually built into the raft data protection regulation, which is the next generation of the EU data protection directive that we will see probably around 2015 or so come into place. So this is a big topic of discussion: do you have a right to delete your data?

And it's a very interesting discussion point because yes, you can maybe argue that you can delete the data that you posted, but what about the data that somebody has posted, and what if that data is accurate versus inaccurate? It's very difficult issues here, and certainly in this country we've got bigger constitutional issues to think about with respect to that data.

**ANNA DAVIS:** Yeah, compared to that extreme under that model a convicted pedophile would have the right to say, "I don't want that listed anywhere; that's behind me and that should not be made public," and so you can see situations where that information that could be critical, it would be repressed because they have that right.

**JAMES COOPER:** A follow up on kind of a related subject: we had a case about a year ago in Iowa. We have an online computerized docket, so in the old days if you wanted run a criminal background check you sent the person's name to DCI and paid the fee and it would come back. Nowadays what employers generally do is they just get on our free online docket. So we had folks who, criminal cases have been resolved in their favor either by dismissal or whatever or acquittal, who sued to try and get off the online docket.

We ultimately checked into the case reasoning. Partly it is a public record; it is the record of what happened in your criminal case, which is a public record but what they really objected to was not the record is public but that it's on the Internet. And so my question is, have there been any legal efforts to kind of create sort of an intermediate level of privacy? That is, the information could be public but you can't put it up on the Internet?

**MATT FITZSIMMONS:** I think, speaking at least from a state that has a respond to courier requests, is constantly, I think having public information available on the Internet as long as it is accurate is very useful. Because the resources that go into responding to courier requests is just sometimes phenomenal, the amount of documents that you have to search through and then the production clause even though there's a statutory fee for production of paper documents. I think there is utility in having that information public, information freely available to the public again as long as it is accurate.

**JAMES COOPER:** I think that we have time no; we don't have time. I got conflicting calls from the refs in the back, so I guess we have time for one more question.

**AUDIENCE MEMBER:** Two quick ones.

**JAMES COOPER:** Or two quick ones. This is like the scabs in the NFL, right?

**AUDIENCE MEMBER:** I understand we have a problem with globalization and Internet personal discovery, and the problem there is in this country we are allowed to get very broad discovery, but I understand when you start going after the discovery in other countries they raised the right of privacy. Any comments on that?

**LISA SOTTO:** Yeah, particularly vexing to the private sector, and really vexing, this is a direct conflict of laws; it is irreconcilable and it is a huge problem. In Europe, as an example, and many other countries that use the European model of data protection, you are not permitted to transfer personal data to a country that is considered to not have quote, unquote “adequate data protection laws in place.” We in the United States are not considered adequate and therefore it is illegal to transfer for personal data to the United States without having a legal mechanism in place for that data transfer, which is very, very difficult to put in place in a discovery context.

So you can see complete rock and a hard place. We have not resolved that from an international perspective, it is an extremely cumbersome and time consuming and impossible to do. Really, so this is an issue too that’s been debated for now several years and continues to be debated. I have no answer for you, but thank you for raising it. It’s a very difficult question and one that you certainly as judges are going to need to think about and certainly will face.

**JAMES COOPER:** Anna.

**ANNA DAVIS:** It comes up with a context of the FTC and enforcement something called the U.S. SAFE Web Act:<sup>23</sup> a law enacted six years ago that helps the FTC do international consumer protection actions. For example, if there was a Canadian telemarketer preying on American Citizens, in the old days we would call the Canadian enforcement and say, “Shut them down.” And they would say, “Okay, give us the evidence that you have and we will,” and we would say, “Oh, we can’t share that with you.” So you have, safe web allows for that sharing but it can work both ways, and there was a concern in the re-off, the re-authorization effort of some members of Congress.

Well what if a country, France, wanted information about an American company so that they could prosecute for something that wasn’t illegal in the United States but is in France? There are some examples in advertising law where there are restrictions abroad that still exist, and so we had to be very, very clear that we could never share information that would enable

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<sup>23</sup> Undertaking Spam, Spyware, and Fraud Enforcement With Enforcers beyond Borders Act, Pub. L. No. 109-455, 120 Stat. 3372 (2006) (as codified in scattered sections in 15 U.S.C. and 12 U.S.C.).

prosecution and/or enforcement against a U.S. citizen or company for something that wasn't a violation of our own law.

**JAMES COOPER:** I guess, do we have time for one more?

**AUDIENCE MEMBER:** For mine, yes. To what extent have state courts seen any of these cases, data breach or otherwise, or is this the calm before the storm?

**LISA SOTTO:** There is no calm, no. I think that we are in the middle, we are not at the middle of the storm; we are at the beginning of the storm. This is a nascent area; we are really just starting to understand, really get our arms around the framework here, the infrastructure, and I don't think that it has been shaped yet. Frankly I think that we are just starting. This is a fascinating area, and you can see, I think, lots of passion from the panel because it's so interesting and evolving so quickly.

**JAMES COOPER:** Matt.

**MATT FITZSIMMONS:** I think that is probably to the extent that you haven't seen it in a case in front of you yet; I'm sure that you will because these things aren't going away, and a lot the speeches that I give and the Attorney General give, you have to understand data breaches are going to happen no matter what protections that the company has in place, it is going to happen. And when something happens to a large number of people, somebody is going to sue over it. So you are going to see these kinds of cases no matter what kind of protections are in place and how aggressive enforcement is. Because when these things do happen and there are a lot of people, somebody is going to sue over it.

**JAMES COOPER:** Do you have anything to add Anna?

**ANNA DAVIS:** In the FTC the areas escalating in the context of a reviewing COPA Act,<sup>24</sup> is on my Privacy Protection Act,<sup>25</sup> and we're the middle of that and receive lots and lots of comments. The expectation is going forward that we will get our recommendation from staff. It has been hugely controversial because there are proposals that expand the definition of an operator and also have additional implications for a third party collector. For example, an app on a mobile device: if the app collector uses a plugin that collects data, who's responsible? So it's very complicated, very con-

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<sup>24</sup> Child Online Protection Act (COPA), Pub. L. No. 105-277, 112 Stat. 2681-736 (1998) (codified as amended in scattered sections of 47 U.S.C.).

<sup>25</sup> Privacy Protection Act of 1980, Pub. L. No. 96-440, 94 Stat. 1879.

troversial. We're getting a lot of very good comments that just show how very much this is a big issue going on and will only escalate.

**JAMES COOPER:** I think that's going to have to be the last word, please join me in thanking the panel for a great discussion.





## THE ASBESTOS LITIGATION TSUNAMI—WILL IT EVER END?

*Joseph W. Belluck, Charles S. Siegel, Michele Hale DeShazo,  
Mark A. Behrens  
Moderator: S. Todd Brown*

**D. BRUCE JOHNSEN:** If you all will please take your seats we can get started with our last panel of the day following which we will have lunch and a keynote speaker. With that it is my pleasure to introduce our next panel moderator for a panel addressing the question of asbestos litigation and whether it will ever end. Our moderator is S. Todd Brown. I am always happy to meet and introduce people who go by their middle name as I, myself, go by D. Bruce Johnsen.

S. Todd Brown is an Associate Professor of Law and the Director of the Center for the Study of Business Transactions at SUNY Buffalo School of Law where he teaches bankruptcy, torts, mass torts, and business courses. He is the author of a very influential article, *Section 524(G) Without Compromise: Voting Rights and the Asbestos Bankruptcy Paradox*, which has been cited in a number of district court and circuit court opinions.<sup>1</sup> Todd has also testified before the House Judiciary Committee concerning the bankruptcy trust system.<sup>2</sup>

Todd earned his Juris Doctor degree from Columbia University School of Law where he was the Articles Editor of the *Columbia Business Law Review*. He earned his LLM from the Beasley School of Law at Temple University in 2009 and prior to law school he received his Bachelor of Arts in Philosophy summa cum laude from Loyola University in New Orleans, Louisiana. For some period of time, eight years I believe, he practiced law at WilmerHale in Washington, D.C. and at Jones Day. Thank you very much and let us welcome Todd.

**S. TODD BROWN:** Well thank you D. Bruce. You know a few years ago I was on the teaching market and told one of my advisers that I was going to be giving my job talk on asbestos bankruptcies and he looked me squarely in the eye and said, “Are you trying to chase people out of the room?” Most academics do not like to hear about bankruptcy and even fewer like to hear about asbestos and somehow I managed to merge them. And I think—

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<sup>1</sup> S. Todd Brown, *Section 524(G) Without Compromise: Voting Rights and the Asbestos Bankruptcy Paradox*, 2008 COLUM. BUS. L. REV. 841 (2008).

<sup>2</sup> *Hearing on the Furthering Asbestos Claims Transparency Act: H.R. 4369 Before the H. Comm. on the Judiciary: Subcommittee on Courts, Commercial and Administrative Law*, 112th Cong. (2012) (written statement of S. Todd Brown, Professor, SUNY Buffalo Law School).

I hope—you will find this panel very interesting and informative. We have a fantastic panel and although we are still waiting for a couple panelists to arrive I am going to introduce them and then let them carry most of the labor in this discussion. Then I will come back and talk about how we situate a bankruptcy trust in the current state of asbestos litigation.

So I will begin with Michele Hale DeShazo. I hope I am pronouncing the last name, DeShazo, correctly. She is a Senior Counsel with Kuchler Polk Schell Weiner & Richeson, which I have also mispronounced, in New Orleans. She focuses on product liability defense.

Mark A. Behrens, who is immediately to my left, is a partner at Shook, Hardy & Bacon in the District of Columbia. He has probably written more law review articles than most academics I know. He has also taught at American University and been a Practitioner in Residence at Pepperdine. He is a member of the ALI and he is very active in the asbestos field. I could run down all the organizations that he has been involved with but I will spare you that.

Also joining the panel will be Charles S. Siegel, who leads the appellate practice at Waters & Kraus & Paul in Dallas. He has been an adjunct professor and lecturer at the University of Houston, the University of Texas, Southern Methodist University, and others.

And then of course there is Joseph W. Belluck who is a graduate of the law school where I teach. He is a name partner at Belluck & Fox in New York City. Prior to establishing that firm he worked for Baron & Budd in Texas. He was also a staff attorney and lobbyist with Public Citizen. He focuses on asbestos litigation, as does Mr. Siegel.

To begin our discussion today, Mark is going to walk us through how we got to where we are and set the stage of where we are going.

**MARK A. BEHRENS:** Thank you Professor. It is an honor and a privilege to be here this morning and I want to thank you all. This is the second time I have presented at this conference. Last year I spoke about causation evidence and today I am going to take up a 50,000 foot view of the asbestos litigation. Before I start and our colleagues come in to the discussion, we had stressed the need for balance on this panel and we put the other speakers on the panel to have balance. Hopefully, they will decide to come and provide the balance that they sought so hard to get. If not, then I can probably argue Joe's position.

Early in my career, in the early nineties, my senior partner was a real legion in the tort field, a guy named Victor Schwartz.<sup>3</sup> Victor wrote the torts casebook, Prosser, Wade, and Schwartz,<sup>4</sup> which is used in about eighty percent of law schools in America. Prosser was sort of a Dean of tort law

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<sup>3</sup> Victor Schwartz is a partner and the chair of the Public Policy Group of the law firm Shook, Hardy & Bacon L.L.P.

<sup>4</sup> VICTOR E. SCHWARTZ ET AL., *CASES AND MATERIALS ON TORTS* (11th ed. 2005).

and he and Wade were the authors of the Restatement Second<sup>5</sup> and 402A.<sup>6</sup> Then Victor took it over from them. And so in the early nineties I was a young associate right out of law school working with Victor and we were working on federal product liability reform legislation. And Joe was Ralph Nader's right hand person and we had a lot of fun because we were about the same age and used to do these radio shows together. And it got to the point where we did them so often that we could literately say, "Hey tonight let us switch places. And you be me and I will be you and we will have some fun." So if we get stuck today I think I can probably do Joe pretty well. Actually, I could probably sum up their conversation in a hurry because whenever I speak they will just say, I disagree with everything that he says, and so they do not really need to be here to say that, I can just do it for them.

But when I come to groups like this I think that it is very important to note that there is a time and a place to be an advocate. When I am in the court room I am an advocate, when I am writing articles, and amicus briefs—which is really my specialty, we file about twenty-five amicus briefs a year in state supreme courts around the country, I have filed over 130 amicus briefs in the state appellate courts in the last decade—that is a time to be an advocate, this panel is not.

I also sometimes teach in law schools and when I go and talk to the students I always feel that the students do not come there to be indoctrinated, they come there to learn. I know that you all are here for the same type of reasons. To learn something and hopefully be a little bit entertained and go home knowing more than you did. It is really impressive to see—I wish all of the folks in your jurisdictions could see how hard you all work. I know coming to programs like this can be a little overwhelming, getting hit over the head with one panel after another on many different topics. But you all take your jobs very seriously and we appreciate that very much.

I am going to start off with where are we in the asbestos litigation and it may astound you. How many of you all have had asbestos cases in your courts—a good number of you. That is actually surprising to me as one of the things that we are going to talk about is how the litigation is really concentrated in a few jurisdictions, which has always been the case but is now increasingly so.

Asbestos cases in the modern era began in 1973 with a case out of the fifth circuit called *Borel v. Fibreboard*.<sup>7</sup> The court held that the asbestos producers could be strictly liable for failure to warn about the hazard of asbestos.<sup>8</sup> That case really kicked off asbestos litigation and not long after that Johns Manville became the first company to go bankrupt due to asbes-

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<sup>5</sup> RESTATEMENT (SECOND) OF TORTS (1977).

<sup>6</sup> RESTATEMENT (SECOND) OF TORTS §402A (1977).

<sup>7</sup> *Borel v. Fibreboard Paper Prods. Corp.*, 493 F.2d 1076 (5th Cir. 1973).

<sup>8</sup> *Id.* at 1092.

tos litigation.<sup>9</sup> We are now in our fourth decade of asbestos litigation; the longest running mass tort in United State history. What is more astounding is not that we are four decades into it but that the most recent actuarial studies project that asbestos claims will continue until 2050.<sup>10</sup> That is forty years from now so when you think about it we are only half way through this litigation, which is really mind-boggling. The good news, if there is a silver lining, is that even though we are only half way through the litigation those same studies project that half of all the claims we will see in the next fifty years are probably going to come within the next ten years.

So we are really looking at the next decade or so—hey Joe how are you, good to see you. I told them that we used to battle each other when you were with Nader and that I could probably sum up your remarks by just saying, I disagree with everything he had to say, after I finish. But we will give you fifteen minutes to say that yourself. And Charles, good to see you again.

**JOSEPH W. BELLUCK:** I do have a rebuttal.

**MARK A. BEHRENS:** I have just been telling jokes until you came in so we will get going on this now. In all seriousness we are really glad to have these guys here because they are the best for representing people who are victims of asbestos related injuries and so we are very pleased to have you all here. What I was saying was that *Borel* was forty years ago and we are now four decades into asbestos litigation and at the latest studies that I have seen, and the latest actuarial studies say, that this is going to go on for another forty years. What is really mind-boggling is that we are expected to see half of those cases come within the next decade.

So this is going to continue be a problem of monumental proportions for probably as long as most of you are going to remain on the bench. When we talk about who is suing whom today the makeup of the plaintiffs are different, the makeup has changed over time. When the litigation first started the plaintiffs were people who were really sick. If you look at studies that [inaudible] did in the 1980s they said that the claimants had mesothelioma,<sup>11</sup> which is a horrible asbestos related cancer, that they had asbestos related lung cancer,<sup>12</sup> that they had debilitating asbestosis.<sup>13</sup> But as we

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<sup>9</sup> In re Johns-Manville Corp., 26 B.R. 420, 422-23 (Bankr. S.D.N.Y. 1983).

<sup>10</sup> JENNI BIGGS, ET AL., TOWERS WATSON, A SYNTHESIS OF ASBESTOS DISCLOSURES: FROM FORM 10-KS, 4 (2010).

<sup>11</sup> *Mesothelioma*, MAYO CLINIC, <http://www.mayoclinic.com/health/mesothelioma/DS00779> (last visited Jan. 23, 2013).

<sup>12</sup> *Asbestos Related Lung Cancer*, THE MESOTHELIOMA CENTER, <http://www.mesotheliomacenter.org/about/asbestos-related-lung-cancer.php>.

<sup>13</sup> *Asbestosis*, MAYO CLINIC, <http://www.mayoclinic.com/health/asbestosis/DS00482> (last visited Jan. 23, 2013).

moved into the late-1990s and into the early-2000s the makeup of the plaintiffs changed.

There were a 100,000 cases being filed in that time frame and almost all of the studies said that around eighty to ninety percent of those plaintiffs were asymptomatic.<sup>14</sup> They were exposed to asbestos but they had nothing wrong with them in-terms of their ability to continue their daily lives. These cases were causing a crisis. They were causing companies to go bankrupt and were putting pressure on the people who actually had serious illnesses. Some of the plaintiffs' lawyers, whom I respect most, like Charles and his firm, recognized that people suing on behalf of the uninjured were becoming a problem. These cases were taking resources away from the people who were injured and needed those resources. The courts responded and the legislators responded.

We will talk a little bit about what those responses were. But what we are seeing today is that the problem with unimpaired plaintiffs, which was the hallmark of the litigation in the late-1990s and through the mid-2000, is no longer the case. Today the litigation has been refocused on people who are seriously ill. You have probably seen the mesothelioma TV ads running all day long. They are no longer asking simply whether you have been exposed to asbestos but are asking whether you have mesothelioma. That is where the litigation is today and that is where the money is today. So we are seeing that the nature of the plaintiffs has reverted back to where it started, to people who are actually sick.

Who are these plaintiffs suing? This is one of the questions today. Even though the plaintiffs may have legitimate illnesses, virtually all of the cases today concern a real controversy over whether many of the defendants being sued are what the defense bar would consider "legitimate defendants." Because the major producers of asbestos have virtually all been forced into bankruptcy. There are now ninety-seven companies that have been forced into bankruptcy due to asbestos litigation.<sup>15</sup>

What has happened as those companies have gone bankrupt? Solvent companies that are more peripheral are brought in. There are now over 10,000 defendants that have been named in asbestos cases<sup>16</sup> and many of those defendants would question whether they legitimately belong as a defendant even when the plaintiff has a legitimate illness. So we are seeing the nature of the defendants change and we will talk about the change in the theories used to bring in new defendants.

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<sup>14</sup> Stephen J. Carroll et al., *Asbestos Litigation Costs and Compensation* 41 RAND INST. FOR CIVIL JUSTICE (2002).

<sup>15</sup> Amici Curiae Brief at 6, *Simpkins v. CSX Transportation, Inc.*, 2012 IL 110662 (Ill. 2012) (No. 110662).

<sup>16</sup> JENNI BIGGS, ET AL., TOWERS WATSON, A SYNTHESIS OF ASBESTOS DISCLOSURES: FROM FORM 10-KS, 1 (2010).

Where are the asbestos cases being filed? They continue to be brought mostly in specific pockets of the country. In Illinois—this is astounding—there are about 3,000 Mesothelioma cases filed a year, there will be about 1,000 Mesothelioma cases filed this year in Madison County, Illinois. If you add in Cook County, Chicago to that number, then roughly forty percent of the mesothelioma cases brought in the United States are going to be in Illinois. Really unbelievable.

Where the rest of the cases being brought? New York City, Philadelphia, the Bay Area of California, Los Angeles, some in Texas, many in Philadelphia, and some in Norfolk. They tend to be based in areas where there is shipping—Baltimore is another one. So that is where we are today. Many of you have been a part of successes in this area. The reason unimpaired plaintiffs are no longer bringing cases is because of reforms that many courts have adopted. One of the things that courts discovered first is that when the sick were competing with the healthy for resources it was bad for the cancer victims, it was bad for my clients, the corporate defendants, and it was bad for the courts.

To remedy the problem of limited resources, many courts created inactive dockets.<sup>17</sup> They said if you are sick you can get your case heard and if you are not sick we are going to park it. We will suspend the healthy plaintiff's case so the statute of limitations will never run out on that plaintiff. We will treat the plaintiff fairly but the healthy plaintiff will not get a trial date until they can actually show that they are sick. That way the healthy plaintiff's claims are preserved and the sick get their day in court faster.

That reform was really a good idea. We advocated for that all over the country. Many state courts responded, Chicago, in New York City, Boston, Baltimore, Texas, Florida, Kansas, and in South Carolina the courts have responded by taking the healthy plaintiffs out.

Another thing that judges were doing in the late-1990s and early-2000s was consolidating a large numbers of cases. The thinking was that if we just get these cases through the pipeline then we would get through this problem faster. But we have learned in the last twenty-five, and now in forty years of this, is that if you make it easier for people to sue you do not get through the pipeline faster. It is not like you speed through tunnel and you come out the other end faster instead you simply invite more people to come. This made the litigation worse and judges have now learned that if you treat these asbestos cases like any other complex product liability case then the legitimate cases will come forward and the junk cases will not.

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<sup>17</sup> HOUSE RESEARCH ORGANIZATION, TEXAS HOUSE OF REPRESENTATIVES, FOCUS REPORT: ASBESTOS LITIGATION: AN INACTIVE DOCKET PROPOSAL 1 (Apr. 2, 2004).

So now we are seeing Judges that have said no more trial consolidations. The Michigan Supreme Court did this under administrative rule,<sup>18</sup> the Ohio Supreme Court did it through changes to the Ohio rules to civil procedure,<sup>19</sup> and just this year the Philadelphia courts said no more trial consolidations unless the parties consent.<sup>20</sup>

So we are seeing judges screen the screeners. One of the problems ten years ago were that bogus claims were coming forward by doctors that were signing off on reports that no real physician would ever do. Judges are now getting rid of those bogus claims. You are not seeing those come forward. Judges are doing their job and focusing the litigation on the people who are really sick.

Now we have new challenges, as I said, ninety-six companies have been forced into bankruptcy.<sup>21</sup> So how do you go after those companies that are still solvent that are on the periphery. One of the things that we are seeing, and we can get into this in questions, we are seeing some claims where they are saying to a pumper valve company, that maybe never had asbestos in their product, they are saying that if you sell a widget to the Navy then Navy installs it and puts it into an engine room, and the Navy covers it with asbestos made in Manville, they are saying that the widget maker has a duty to warn of the asbestos made by an entirely different company. This is the third party duty to warn. We are seeing this type of claim come forward. The California Supreme Court, about a year ago, ruled unanimously that you are only responsible for the product that you make.<sup>22</sup> But this is one of the theories that are being tried. It is coming up all over the country and courts so far are almost all ruling no on the third party duty to warn theory.

We are also seeing new claims against property owners for secondary exposures. The fact pattern is: the worker worked around asbestos in a plant, he had asbestos on his clothes, he takes them home, most often it is the spouse, a female spouse at home would handle those clothes, or young children in the family, and these secondary handlers contract an asbestos related disease. These secondary handlers are now suing property owners and the courts are really split down the middle on whether there is a duty owed in that situation. The decision depends on how the state looks at the secondary duty issue.

We are also looking at the science behind exposure. When you go after more peripheral defendants those exposures are going to be more peri-

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<sup>18</sup> Prohibition on “Bundling” Cases, Administrative Order No. 2006-6 (Mich. Aug. 9, 2006), available at <http://courts.michigan.gov/SUPREMECOURT/Resources/Administrative/2003-47-080906.pdf>.

<sup>19</sup> OHIO R. CIV. P. § 42(A)(2) (2005).

<sup>20</sup> In re: Mass Tort and Asbestos Programs, General Court Regulation No. 2012-1, 2 (2012).

<sup>21</sup> Amici Curiae Brief, *supra* note 16.

<sup>22</sup> O’Neil v. Crane Co., 53 Cal. 4th 335, 365 (Cal. 2012).

pheral. Today, there is a great battle going on in the country over the level of evidence that plaintiffs must bring to the prove causation against some of these more peripheral defendants or peripheral exposures. Recently, the Texas Supreme Court has spoken on that subject<sup>23</sup> and the Pennsylvania Supreme Court has said that it is not enough for a plaintiff's expert to simply come in and opine that any exposure is enough to overcome summary judgment. You actually have to show that the plaintiff had enough exposures to cause disease and just saying that any amount of fiber is enough is not good enough. That issue is now before the Virginia Supreme Court and before the Ninth Circuit.

The final issue that is being litigated all over the country is what to do now that there ninety-seven companies that have been forced into bankruptcy due to this litigation.<sup>24</sup> The money from those trusts is out there. This is going to blow you away, last year, the GAO looked at the trusts that have been set up from the bankrupt companies and said that there is \$36.8 billion available in the trust system to pay claimants,<sup>25</sup> almost \$40 billion out there to pay claimants, completely outside the torts system. Now there is a big battle among the defendants that are left at the settlement table because they say that the money that had always been on the settlement table is now outside the tort system. They say that we should be able to get some sort of credit for that so the plaintiffs do not get paid twice for the same injury. That is a big battle we will talk about.

Those are the issues that we are seeing at the 50,000 foot level that you are going to see in your courts over the next decade. With that I will be happy to turn it over to the next panelist and we can discuss a little bit more about this when we go to questions.

Charles S. Siegel: I think the way that Joe and I, who are outnumbered here, are going to attempt to deal with this is that I will respond to some of the points that Mark has made and Joe, will focus particularly on some of the assertions that have been made about the bankruptcy system and how it interacts with the torts system and so on. I want to thank Mark for his compliments about my firm and Joe's firm. Our firms exclusively represent mesothelioma victims. We also represent the occasional victim of lung cancer, and other kinds of cancer, who has the temerity to sue for that damage.

I have to respond first to the portrayal of certain kinds of plaintiffs, or categories of plaintiffs, as non-sick, bogus, or asymptomatic. It is true today that people who have malignant diseases, mostly mesothelioma, bring the vast majority of claims, though a number of claims are of lung cancer as

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<sup>23</sup> Borg-Warner Corp. v. Flores, 232 S.W.3d 765 (Tex. 2007).

<sup>24</sup> Amici Curiae Brief, *supra* note 16.

<sup>25</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-819, COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES: ASBESTOS INJURY COMPENSATION, THE ROLE AND ADMINISTRATION OF ASBESTOS TRUSTS 3 (2011).



well. As most of you know, mesothelioma is a cancer of the lung lining, though in less frequent cases it can be peritoneal mesothelioma or pericardial mesothelioma and these tumors tend to show up in the linings of the abdomen and the heart, respectively. But there is also lung cancer—cancer of the lung itself, sometimes in people who also smoke but sometimes in people who did not smoke at all and instead had occupational exposure to asbestos.

In years past there were many claims brought by people who do not have a malignant process but had asbestosis, which was a classic disease, irreversible, progressive, and an eventually fatal scarring of the lung tissue. People also sometimes had a less serious condition called pleural thickening<sup>26</sup> or pleural plaques.<sup>27</sup> These cases are obviously typically resolved for much less than a case concerning fatal mesothelioma. However, I am pretty sure that there is not a single person in this room that would trade their pristine lungs, that there is not a single person in this room that would say, I would gladly accept pleural thickening or pleural plaques for the typical settlement value that results in those kind of case. I do not think anybody would want that condition.

Many of those cases were filed because of the pressure of limitations. And Mark's clients and other counsel's clients very capably asserted that once you have any kind of disease process going on your barred period—then your limitations period begins running, no matter what, no matter what condition may eventually assert itself, including mesothelioma. As Mark said, that tension has been solved by the enactment of a number of, so called, inactive dockets, where you can file your case and be placed on an inactive docket and not worry about the limitations pressure that might result if you developed a more serious condition like lung cancer or mesothelioma. I need to resist the characterization of bogus cases that we had decades ago as, again, I do not think anybody in here with these conditions would view them as bogus.

Mark is really a master at this, he does this all over the country. Mark is freed from the obligation of actually representing individual clients in ongoing lawsuits like Joe and I have to do so he can take the 50,000 foot view, as he put it, and he is practiced at this using this phrase, you heard it three times just since I walked in, ninety-seven companies forced into bankruptcy.<sup>28</sup> You notice that he was at pains to repeat that phrase.

This is like speech to spelling that has to occur here; when we hear the word bankruptcy we think of padlocked factories, thousands of employees out of work, production lines shut down, and so on. That is not the case in

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<sup>26</sup> *Pleural Thickening and Asbestos*, THE MESOTHELIOMA CENTER, <http://www.asbestos.com/mesothelioma/pleural-thickening.php> (last visited Jan. 23, 2013).

<sup>27</sup> *Pleural Plaques and Asbestos*, THE MESOTHELIOMA CENTER, <http://www.asbestos.com/mesothelioma/pleural-plaques.php> (last visited Jan. 23, 2013).

<sup>28</sup> *Amici Curiae Brief*, *supra* note 16.

the typical asbestos bankruptcy. Fiberglass went into bankruptcy because of its asbestos liabilities; however, it has more employees today than it did on the day it filed for bankruptcy and it continues to produce fiberglass. The day after it declared bankruptcy it did the same thing it was doing the day before. It produced tons and tons of fiberglass.

Bankruptcy these days is simply an elective way to deal with asbestos liabilities. Let me give you another example. Some of you may have heard of a company called Halliburton. Dick Cheney had the bright idea to buy Halliburton or have Halliburton buy into asbestos liabilities, I should say KBR, in the nineties.<sup>29</sup> Halliburton then declared bankruptcy to solve its asbestos liabilities.<sup>30</sup> Halliburton is not, and never has been, nor has KBR ever been, bankrupt in any sense that is familiar to anybody in this room, or certainly in any way that is familiar to anyone outside the legal system. Halliburton is a thriving, sprawling company that elected to declare bankruptcy to deal with its asbestos liabilities.<sup>31</sup>

The same could be said for other presently functioning companies like WR Grace and any other companies you could name. Yes, there have been small mom and pop outfits that have declared bankruptcy because of asbestos liability, but the large asbestos bankruptcy liabilities that we tend to hear of these days, and certainly for the last fifteen years or so, are all business decisions of the type that Halliburton took. That is one thing I want to make sure we understand.

Mark said that 10,000 entities have been sued in asbestos litigation. I do not know if that is true as that is a ballpark figure. It could certainly be true. We have to sit back and think about it in the following way, there has been asbestos litigation for forty years now and why is that? Why have there been so many cases? Why has it occupied so much of the legal system's attention? Why have there been so many suits filed against so many different entities?

The reason is that there has never been another product like asbestos and probably never will be, in the sense that it was used so pervasively, in so many applications, in so many different kinds of products. Unfortunately, it has resulted in millions and millions of deaths and injuries. It has occupied a central place in the legal system for the last forty years for that reason and that reason only. There have been so many people exposed in so many different settings, from so many different products, on so many different work-sites, working for so many different employers, on land owned by so many different premises owners, exposure that resulted in terrible consequences. So it is really not surprising that so many different entities have been drawn into legal proceedings.

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<sup>29</sup> Peter Elkind, *The Truth About Halliburton*, FORTUNE MAGAZINE (Apr. 18, 2005), [http://money.cnn.com/magazines/fortune/fortune\\_archive/2005/04/18/8257012/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2005/04/18/8257012/index.htm).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

When Mark said that 10,000 entities have been sued, or 10,000 defendants have been named in asbestos cases, again, I do not know if that is true. Ten thousand entities is a ballpark figure that gets tossed around. But when you think of the hundreds of thousands or millions of people who have been affected, and the fact that a typical asbestos worker may work with dozens of different products over his career, and for many different employers, on many different job sites, at premises owned by many different companies, that number is really not that surprising.

I want to advert to what Mark said about so-called peripheral defendants. Again, it is true that the most straightforward defendants in the legal system have gone into bankruptcy. They have not been forced into it, but they have gone into it. Most of the defendants these days are not the direct makers of asbestos insulation products, however, some of them are. Owens-Illinois, which made pipe covering, was an asbestos products manufacturer that DeShazo's firm represents, and is, perhaps, the most straightforward defendant there could possibly be. I believe her firm represents Union Carbide, which actually mined raw asbestos out of the ground.<sup>32</sup> You cannot find a more straightforward defendant than that.

To take the example that Mark used, about pump companies, say that a pump company like Crane Company or Buffalo Pumps sold a pump to the Navy, and when that pump left Crane Company's factory it asbestos in it. It had asbestos containing gaskets inside of it, it had asbestos containing packaging, and so on. It was probably insulated with exterior insulation by the Navy but Crane knew that would happen and Crane, or its fellow pump companies like Warren, told the Navy to put on the exterior insulation, and so on.

These are products that had asbestos in them and had to use asbestos on the exterior. It is true that Johns Manville, Owens Corning, and Pittsburgh Corning, that those companies that made asbestos containing insulation are not the defendants these days however, the defendants that do remain are not defendants that are being sued on some sort of crazy attenuated theory. They are being sued on a theory that has commended itself and has made sense to many juries. And certainly defendants like Union Carbide, are being sued on very straightforward theories.

Mark talked about the causation theories that are the subject of many debates in courts. It is true that there is a decision out of Texas called the *Borg-Warner* decision, which provided an extremely stringent and difficult causation standard to meet.<sup>33</sup> This standard requires evidence of the exact dosage of a particular product to which a plaintiff was exposed. Unfortunately, neither my clients nor Joe's clients ever brought a toxic dosimeter to work every day so they could measure the number of fibers in their work-

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<sup>32</sup> *Union Carbide*, THE MESOTHELIOMA CENTER, <http://www.asbestos.com/companies/union-carbide.php> (last visited Jan. 23, 2013).

<sup>33</sup> *Borg-Warner Corp. v. Flores*, 232 S.W.3d 765 (Tex. 2007).

space in case developed mesothelioma thirty years later. So the *Borg-Warner* decision is a very difficult standard to meet. No other court in the country has really adopted it.

But that is the subject of a lot of litigation these days. What level of exposure evidence is required to get to the jury as to a particular defendant? Defendants like to characterize it as plaintiff's advanced theory that even exposure to a single fiber of asbestos is sufficient to cause disease. That is not a theory that we have ever advanced, it is not a theory that our experts advanced.

Defendants frame the contention as effective but no firm that I am familiar with ever sues a defendant, or certainly, never attempts to go to trial against a defendant on that kind of theory. We only sue companies to whom we can document *non-de minimis* substantial exposure. No plaintiff is well advised if they attempt to proceed on any bases other than that.

Finally, on the bankruptcy issue, and Joe is going to deal with this more, to say there are \$36 billion dollars out there to pay claims is not entirely true. If you take all of the dollars today that are either sitting in trust or may one day sit in trust under currently existing or anticipated trust distribution plans, that total may add up to \$36 billion but that money is not sitting there available to pay any plaintiff or all plaintiffs. There is certainly no plaintiff that would ever qualify for a payment from every trust or even a majority of all of the trusts. The trusts exist for a variety of different defendants and there is no plaintiff who would have ever been exposed to all those different kinds of products. You might have a person who was a plasterer who may have a claim against the United States Gypsum Trust. But the plasterer probably would not have worked with a Babcock & Wilcox Boiler, or he would be entitled to a claim against the Babcock & Wilcox Trust.

So to say that there is \$36 billion is simply an overstatement—I mean it is not an overstatement but it is sort of an irrelevant statement. There are very few claimants who qualify for anything close to a million dollars, accumulatively, from all trusts. So what these cases are worth—what the average mesothelioma case is worth—is a matter for philosophical debate and is really ultimately up to the jury and the governing state's law. There are vast differences in the damages that are recoverable in different states and so a case's worth is determined by the particular jurisdiction, on the particular day, tried to the particular jury. And then whatever the component of that might be, or should be, from a bankruptcy trust depends on what particular products that worker was exposed to and what evidence there is that has been put forward about the worker's exposure to those products.

That is the defendant's burden just as it is our burden, to develop evidence against the defendants in the legal system. Anyway, that is sort of my off the cuff response to the points I heard Mark making after I walked

in and I am sorry for being late but maybe we will have time for questions later and we can develop some of these topics further. Thank you.

**S. TODD BROWN:** All right thank you Charles. Michele, would you like to lead us through a discussion on other current issues?

**MICHELE H. DESHAZO:** Yes. I would like to touch on some of the points that Charles made. Our firm, as Charles suggested, represents many of the more peripheral defendants in asbestos cases and what we have seen are that the bankruptcies are really driving the lawsuits now.

Mark touched on this already as well, certain defendants file for bankruptcy and the nature of plaintiffs' cases have changed as a result of those bankruptcies. A good example would be a plaintiff submitting bankruptcy trust documents, for a company like Johns Manville, alleging that their main exposures to asbestos were from Johns Manville products. However, the name Johns Manville never comes up in plaintiff's tort suit when the plaintiff is asked about products that caused his exposure to asbestos.

So there is a contrast between the exposures alleged in the tort system and the exposures alleged in the bankruptcy process. Clearly, the purpose of this contrast is to try to remove the advocacy hat and to try to be objective and provide the facts. The purpose of not disclosing that information in the tort suit is because the plaintiff is going to recover less in the tort suit if they disclose the bankrupt companies. If we are really trying to figure out how these plaintiffs were exposed to asbestos in the tort suit then that information must be disclosed.

In Louisiana, we have had some battles over the ability to discover and obtain information submitted by plaintiffs in the bankruptcy trust process. This information is really necessary in the tort suit to paint a picture of the plaintiff's exposures. Plaintiffs' counsels have fought us and said that that information is not discoverable and so we have obtained relief from the court system. In order to be completely transparent we need that information and I would think that you, as judges, would really want that information as well, to access a plaintiff's case.

Charles touched on some other issues regarding what defendants are left in cases and has said that they are culpable defendants and they are not peripheral defendants. Again, speaking from my vantage point in Louisiana, we are seeing an increase in cases against peripheral defendants like pump manufacturers and valve manufacturers. These are defendants not in the business of manufacturing products containing asbestos but, at some point down the line, maybe a Navy specification required that asbestos be put on the product and asbestos may have been put on the product by another entity, but there may not have been asbestos on the product when it left the factory.

Mark talked about *O'Neil vs. Crane Company* from the California Supreme Court, where the court did hold that a manufacturer was not liable

for downstream replacement parts it did not manufacture.<sup>34</sup> So that is one issue that will continue to be litigated at the state level. It is certainly important, but we have seen, after the California *O'Neil* decision, efforts to eat around the edges of the *O'Neil* decision in California suits and a gearing of testimony in an effort to escape the reach of the *O'Neil* case.<sup>35</sup>

These are issues that we will face in the cases moving forward. Unfortunately, asbestos cases will continue to be filed. It seems that in every decade there is a prediction that it will be the last of the asbestos suits and that we will not see anymore. Then, you see predictions that these cases will be filed until 2050, I think is the latest one. So these cases are here to stay. I think we just need to come up with some common sense solutions to try to manage them.

**JOSEPH W. BELLUCK:** Good Morning, my name is Joe Belluck, and I want to thank the Law and Economics Center for inviting me. Mark and I, as you were saying, have known each other for a long time. We used to have a little road show around the country debating tort reform. At that time he was representing Big Tobacco and now he has moved to Big Asbestos, but you know, one conspiracy for another.

**S. TODD BROWN:** Actually, back then his firm represented Lorillard, which made a cigarette that had asbestos filters in it, which was the all-time, most lethal product ever.

**MICHELE H. DESHAZO:** This is the crossfire reunion show here.

**AUDIENCE MEMBER:** I am waiting for him to call it.

**JOSEPH W. BELLUCK:** It is coming, do not worry. I am proud to be here with Professor Brown. I am a graduate of the University of Buffalo Law School. I am also now a trustee of the State University System, which means I am his boss, so I have to be—no, but I am very proud to have him here. Buffalo is an excellent law school and he has been a great edition to the faculty there.

I just want to make a couple of comments and later we will be talking more about the bankruptcies. I hope to show you what actually happens with the bankruptcies in an actual lawsuit that we tried to a verdict in New York and show you exactly what has happened with the bankruptcy claims.

The first point I want to make is, if you were asking financial advice from someone in this country it would not be Mark Behrens, it would be Warren Buffett. And the reason that is significant is because Warren Buffett has made a big play in asbestos in two ways. Number one, he has

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<sup>34</sup> *O'Neil v. Crane Co.*, 53 Cal. 4th 335, 365 (Cal. 2012).

<sup>35</sup> *Id.*

bought several of the companies that have gone into bankruptcy, Johns Manville and U.S. Gypsum are now owned by Warren Buffett. So, again, when you hear that these companies have gone into bankruptcy they have not gone into a traditional bankruptcy. They have shut the door one day the next day they are open again and in many cases have become valued investments for investors like Warren Buffett.

Number two, within the last year Warren Buffett has bought the asbestos liability policies from many of the major insurance companies in the United States. Why would he do that? He has done that because he believes that he can buy those policies and save money on the payouts and make a profit for his insurance subsidiaries. Those are two important things to keep in mind about when you hear that there is a litigation tsunami, when you hear it is never going to end, and when you hear that there are no checks and balances on the system. You have to look a little broader and see what the people who have done extensive analysis of the actuary and claims data are actually doing. The most important one, in that regard, is Warren Buffett. I am sure Michele will tell you that she deals with Resolute Forest Products, which is Warren Buffet's company, and the role that they now play in the litigation.

The second point I want to make is that we live in a great country and one of the greatest things about it is the jury system and the role that judges and juries play in our system. As a plaintiff's lawyer, I trust judges and I trust juries pretty much implicitly. In the state that I practice in, New York, the judges and the juries have done an excellent job of grappling with issues like, when is there a duty? Mark likes to talk about this outlandish idea that a company that sold a product that had asbestos added to it may be responsible. That it is an expansion of duty, it is a third party duty, and the courts are running away with it, but this is not the case. In New York, we use very standard principles of tort law. The question revolves around foreseeability. If it was foreseeable to the defendant that there was a risk about which they should have warned then the company is held responsible. If it was not foreseeable to them then they are not held responsible.

It is the same law that has been applied for hundreds of years in New York and it is now just being applied in the asbestos context. As I am going to show you later, the same is true with bankruptcies. We have a well-developed law about joint liability in New York and in many states; a law about joint, about offsets, about contributions, and about the role of settlements. These principles are being applied in these cases by judges who are acting as gatekeepers, who are applying the law, and who are coming to a balance in the system. So I just wanted to make those comments to provide a more practical response to the broader critique of the system. Now I think we are going to have some discussion.

I am actually going to stand up because I am used to teaching standing. Some of what I am going to cover is really just a basic primer on what bankruptcy trusts are. We have heard a lot about them, but what are they in

reality? Today, the bankruptcy trust is formed under Section 524(g) of the bankruptcy code.<sup>36</sup> The idea there is that we want these companies to come in and we want them to reorganize, because if they reorganize they are going to have more value. That value can then be saved for compensating injured plaintiffs. That was the basic decision that went into establishing Section 524(g) in 1994.

In order to do that you have to go through certain steps, which are not going to be really relevant to many of you. But after this bankruptcy is filed, typically a Chapter Eleven case,<sup>37</sup> we process some claims but not asbestos claims. Asbestos claims are typically left to the side and not dealt with during the bankruptcy case. Some may be investigated for estimation purposes, for figuring out how big the liability is ultimately going to be, but there is very little actual claim review.

In bankruptcy, the reorganization stage is where the debtor comes forward and says, this is how we are going to pay off our debts, this is how we are going to resolve all of our liabilities going forward and hopefully get a discharge and come out as a clean company. Once the case is toward this stage then the court will consider what has been proposed and whether or not it complies with applicable law, whether or not it actually treats all different creditors fairly.

The bankruptcy code does not really tell us what the bankruptcy trusts have to do. It simply says that you can establish a bankruptcy trust. It says that you have to provide reasonable assurance that current claims on the trust will be paid in roughly the same manner to people who get sick ten years or twenty years from now as they will to people who are sick today. So that requires thinking about what the liabilities are going to be in the future, figuring out what the size of that pool is, and then trying to apportion the assets that are available evenly across the entire range of claimants.

Of course, that does not happen. What we typically see in these bankruptcy cases is that we have what Francis McGovern would have coined as *The Field of Dreams*—if you build it they will come. When you build a bankruptcy trust you see an onslaught of claims filed. I am not going to go into speculation as to why that is, others have done that pretty extensively and that is not really relevant for your purposes, but it is relevant, for those who might be dealing with asbestos trusts in the tort system, to understand that a trust that was paying \$100,000 for a mesothelioma claim a year ago might only be paying \$10,000 on that claim today.

The reason for that is that a trust can set a payment percentage.<sup>38</sup> Once they realize that the volume of claims far exceed what were projected, they can go back and say, we realize our projections are not right and we are

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<sup>36</sup> 11 U.S.C. § 524 (2012).

<sup>37</sup> 11 U.S.C. § 101-12 (2012).

<sup>38</sup> Lloyd Dixon et al., *Asbestos Bankruptcy Trusts: An Overview of Trust Structure and Activity with Detailed Reports on the Largest Trusts* 38 RAND INST. FOR CIVIL JUSTICE (2010).



going to reduce payments going forward. We are going to reduce our percentage of what we allocate the value to be today and hopefully that is going to be the end of it. Some trusts have been reducing payment percentages yearly since 2006. U.S. Gypsum has reduced its payment percentage four times in the last four years.<sup>39</sup> And so the assets that are available to pay any one claim from any particular trust are going to be in flux.

How does the payment process actually work under the trust? The first thing you are going to do is submit a claim form. I track thirty-seven trusts on a consistent basis because those are the ones that control over ninety-eight percent of the assets throughout the trust system. These trusts also largely control some of the same government system, the same basic trust distribution design. So the first thing you do is file a claim form and that is going to require that you identify your exposure. If they have recognized work-site lists, you can just say, I worked at this site therefore I was exposed, so you can list that site. You then have to establish some sort of injury and those injuries are going to be broken down into different categories; mesothelioma is consistently the highest level of compensation, but then you also have lung cancer one, lung cancer two, and you may have different categories of asbestosis.

And down at the very bottom we have what we would call an ordinary bankruptcy parlance, convenience class claims. Where the standards are much lower but the payments are very low.

For many of these claims, if they are submitted under expedited review, there may not be a significant challenge from the trust. If you submit the information that they request and you are not seeking some kind of extraordinary claim value then they can take that information, they can process it, and they can assign a value according to a grid that has been established under the trust issue distribution procedures. Once that is done there is really no negotiation, there is no settlement discussion to take place. According to the GAO Report from last year ninety-eight percent of claims that are submitted to the bankruptcy trust system are submitted for expedited review.<sup>40</sup>

If they are approved then they are going to receive a scheduled value. That will be according to the value that is assigned in the trust distribution procedure. But that is not the amount that is going to be paid unless the trust is paying one hundred cents on the dollar, currently no active trusts are paying at one hundred cents on the dollar, then you are going to multiply that by the payment percentage. So if USG assigns a \$130,000 value to a mesothelioma claim whose payment percentage is now twenty percent, you do the math, you break it down, it comes out to under \$30,000.

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<sup>39</sup> *Hearing on the Furthering Asbestos Claims Transparency Act*, *supra* note 2, at 12.

<sup>40</sup> Reyes et al., *Accusations of Fraud in the Asbestos Bankruptcy Courts: Plaintiff's Deception of Defendant's Obfuscation*, MESOTHELIOMA LAWYERS BLOG (Dec. 5, 2011), <http://www.mesothelioma-lawyersblog.com/?page=3>.

Knowing this is important if you are considering contribution because there are variations across states as to how contribution might be considered. I would take up our entire time going through all the different variations. But if you are considering a contribution, you really need to take into account what is actually being paid after the payment percentage is applied. If you applied and said, well they settled this for \$135,000 under the USG settlement criteria, then that plaintiff is not going to receive \$135,000. They will never receive \$135,000, ever. At best you may expect that that payment percentage is going to go up a few percentage points if claim volumes suddenly decline at a level below what they have been seeing. That has not been our history but perhaps it could happen.

This remainder value, this additional amount that goes above what they actually receive after the settlement is offered. If it were me I would say let us make this remainder value the actual amount that is being offered in the settlement. If I were going to apply a more active law in economics approach I would say, is there a remainder value to that leftover portion that is unpaid. That would be my own approach.

So that is one thing, one contribution. The biggest area of dispute right now, and we have seen it touched on today, is discovery. Can we get discovery of trust forms? What can we do with that information as judges, as defendants? What can you do? Trusts do have confidentiality language. Much of the confidentiality language for trusts that were established after 2006 was added after the bankruptcy court confirmed the case. We did not really start seeing many of those until trusts that were confirmed around that time. Before then it was rare. These do not purport to bar discovery nor do the confirmation orders that approve them today. But they do say that we are not going to freely give this information up. And there is a reason for that—the bankruptcy code does not have provisions for saying the bankruptcy trust can suddenly ignore applicable state law. If you establish a trust you can just ignore state law as discovery and that is still a state law issue.

Trying to figure out who is responsible for what and trying to allocate recoveries, that is still firmly within the states. You might recall a few years ago when one of the big energy producers out in California, Pacific Gas & Energy, filed for bankruptcy.<sup>41</sup> And they came in with their plan and tried to say, well you know what we are no longer going to have to abide by the regulatory agencies or the rate determinations and so forth, and we are going to put that in our plans, and we are going to get that approved. Bankruptcy court said, where is the bankruptcy plan that says you can do that? That is not the bankruptcy issue. I would argue that this is the same case here. What happens in the tort system is not the bankruptcy court's con-

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<sup>41</sup> In re Pacific Gas and Elec. Co., 283 B.R. 41 (N.D. Cal. 2002).

cern. The bankruptcy court is focused on this case, these assets that are available, and the plaintiffs who have legitimate claims against those assets.

It is not about co-defendants. In fact, when you talk about co-defendants coming in and trying to argue these cases in bankruptcy court they are routinely denied standing. They are denied standing because the court says, this is not your issue.

Just a word about the assets available in the tort system. While it is true, as Mr. Siegel noted, that the \$36 billion is not just money that is sitting in a field somewhere, it is not just cash sitting in a field somewhere, where plaintiffs' lawyers are given kind of a ordinance and told to come running and get it. However, if we look at how much has been paid out of the trust system since 2006, it has been more than \$14 billion,<sup>42</sup> since 2006 and that is a lot of money. The rates peaked in 2009. Approaching 2009 the rates were just under \$4 billion, which is about \$10 billion in in 2009 alone.

Payments in 2010 and 2011 were over \$2 billion per year.<sup>43</sup> So we are seeing a lot of money come through the trust system and paid to claimants. Now which issues—what should you be looking at, as a judge, if you are asked to consider discovery of a trust claim form or trust communications. There has been a pretty substantial amount of ink spilled on this in just the last few years. We saw, of course, the Volkswagen case in California, which dealt with this issue.<sup>44</sup> The court ultimately concluded that the trust forms were discoverable.<sup>45</sup> Most of the courts that considered this have followed Volkswagen, though a couple courts have not.

The real issue for these courts has been whether or not this is going to generate information that is reasonably calculated to lead to a discovery of admissible evidence. Of course that does not mean that the evidence that has been discovered has to be admissible itself. The question is whether or not it is reasonably calculated to lead to the discovery of admissible evidence.

The response that we often see is that trust exposure criteria, are uninformative. We saw this on a panel here, I believe, three or four years ago. Mr. Finch was up here and said, look the trust standards are so low that they do not tell you anything about exposure under the tort system. As a bankruptcy academic I find that troubling. But even if that is the case, the courts that have considered that argument have said that the trust standards can also reveal a lot more. They can be used to impeach, they can be used to identify things that were not identified in discovery, and sadly, we do see some lawyers who will, either intentionally or not, fail to disclose trust

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<sup>42</sup> Marc. C. Scarcella & Peter R. Kelso, *Asbestos Bankruptcy Trusts: A 2012 Overview of Trust Assets, Compensation & Governance*, MEALEY'S ASBESTOS BANKRUPTCY REPORT, June 2012, at 1, 1.

<sup>43</sup> *Id.* at 3.

<sup>44</sup> *Volkswagen of America, Inc. v. Superior Court*, 139 Cal.App.4th 1481 (Cal. App. 2006).

<sup>45</sup> *Id.* at 1497.

forms they have filed. But probably more commonly there was simply a miscommunication when that happens.

Some law firms represent their clients in all aspects of asbestos litigation. Some do not. Some recruit clients, keep the asbestos trust commissions for themselves, and then refer the cases to lawyers more familiar with the law in the appropriate jurisdictions. A case in Delaware that we recently saw ran into that issue, where a firm in Texas referred a case to lawyers in Florida. The Texas firm submitted bankruptcy trust claims to, I think it was twenty or something (lawyers), and did not tell anybody. The Delaware lawyer goes through the entire case and literally two days before the hearing, this case was supposed to go to trial, they suddenly discover that all of these bankruptcy trust claims forms were filed and it completely wrecked the entire preceding.

That is one way that it happens. Another way that we have seen it happen involves very large firms that have compartmentalized responsibilities for trust claims. One of the more prominent firms that is out there, I will not name them because they are not here, they had three different tracks. They had one group that filed claims in their local area, another group that was responsible for claims filed outside of the state, and then a third group that was responsible for filing bankruptcy trust claims, all within the same firm.

The left hand, the right hand, and the other hand, did not know what any of the other hands were doing. And so they actually filed twenty plus bankruptcy trust claims again, they filed a suit in their local court against, something like, eighty defendants, and then in the foreign court they also filed against another seven or eight defendants. So it is not just that maybe the lawyer in front of you is being untruthful, it may be that there has simply been a lack of communication. Defendants who try to take this approach may have some basis for believing that there are some weaknesses there.

Now the problem with all of this is that it is hard to quantify how often any of this happens. This is largely because none of the asbestos trust claims keep the process for these claims secretive. Even if you do get discovery of these documents you may be subject to some kind of confidentiality restrictions, and therefore, will not be able to disclose them to people like me, who go in and try to figure out what is going on in this process. So there is that possibility.

The other thing I would say is that when we talk about confidentiality the Volkswagen court said, well how do we characterize bankruptcy trusts as they are an entirely new animal. They are not something that we have seen out there before. One theory is that we should treat the trust as stepping into the shoes of the defendants and therefore any kind of settlement that they ultimately make and every discussion related to that settlement should be subject to settlement privilege.

If you look at how the trust operates, as the *Volkswagen* court and as some others have, you will see that it does not exactly work the same way

as the settlement. You have a very clear set of criteria that you have to satisfy, you have put it into an official form, you swear to under penalty of perjury that everything that you are asserting there is truthful and accurate, very much like a complaint. And so trying to say that it is similar to one or the other, those courts have said that it is very much like a complaint and therefore would not be subject to the settlement privilege.

This is something that I think ultimately you have to look at under your own respective laws. Figure out what is demanded under the settlement privilege, what applies, and whether the trust system looks more to you like a private entity that is settling claims and engaging in discussions that help avoid litigation, which is typically how the settlement privilege is viewed. Or is the trust system simply something that they are going to be filing, much like they would with a workers compensation board or some other administrative regime.

The last thing I am not going to talk about but will raise, is the concern of timing on the defense side. Most trusts allow three years from the date of discovery to file a trust claim. That can actually be pushed back under certain conditions. So the idea here is, why would you file a trust claim if you have active litigation pending in the tort system? When you look at the RAND Report from 2010 when they interviewed different lawyers, some lawyers said we have a duty to be sure that we do not file those trusts claims till after discovery is ended.<sup>46</sup> Why, because they might be discovered. Others said no, we have a duty to file them quickly because if we do not then the payment percentages are going to go down and our clients are going to get less money from the trusts.

The fact that there is disagreement, even amongst the plaintiffs' bar on this issue, which is very telling, how novel these issues are and how far we have to go in sorting out these issues. Some legislative efforts have been made to try to force plaintiffs in the tort system to file trust claims before trial takes place. I will leave that debate to others who are more attuned to that. The one thing that I would caution anyone who is considering doing something novel in this area, carefully consider what—how that novel approach might unduly balance the litigation or the settlement incentives on both sides. One of reasons we have seen some of the dysfunctions in the tort system is that perhaps those unintended consequences were not bedded out as fully as they might have been and have led to some dysfunctions, frankly, on both sides.

This is a very contentious area of law. Perhaps the most contentious area of practice that I have seen and as a former bankruptcy lawyer, I have seen it all. You want to be very careful when you are looking at making changes that could have a dramatic shift in the perception of your process

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<sup>46</sup> LLOYD DIXON & GEOFFREY MCGOVERN, RAND INST. FOR CIVIL JUSTICE ASBESTOS BANKRUPTCY TRUSTS AND TORT COMPETITION 19 (2010).

and in the way that the different parties approach each other in settlement negotiations. That is all I have for this one.

**JOSEPH W. BELLUCK:** So I wanted to quickly, so that there will be some time left for discussion, walk you through a couple of trials that we handled in New York, and show you, from a practical standpoint, why I think much of what you have just heard is not really accurate.

So the first thing is, I have a client to represent. I am not a professor, I am not a public relations person, I have a client and my obligation for that client is to get the largest recovery I can for my them and their family. This means what? This means I have to prepare them adequately for their deposition within the ethical guidelines of where I practice. It means I have to take whatever steps necessary to make sure that they get as full of a recovery as possible, and it means I have to explain to them what the law is in the state where the case is filed. This is what I do in every case, I explain to my clients what the law is, I tell them about the questions they are going to be asked at the deposition, I refresh their recollection if appropriate, and I try to prepare my client's case in the best way that I can.

The issue in asbestos cases today, ninety-nine percent of where the battle is in these cases, is over the allocation of responsibility to the defendants in the case. The issue of whether my client has mesothelioma is almost never contested. The issue of whether or not the mesothelioma is asbestos related is almost never contested. There are some issues about whether we have the right company or the right product, but usually those are resolved well in advance of settlement or trial.

The issue is really the percentage. As I say to my clients, the best way to think about your case is like a big pizza and the issue is going to be how much, or how large each slice of the pizza is going to be. That is what all of this stuff is about.

The first thing that happens in my clients' cases is that they testify at a deposition. This is my biggest problem with this whole discussion that you have heard. At the deposition my clients are asked to say their name, their social security number, their father, what do they do for a living, talk about their medical history, when they got sick, what treatment they have gotten, and then how they were exposed to asbestos. The people asking those questions, that is her. I do not tell her what to ask. She is free to take a list of every bankrupt company. She is free to take a picture of every bankrupt product and show it to my client and say, sir did you work with Johns Manville? Did you work with Owens Corning? Did you work with US Gypsum? That is her discovery about my client's exposure, or at least what my client knows about bankruptcy exposure.

I do not know Michele at all. And from what I have heard, she is a great lawyer. The lawyers in New York who do this, who represent the defendants, they do a poor job questioning my clients. I would not hire them. I am being perfectly honest with you. And you can ask Michele

because she has sat in depositions with her colleagues and they do not ask the right questions. My client comes in for a deposition prepared, and his recollection about his exposure to asbestos refreshed, he testifies about how he was exposed to asbestos, and they ask about their product. Sir you said you worked with Union Carbide asbestos, what did it look like? How big was the bag? What was the name on it? How often did you use it? They do not ask that about the bankrupt exposures. They do not do the work to prove up the bankrupt exposures.

Beyond my client's deposition, how do I prove bankruptcy exposures? One way that I do it, for example, if the person worked in the Navy I go to the Naval Archives in Washington and I get the ship specifications. In the specifications it will say, there was a Babcock & Wilcox boiler on the ship. Babcock & Wilcox is bankrupt and that is a basis for me filing a bankruptcy claim. These other lawyers do not do it. They do not do the work. They could go to Washington and pull the ships specifications, they could serve discovery on my client's employer and ask for the product identification the same way we do but they want to have me do their work for them. Then when they go to trial they can put these other companies on the verdict sheet and ask the jury to assign responsibility to these other entities.

That is what all of this is about. In my practice, the way we do things, we do not file the bankruptcy claims until after the case is resolved. In New York, we are not obligated to do it before.<sup>47</sup> And unless my client is in a particular situation where he would benefit from the filing of the claims we do not file them during the pendency of the action. If we do file them we turn them over. Every court in New York has determined that the bankruptcy claim forms, if filed, have to be provided to the defendants.<sup>48</sup> And we do provide that. Apart from us filing the bankruptcy claim form nothing precludes the defendants from getting this in discovery. They can ask my client and his co-workers about his positions. They can serve discovery on the job sites. They can hire investigators. They could prove all these shares without any of the need for these transparency discovery issues you are hearing.

So let me just quickly show you this. These are recent verdicts in New York. The last two my office tried last summer. The majority awarded \$32 million and \$19 million. The judge remitted both of them to about \$8.5 million. This is the number of active trusts that we deal with. There are some that are particular to a particular locality, like California, but in New York we deal with about forty-one trusts. My clients get an average of about \$300,000 total from those forty-one trusts. The verdict value in New York, after remittance, is \$8 million. My client gets \$300,000 from all the bankruptcy trusts combined in a mesothelioma case. That is an average, some get higher, maybe \$400,000, and some get lower.

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<sup>47</sup> *Id.* at xiv.

<sup>48</sup> *Id.*

There is not a pot of gold sitting in the bankruptcy trusts for my clients. Why? This is what they actually pay. This is the actual pay out from a number of bankruptcy trusts. If you qualified for all of them, you would get about \$750,000 to \$800,000. But our clients do not qualify for all of them because they have to submit proof of exposure. Look at Johns Manville, \$26,000, and these are going down. In the abstract, it sounds like there is a lot of money but the actual payout per trust is pretty low. If you look, some of them are \$4,000, \$6,000, and \$1,200. Most of our clients do not qualify for the largest one on here, Western Asbestos Trust in California, because we practice in New York and our clients were not exposed in California.

**AUDIENCE MEMBER:** Joe, if I could interrupt for one second. It is important to recognize that Johns Mansville was the largest distributor of asbestos containing products, probably the defendant from which most of our clients had the most exposure, or the largest single exposure, and so that is what they pay. That is what the bankruptcy system yields with the single biggest supplier of asbestos ever in the United States.

**JOSEPH W. BELLUCK:** This is a case we tried in Buffalo, New York, called *In re Eighth Judicial District Asbestos Litigation*.<sup>49</sup> As you go through the questions—this is the actual verdict—I am going to go through this quickly but I just wanted to show you this. The first question was, was the defendant, Fisher Controls, negligent? And the jury found that they were. The second question was, were they exposed to the defendant's products? And they answered yes, that the plaintiffs were. The third question was, our causation question in New York, was the plaintiff's exposure to the defendant's product a substantial factor? The jury found that it was. The next question is important in New York because it is a finding of recklessness. New York is basically a several liability state meaning that unless the defendant is found reckless, or more than fifty percent responsible, then it becomes a joint defendant in several states. And when the jury answered this question, the jury held that Fisher Controls was one hundred percent responsible for my client's damages.<sup>50</sup>

This is important. This is a question that is asking the defendants and asking the jury to determine which other defendants are responsible. On this list are a number of bankrupt companies that the jury heard evidence from. The defendants put on the evidence at trial that my client was exposed to GAF Ruberoid—bankrupt, Garlock—bankrupt, Johns Manville—bankrupt, Special Asbestos Company—bankrupt, Vermont Asbestos Group—bankrupt. The defendants had the evidence to give to the jury to hold the bankrupt entity partly responsible. They then asked them, was the

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<sup>49</sup> *In re Eighth Judicial Dist. Asbestos Litig.*, 92 A.D.3d 1259 (N.Y. App. Div. 2012).

<sup>50</sup> *Id.* at 1260.



exposure a substantial—were they exposed to these products? The answer was yes.

Now what you will see as I flip through this. The last few questions I did not show you were questions about whether the employer was responsible. This is the jury's actual allocation. They found the trial defendant five percent liable after hearing all of the evidence. They found the plaintiff's employer sixty-two percent liable, and they assigned a percentage to the other companies, many of who were bankrupt. There is no issue of transparency in this case. The defendants had evidence of bankrupt products being used in my client's factory, they showed the jury the evidence, we had some bankruptcy claims forms that we filed, we gave the forms to them, and the jury assigned a percentage to those companies.

This is not an aberration. This is the *Dummitt* case,<sup>51</sup> which we tried this summer. The verdict was \$32 million, remitted to about \$8.5 million.<sup>52</sup> They asked the same questions as the previously discussed case. Where the plaintiffs exposed to asbestos from Cranes valves? Yes. Was Crane negligent? Yes. Was there a substantial contributing factor? You will that see as you go through it they are answering questions about the trial defendants, which were Crane and Elliot. Here is where they asked whether other people were responsible? You will see that on this list are some bankrupt companies, Babcock & Wilcox and Flexitallic.

Now here is the interesting part about this verdict. The jury found that even though my client was exposed to bankrupt products the bankrupt companies were not negligent. Why? Because the defendants did a poor job. They did not give evidence of the defendants' negligence. They said to the jury, Mr. Dummett was exposed to Babcock & Wilcox's boilers. However, they did not offer evidence that Babcock & Wilcox knew asbestos was harmful and that they had a duty to warn. The law in New York says, if you are going to hold someone responsible, you have to show that they were negligent; it is pretty simple. If we did not have to show that they were negligent Mark would be running around the country saying, this is crazy you can hold people responsible without showing that they are negligent.

So, what did the jury do? They said that Babcock & Wilcox were not negligent. Then, they assigned ninety-nine percent of the responsibility to one trial defendant and one percent of responsibility to the other trial defendant. The jury understood there were two defendants at trial and they should be handled differently. What happened to this case? This is the judge's post-verdict decision. The defendant in this case argued that the jury did not act appropriately when they found no negligence on the part of

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<sup>51</sup> *Dummitt v. A.W. Chesterton Inc.*, No. 1090196/10, 2012 WL 3642303 (N.Y. Sup. Ct., N.Y. 2012).

<sup>52</sup> *Id.* at 24.

these other entities. After eight weeks of testimony the trial judge wrote a 130 page decision saying that the defendant seeking to apportion liability to non-party bankrupt companies has the burden of showing those companies' the negligence.<sup>53</sup> And in this case, they did not show that. So the judge said that the jury was fully within their province to say, you do not get to apportion any fault to the other companies.<sup>54</sup>

Now, this is what happened in the judgment. The defendant at trial, Crane Company, received an \$8 million offset from the verdict for what we had already settled, which was about four million dollars in settlements. Bankruptcy settlements were included in these four million dollars. Any money that I had already collected from a bankrupt entity, Crane was able to offset that. What happened in this case is exactly what they are telling you they want. We received settlements from non-party tort [inaudible] and they got an offset for them. Their responsibility was reduced by what I had already collected.

Now the timing issue. Professor Brown said that there was a timing issue because we do not file all of the bankruptcy claims until the case is done. So, theoretically, after this judgment, I can go out and file additional bankruptcy claims. What did the judge say? The judge said, Mr. Belluck, you have a judgment for the full value of the case. You will now give the trial defendant the right to file any other bankruptcy claims, any claims that you did not already file at the time of the judgment, now belong to Crane Company. And Crane Company can step into your shoes and collect the money from the other bankruptcy trusts and reduce what they have to pay, they are free to do this. It is a pretty reasonable solution for the timing issue; the plaintiff can file it before the verdict and it will offset the damages. However, if the plaintiff does not file it before the verdict, then the defendant gets to go out and collect and reduce their payment, but the judgment is a full verdict.

I just wanted to show that this case was not an aberration. This is another case we tried this summer. The verdict was \$19.5 million reduced to \$8 million. They held that the premises owner liable and reckless. These are the questions about whether the trial defendant was responsible, whether they were substantial contributing factor. This question here is whether the plaintiff was exposed to other company's products besides the products of the defendant at trial? The jury answered yes. Included in that list is US Gypsum, a bankrupt company. How did the jury know that? They know that because of the deposition, this lawyer happened to do their job. And they asked my client, were you exposed to a US Gypsum compound? The client answered, yes. And here it is on the verdict sheet.

So they found the bankrupt entity responsible. They found them negligent and found that they were a substantial factor. These are the percen-

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<sup>53</sup> *Id.* at 21.

<sup>54</sup> *Id.*

tages. You can see that they awarded a percentage of the total verdict to US Gypsum, a bankrupt entity. I would say that there is really not a transparency issue. If these cases are well litigated on both sides by competent lawyers then all of the information about these exposures is available. All that has to happen is that the lawyers on the defense side have to do their job. They have to ask the questions. They have to do discovery. They have to prove that there was exposure to a bankrupt entity. I personally believe that if you file a bankruptcy trust form as a plaintiff's lawyer during the pendency of an action that you should turn it over and that is what we do.

Todd mentioned that there are some communication issues. Sometimes we get cases referred to us where we do not actually file the bankruptcy claim forms, and there are problems like that. But in general, I would tell you that the system is working.

**UNIDENTIFIED SPEAKER:** I want you all to know I have sent an email to my partners to immediately begin filing more suits in New York.

**MICHELE H. DESHAZO:** Yeah. It seems like everything in New York works so perfectly, but for the defense attorneys.

**UNIDENTIFIED SPEAKER:** I just want to add that there has been a rule in place in New York for quite a while that does require connection with the original interrogatories that actually has the list of all of the bankruptcy trust defendants to the extent that those lists are available. It is ultimately going to depend upon the quality of the defense representation. Unfortunately, we do not see that in all states. I think we have fewer than a dozen states that have adopted a statewide Claims Management Order of that nature. And unfortunately, it also relies upon the ability of the lawyers who are involved, and even the plaintiffs themselves, to say that these are the companies we filed claims against.

I have a number of relatives who have been exposed to asbestos, my grandfather died from asbestos cancer. I have seen how these things unfold in other jurisdictions. It is a little disturbing when somebody comes to you and tells you that they have received a number of settlement dollars but they have no idea why. No idea who they sued. I think it is important to note in this area of litigation that there are good apples and there are bad apples on both sides and, unfortunately, it is not always easy to distinguish the good from the bad.

This is an emerging area and those of you who have asbestos claims are going to be at the forefront of it. Look at what has been done out there. If you like what you have heard about the New York model, I happen to like a lot of what I have seen in the New York model, then it is a good starting point. But you have to adapt and you have to adjust. Hopefully we have been able to provide you with some insight in this area. I am going to

open the floor to some questions now. We will be happy to answer them. Yes?

**AUDIENCE MEMBER:** I have a two-part question. One, to Mr. Belluck, in the case involving the property owner, can you give just a brief example of the kind of evidence that showed that the property owner was reckless. What evidence did you rely on? Number two, does New York have the same relentless television advertising for plaintiffs that Florida has? I am from Florida. And do you think that advertising has affected jurors' attitudes about the cases at all? And do you take that into consideration in jury selection?

**JOSEPH W. BELLUCK:** I can tell you that my firm does not advertise on television. I think the advertising is terrible. It has made my job harder because now when you do jury selection everybody has seen the ads and I think in some ways it has diminished the severity of the claims. Mesothelioma cases are serious cases. These are people who are not going to live longer than a year and a half to two years and there is no cure. Mesothelioma is a signature injury caused by asbestos exposure and personally, I think that the television ads have made litigating these cases harder. We have them in New York, my competitors in New York run them twenty-four hours a day.

The evidence of recklessness was a little thin. I will grant that to you. But there was evidence that—the defendant was a construction company—there was evidence that they knew about the hazards of asbestos and had not provided appropriate protection to my client, who was on the site doing other work. The trial judge sustained the recklessness finding. There is a little bit of a backstory to it. In New York we are not allowed to get punitive damages in asbestos cases, they are basically deferred. So I think that the judges, and there has been some [inaudible] case law in this too, have to kind of split the baby a little bit and allow us to prove recklessness, but have then found that we do not have enough evidence for punitive damages.

Like everything else it is a little bit contextual.

**MARK A. BEHRENS:** I want to make one quick comment. I have sat through being called every bad thing in the world. I know it is lunchtime so I will not keep you here until three P.M. responding to those things. In defense of the lawyers of New York, though I do not litigate there, one of the issues that comes up, the reason the trust claim forms are an important tool, is that a plaintiff maybe asked about it at the deposition. In some of these cases maybe those defendants did ask the plaintiff, tell me what you were exposed to, because I know they do in other cases.

The plaintiff may not know the answer to that question. But you know who does know the answer? His law firm. If you go to the plaintiff's law firm's website, they recruit plaintiffs by telling the world how easy it is to

file a claim and how they have all of the information to do it because they have testimony from co-workers. They have documents from the plant. Therefore, you may not receive the information from the plaintiff but the information is out there and some of it may be out there if the defendants did the work, but the plaintiff's firms have it. Go to any of their websites and it is there. This is one of the reasons why the claim forms are an important tool.

I see an element of hypocrisy here because we hear about how the jury system is the most important cornerstone in our democratic system. We hear that we have to trust juries and yet, what is really going on, is they want to hide the ball from the jury. They want to file the claim forms after the jury trial is over because they do not want the jury to have all of the information about the plaintiff's exposures. If you really trust the jury system you would file the claims before the case goes to trial and give the jury all of the information and let them make a fully informed decision about what is going on.

**UNIDENTIFIED SPEAKER:** I do not know how badly people want to get to lunch but—there is obviously a response to that. You know it is really not the plaintiff's lawyer's job to do the defense lawyer's work, it is the plaintiff's lawyer's job to maximize the plaintiff's recovery and it is the defense lawyer's job to assign blame to as many other sources as possible. If you know that a plaintiff worked at a particular job site and the plaintiff's lawyer has evidence of which products were used at that job site that would seem like a pretty easy thing for the defense lawyer to put together. It is not the plaintiff's lawyer's job to create other shares of apportionment for the defense lawyer.

Having said that, we know from the results of Joe's trials—I have testified in congress and brought many examples of verdict sheets from cases that my firm has tried—we know that no balls are being hidden and we know that juries are getting the full story because juries routinely assign responsibilities to bankrupt entities. My firm tries a lot of cases in California and it is very typical in California for bankrupt entities to make up the majority of jury fault allocation so we know that no balls are being hidden from the jury.

**MICHELE H. DESHAZO:** Just a final thought. I know that we can go back and forth forever and that each time somebody makes a point there will be a rebuttal. I know that Joe has discussed how well New York works, and that is great, but many other states do not work as well. In Louisiana we have issues getting the trust forms from the plaintiff's counsel. Although we can ask questions in a plaintiff's deposition about their sources of exposure, as Mark has said, many times either they do not know or there may be some emphasis on not disclosing the bankrupt entities in the deposition. So the

trust forms are of vital importance to obtain and hopefully other plaintiffs' attorneys throughout the country will follow Joe and the New York model.

**MARK A. BEHRENS:** I should say that our firm does not contest the discoverability of any trust claim forms we file. I do not disagree with that at all. I think that if a trust form claim has been filed it is totally discoverable and that is our firm's practice.

**S. TODD BROWN:** I think that is going to end our session. Thank you to everyone here for being here.

**D. BRUCE JOHNSEN:** We will have lunch around the corner and we have a great speaker there for you to listen to so we will see you there.

## RULE 4(b) AND INCENTIVES FOR LITIGATION ABUSE

*E. Donald Elliott*

**D. BRUCE JOHNSEN:** Let's all depart, say good-bye and go our separate ways. I hope you've all enjoyed the conference as much as we've enjoyed having you. I am here now to introduce our last and keynote speaker. He comes highly recommended from our fearless leader, Henry Butler, who cannot be here today. E. Donald Elliott received his bachelor's degree, from Yale University in 1970, and graduated summa cum laude, even went on to Yale Law School to graduate first in his class in 1974.

Following graduation he clerked for Gerhard Gesell of the U.S. District Court for the District of Columbia and then for Chief Judge David Bazelon and the U.S. Court of Appeals for the District of Columbia Circuit. In 1980 he joined the faculty at Yale Law School. During that time, he authored or co-authored at least 70 scholarly articles, and seven books. He still continues to teach at Yale Law School; although because he so much enjoys his practice he has gone on adjunct status although he continues to be a full time faculty member.

He works in the area of environmental and safety and was the head of the environmental and safety practice and at Willkie Farr & Gallagher in Washington D.C. before joining Covington and Burling earlier this year. Congratulations. He has litigated many high profile civil and criminal cases in federal and state courts, is an elected member of the American College of Environmental Lawyers, top ranked by Chambers and Martindale-Hubbard, and selected as one of the best lawyers in the National Law Journal as an environmental lawyer. He, at one time, was the Assistant Administrator and General Counsel of the U.S. Environmental Protection Agency, and held the Julien and Virginia Cornell Chair of Environmental Law and Litigation while at Yale Law School. Please join me in welcoming E. Donald Elliott.

**E. DONALD ELLIOT:** Thank you very much, Bruce. So we're sitting over there and Bruce says, shall we allow the people to continue to enjoy themselves or is it time for your speech? So is anybody else in the room from Indiana? Oh good, I went through the list. I didn't see you. I'm from Southern Indiana. One of the things that I learned growing up is that you should always start a speech, particularly a luncheon speech, with an amusing antidote and I said to myself how am I going to come up with an amusing antidote about Rule 4 of the Federal Rules of Civil Procedure but then I thought about the famous who's your three kick rule, you know what I am talking about the who's your three kick rule?

No. So it appears that there is a young judge from Chicago that was down in Southern Indiana doing some duck hunting and he shoots this duck and the duck falls into a field. He starts to climb over the fence to get his duck and the old farmer comes running up to him on the tractor and says, "What are you doing young fellow?" He says, "I'm getting my duck." He says, "Not on my property you're not." The judge says, "Don't you know who I am? "I am a very powerful judge. I have powerful friends. I could get you in a lot of trouble. I could sue you."

The farmer says, "I tell you around here we settle this kind of dispute with the 'who's your three kick rule.'" He said, "Well, what is that?" He says, "Well I kick you three times and then you kick me three times and we keep this up until one of us gives up." The judge looks at him and says, "Looks like an old guy not very strong up okay." So, the old farmer kicks him first in the groin with his old work boot, and just about the time he's recovering with that the old man he kicks him in the face, and then a karate kick to the back. The judge was about to give up but he gradually gets up and says, "Okay now it's my turn," and the farmer says, "No you can keep the duck. I give up."

Now, the point of the story is that we sometimes lose sight of the relationship between the cost of litigation, on one hand, and the states in the litigation on the other. And that is really what my little talk is going to be about. It's based on a 65 page law review article with 265 footnotes as befits a good law review article.<sup>1</sup> And I brought copies with me if anybody wants the full version of it. It's a little tough to reduce a law review article to a speech, but I'm going to try. So, here's the article downloaded if you want it. It's about Rule 4(b) of the Federal Rules of Civil Procedure. Here's a test. How many of you from memory know what Rule 4(b) of the Federal Rules and Civil Procedures says? No one. Okay.

So, here is what it says. It's kind of hard to believe, but it says, if the summons is properly completed the clerk must sign, seal and issue it to the plaintiff for service on the defendant.<sup>2</sup> So, if you complete it properly you fill in three pieces of information. You fill in the name of the defendant. You fill in the name of the plaintiff or the plaintiffs' lawyer, and you fill in the plaintiffs' lawyers' address. You pay a three hundred dollar filing fee and then the court is required by law to issue an order to the defendant requiring the defendant to come to court and spend substantial resources to answer.

Now, I contend, from the standpoint of strategic incentives, Rule 4(b) is really the foundation of the Federal Rules of Civil Procedure and it has been duplicated in many state systems. And, the reason that it is the

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<sup>1</sup> E. Donald Elliot, *Twombly in Context: Why Federal Rule of Civil Procedure 4(b) is Unconstitutional*, 64 FLA. L. REV. 895 (2012).

<sup>2</sup> FED. R. CIV. PROC. 4(b).



foundation is that is where the principle is laid down, which runs throughout the rules that a plaintiff's lawyer or plaintiff, but most often a plaintiff's lawyer, with a financial interest in the outcome is delegated the power of the state to impose substantial costs on another citizen without any quality control, whatsoever, by the state. It's a breathtaking proposition that if we weren't used to it we'd never tolerate it. So this is the standard summons used in federal court and it clearly, from my standpoint, is an order by the court to appear. It says you must appear, or judgment by default will be entered against you.

You must file your answer or motion with the court. Then, it's signed by the clerk of court and it's an official sealed document. I think it is clear as a bell that the rule gives the plaintiffs' lawyer the ability to, without any review by the court, order the defendant to come to court and start spending resources. The fundamental flaw in this, as far as I am concerned, is that the fundamental obligation of the state is to treat all of its citizens equally unless and until it verifies that there is some reasonable basis to impose a burden on one at the behest of the other. Now maybe, at the time that this was originally intact, well before I get to that the Supreme Court has kind of recognized the problem a little bit through the back door in the *Sinochem Intern* case in 2007 by basically saying there has to be more alleged in the complaint than simply the possibility of harm.<sup>3</sup> Otherwise, the plaintiff, with a largely groundless complaint, would be able to impose.

It's a nice euphemism—take up the time of other people. It costs a couple of thousand dollars to defend in court. This takes up the time of other people. But, we allow people to impose huge costs upon other people without any attempt by the state to verify there is a reasonable basis to do so. Now, I think that *Sinochem Intern* case is misguided, focuses. I think that it is trying to do the right thing, but I think that it's a little bit misguided in that it focuses on the motion to dismiss stage. And, by the time of a motion to dismiss the effects, the financial effects of being sued can already be quite substantial. The Federal Rules actually say, in Rule 12(g), that the judge should rule on the motion to dismiss prior to trial, unless he or she decides to rule on the motion to dismiss later.<sup>4</sup> So, there is really no requirement in the Federal system to dismiss motions early. My law firm recently settled a case for \$5 billion, literally. The motion to dismiss had been pending for over a year. They spent several million dollars. This case illustrates that. This is one of my favorite cases talked about in the article. It's an actual case, *Ward v. Arm & Hammer*.<sup>5</sup>

In this case, a prisoner, in federal prison who is serving a long sentence for selling crack cocaine sues the makers of baking soda, claiming that they failed to warn on the package that it was impermissible to use the

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<sup>3</sup> *Sinochem Intern. Co. Ltd. v. Malaysia Intern. Shipping Corp.*, 549 U.S. 422 (2007).

<sup>4</sup> FED. R. CIV. P. 12.

<sup>5</sup> *Ward v. Arm & Hammer*, 341 F. Supp.2d 499 (D.N.J. 2009).

baking soda to cut crack cocaine. He sues them for \$425 million and the summons is duly served on the defendant ordering them to come to court and answer. Ten months later, the district judge finally dismisses the case. God love them. But, by that time, they had been forced to spend tens of thousands of dollars answering. I actually called them up and asked them how much they spent. They wouldn't tell me the exact amount, but they said it was tens of thousands. It was more than 10,000 and less than a 100,000. It took multiples of tens of thousands of dollars to get this case dismissed. There is more to the story, of course. The guy appeals, and the third circuit, in its infinite wisdom, allows them to appeal, so the defendant has to spend more money responding to those charges.

One of the reasons I particularly like this case is it is very clear that this would not have happened prior to 1938. In the older system, prior to the 1938 reforms, a case like this that was brought well after the two year statute of limitations had expired—six years after the event took place—the complaint would have been weeded out by the clerk's office, and it never would have been served. There are a lot of cases in the article that illustrate that principle. What we have today is what my friend Randy Shepard, Chief Justice of the Indiana Supreme Court, calls a "judicial novelty text." We are so concerned that we might weed out a new or interesting case that we impose a huge tax on the defendants to respond to a lot of cases that have very little merit.

That, I think, fundamentally violates the principle that we are all committed to equal justice. I was thinking about it. If you take one thing away from my presentation, I hope you get more than that, but if you take only one thing away, it should be that defendants are people too. They also have rights to fair treatment. It was not always this way. The First Congress of this country passed something called The Process Act of 1792, which required that any process, including the summons, be signed off personally by a judge, before it could be issued.<sup>6</sup>

Now on most issues, the First Congress didn't create a whole separate federal system. It just said to state courts; "keep doing whatever you're doing," which already existed in The Conformity Act. But on this one thing, the Second Congress thought it was sufficiently important to keep control of court orders under the control of the court. It required that all writs and processes had to be specifically tested and signed off on by the judge. And, throughout the 19th century, the courts uniformly understood that law to reflect the policy to keep process under the immediate supervision and control of the court.

Prior to 1938, there are numerous cases, which I site in the article, and I won't go into today, of what we would today call "frivolous cases," which were dismissed before imposing costs on the defendant. They would be

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<sup>6</sup> Process Act, 1 Stat. 275 (1792).

reviewed by the court or reviewed by the clerk's office, and simply dismissed rather than served. The 1938 Federal Rules reported to overrule that. Quite quietly in the Advisors Committee Note, they said that the 1792 Process Act, which is this statute, is substantially continued. The part that was not continued was about judges having to sign off before process got issued.

There is a serious question, which Judge Carson has noted in a case, as to whether or not after the legislative veto case, this kind of inconsistency between a rule is sufficient to overrule the statute. The statute is still on the books and has never been repealed. In 1938, you could make an argument that the cost of being sued was negligible. Because, remember, until 1970, we didn't have document discovery except by leave of court. I think in 1938 they may have viewed having somebody come to court and answer a claim was no big thing. But certainly, today, that's not the case.

People spend huge amounts of money responding to cases that, I think, never should be served in the first place. So I argue, in this article (I have the full version for any of those of you who are sufficiently masochistic to want to read the whole thing, I brought a few copies along, I didn't bring enough for everybody but I didn't think that'd be necessary) that Rule 4 is really unconstitutional for really four separate reasons.

I think the strongest one, which is really just a slam-dunk, is that Rule 4 is an unconstitutional delegation of state power to a private party with a financial interest in the outcome. I just don't see any way you get around that. It's also quite well supported in the process arguments. I think there is a lot of Supreme Court law that says if you are given an official order to do something and you do it that's a seizure of your person. So, I think all the legal arguments are quite strong. And, I will say, I've given this argument in a lot of different forums and to a lot of federal judges. A lot of people get mad at me and call me names, but no one has ever responded to any of these legal arguments and said that they are wrong.

I'm not going to repeat them all here. You can look at them in the article, if you're interested. It's available online, either at SSRN right before the [inaudible] and you can look at the legal arguments and assess them. I propose a remedy for this situation, which I call a pre-service plausibility determination, which is basically the idea that a magistrate judge, or the clerk's office, ought to review a case before they decide to serve them. I think that, in some instances, we should go beyond simply looking at the complaint and actually call in the plaintiff's lawyer and ask them if they can really have some support for various key items. What's interesting is that that is the usual practice in American Law. That's what we do everywhere else, except in a civil case where somebody can pay the filing fee.

Before we issue a summons in a criminal case, the court has to determine that there is a reasonable doubt. Congress, by statute, has provided that before a complaint is served in a federal case the judge has to verify that there is a reasonable basis for it. If the I.R.S. wants to require you to

produce records, or any other administrative subpoenas, the same criteria are required. The one exception that I could find where we delegate this power, this state power to require another free citizen to come to court and answer without any quality control, whatsoever, is with regard to civil cases where somebody pays the filing fee. I don't think paying the filing fee is a rational basis to say that somebody can exercise state power.

I'm not going to spend any time arguing to you about the legal issues because you know the law. My mentor, Judge Gesell, used to argue in front of an old Judge in D.C., named Alexander Holtzoff. He told me he would always say, "Your Honor, I'm not going to argue the law to you, because, Your Honor knows the law, but let me tell you a few facts." Let me just, take that approach, and share a few facts with you. I made these constitutional arguments and I believe they are right but I also contend, in the article, that policy issues are even clearer than the constitutional ones. Your topic is actually incentives for litigation abuse and what law in economics can show us in this area.

I'm going to spend a little time not talking about the legal aspects of it, but talking about the incentives, or the behavioral economics of the incentives that it will create. There is a substantial body of law and economics about settlement. Most of it is derived from a famous article by Bill Landes and Richard Posner that was published in *The Journal of Legal Studies* in 1979, and it emphasizes the relationship between the states in litigation and the cost of litigation.<sup>7</sup> Hence, my initial story is really right on point. That was the story about the states and the cost of litigation.

Basically, this is an illustration of how the law and economics of settlement works under the, so called, "American Rule," which is where both sides pay their own costs. This has all been worked out under a variety of rules for cost allocation and the results don't change that much, but this is the simplest case so that is the one we will talk about. The key notion here, behind all of this, is that the expected value of the case for the plaintiff is not really just the expected outcome of the case, but also the expected outcome minus the cost that the plaintiff has to pay. The expected value for the defendant is not just the expected outcome of the case, but the expected outcome plus the costs.

Now, of course, there is this notion of judgment. They use the word judgment and they use the letter J to symbolize it. That was probably a misnomer. They don't really mean the legal judgment. They mean all of the consequences in the case. So, if there are reputational effects or if there are collateral philosophical effects or anything else, then that's all part of the "J." Of course, "J" is not one thing. It's the integral. It's the summation of the magnitudes and probabilities and the probability distribution.

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<sup>7</sup> *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979)

What this picture is really showing you is that the tale, the 10% chance of a \$5 million verdict can substantially skew somebody's assessment.

So, although we talk about it as a single number, it's really the summation of all of the subjective probabilities and magnitudes. Here is the same thing putting in all of the variables. The notion is that the plaintiff's subjective expected value of a case, at any given time,  $T_1$  or  $T_N$ , is the sum of the perceived probability of judgment minus the litigation costs. So all of this in yellow we are going to simplify by not writing it every time. The basic idea here is the expected value of the case is not the same as the outcome because you have to take into account the costs of getting there. And that leads to the central insight, which drives this whole body of literature. And the central insight is a case should settle in the sense of economics, if people are acting rationally, if the difference in the assessment of the outcomes is less than the joint cost of litigation.

In words, that's just to say the game isn't the candle. You can have a situation where people disagree about what's going to happen but they disagree by less than what it will take to find out who is right. And, in that situation, the cost of litigation becomes a joint asset. They become a benefit that both parties can divide by avoiding those costs but only by the consent of both parties. Here is just an example of that in numbers, rather than in words or letters, for those of us who never really liked algebra in college. So if one side thinks the case is worth \$2.2 million and the other side thinks the case is worth \$1.7 million so they're about half a million apart, but it's going to cost them \$800,000 to find out who is right it would be collectively rational for them not to try the case but to settle somewhere between the \$1.2 million and the \$1.7 million so that they can both avoid the litigation costs.

That's the basic insight. Now the application of that, for our purposes, and this is really a corollary of the general analysis, is that a frivolous case—a case which both parties know—has no probability of success on the merits, one has substantially less settlement value. That's real important so let me tell you that again.

What this is showing you is that even if both the plaintiff and defendant expect that the actual judgment value of the case is zero there still is a potential benefit of \$800,000 from settling the case and not litigating it. Now you might think, initially, that if there's a negative expected value to the case that the defendant would just litigate the case anyway, in order to discourage them from bringing future meritless cases. That would work if there were one plaintiff and one defendant. But when you're a multiple defendants there is a well known problem called the Prisoners' Dilemma, which means that multiple defendants can generally not coordinate their efforts to do what would be rational if they were single.

The reason for that is that when a defendant invests in what is called buying spite, that is litigating a case to punish the plaintiff, they only appropriate a small proportion of the future benefits of that. So, the benefits

of punishing the plaintiff in trying to defer them into bringing future cases are basically shared with all of the people who are a potential defendant. We have a situation, in which, because of the role of the litigation clause, frivolous cases—cases with a perceived probability of success of zero on both sides—nonetheless, have substantial settlement value. And that is what was called, historically, a strike suit. Interestingly enough, strike suits were a really popular topic from about the 30s to about the 60s or so, and then they basically dropped off the literature. Nobody uses the term much anymore.

But, basically, a strike suit is a non-meritorious action that's filed for the purpose of inducing a settlement because of the litigation cost they're avoiding. Interestingly enough, when the Federal Rules were proposed and were being discussed at the 1937 ABA meeting, there actually was one, Cassandra, who was an associate justice of the New York Court of Appeals, and he saw very clearly, exactly what was going to happen. He said this is an invitation for people to file strike suits. In the court papers at Yale, I found a response in the form of a speech for Attorney General Mitchell, which Clark had written. It basically dismissed the concerns by Justice Mitchell by saying that might happen in New York, where there is a well-known lack of morality among the lawyers but in the rest of the country we would never do that, and rules and procedures have to be designed for the bulk of the country, not cesspools like New York. So the problem was foreseen but not really active.

The difficulty is that Rule 4 creates what is called in economics, an arbitrage opportunity. Arbitrage is a situation where you can manufacture value by doing a transaction over and over again. You can do an arbitrage when the benefit in one arena, or one market, is greater than the risk of loss in the other market. It doesn't have to be a hundred to one. If you can buy gold coins in one country at a certain price and are guaranteed the ability to sell them at a higher price, you just do the transaction over and over again. Because the risk of having damages awarded against you is relatively small, plaintiff's lawyers can create value by filing cases that have little or no economic value and little or no chance of prevailing.

I know some of them. I won't name them for obvious reasons. I would probably get sued if I did, but I know a lawyer who has become a multi-millionaire (I'm sure Martin knew him too) by filing cases where the people are not exposed and not sick. When you say, "but the guy isn't sick and he wasn't exposed," the guy smiles. That's right, that's what these equations are showing you. It's rational for me to settle a case even if it has zero chance of prevailing, because of the litigation clause avoided.

We don't know very much as academics, maybe I should put a period right there. We, as academics, don't know very much about how much of the total cost of litigation, or how much of the settlement value is attributable to this phenomenon of litigation costs as opposed to the merits of cases. There was one study that was published in the Stanford Law Review of

employment cases that concluded that it was about \$4,000 to about \$10,000 a claim for a total meritless case. In my experience in mesothelioma and asbestos cases, that's about right.

People who aren't exposed and aren't sick typically receive settlement amounts of about \$10,000. That's not as lucrative as the cases that the asbestos lawyer from New York talked about in the previous program with \$8 million verdicts. But, actually you can make a very nice living if you file thousands and thousands of cases and settle them for about \$10,000 a head. The figures back in 2002, were that 89% of the cases in asbestos was going to the non-malignant claim.

Those are not all claims of people that have no basis to be in court at all, but it's indicative that we really need to know more than we do about how much money is actually created as a result of procedural cost as opposed to the merits. This is the hardest part. Francis Bacon, the Lord Chief Justice of England and founder of Western philosophy of science, says that when you're dealing with a complex system (with a lot of things going on in the system) and you're trying to figure out how to work, the thing to do is to take as many as the factors to zero as you can. Then you can see what the effect of the other factors is. The point here is that the same logic that I have described applies to all cases, not just frivolous cases.

Frivolous cases are a special case where you can see what's going on more clearly, because the probability of success on the merits is assumed to be zero. So, when the probability of success in the merits is defined on both sides, as everyone knows, as being zero you can still see that there is a positive value created by procedure. The point here is that this increment and settlement value also occurs in non-frivolous cases. So what it comes down to is what I call the "signal to noise ratio."

A lot of law in economics is based on the notion of internalizing externalities; internalizing costs on particular activities. We actually don't know how much of the costs we're internalizing are purely as a result of these procedural leverage factors as opposed to the merits of the law that we are talking about, Alex Demitri.

I said at a recent conference held by the federal courts in Dallas last October that 80% of the decisions that they make at GE are driven, not by the merits of the case, but by avoiding the costs of discovery. I don't know if that's true or not, but if it is, we have a serious problem that is bigger than, simply, frivolous cases. Frivolous cases are an interesting case, because it makes it easy to see what's going on. But the same thing is happening in a large number of additional cases.

My view is that judges should weed out cases that really shouldn't be brought before they serve and impose costs on defendants. We were talking at lunch. I do think that judges have the authority to do that in the federal system. It has never been decided squarely by the Supreme Court whether or not judges have the authority to summarily dismiss a case prior to service. There is, however, a D.C. Circuit decision in which, Clarence

Thomas and Ruth Bader Ginsburg were both on the panel and they agreed that judges have that power, so there is pretty good authority for summary dismissals. The difficulty is that we just don't have a regular system of review and practice for doing it.

I don't think it's really a question of judicial power, but rather a question of creating a regular process. Cases that should not be brought are not cases that will necessarily be won on the merits. We all understand when there is an argument for a change, an extension of existing law, or where the facts are uniquely within the possession of the defendant, the cases ought to be brought. My point, however, is that judges ought to decide efficient social merit that they ought to be brought. We should not delegate that decision on an unreviewable basis to plaintiffs' lawyers who have a financial interest in courting settlements, which is what we do now. So, in some ways, my system of the pre-service plausibility determination is admittedly a second best solution.

It is a use of "command control" approach and it would be better for a lot of reasons that I wrote in an article in 1986 to use a system of incentives that would be self-policing. I have given up on persuading the federal judiciary to go to a system of managing litigation behavior economics in my lifetime. I think that a good step in the right direction would be to use the judicial management process that we use in almost every other area of American Law in this area, too. So that's it. If you're interested in more about economic incentives for litigation abuse, you can read my article, but there's also another excellent little book on this by Bob Bone, who teaches at the University of Texas Law School called *The Economics of Civil Procedure*. Thank you very much. I'm glad to answer any questions. See if I persuaded everybody.

**MODERATOR:** Questions?

**AUDIENCE MEMBER:** No, I don't have any.

**AUDIENCE MEMBER:** What would be the downside? What would you see as the risk, really, what are the barriers to the market that you're suggesting? If we did that what would happen on the downside?

**E. DONALD ELLIOT:** Right. I certainly had my ears filled by people who think there are downsides to this. The most common one that I hear is we just don't have enough judges to do this. It's the process cost of doing it. I have two answers to that. First of all, that's not normally regarded as a sufficient justification: administrative costs, to impose an unconstitutional burden on other citizens. But more than that, it's not clear to me that this wouldn't reduce the demand for judicial resources. Cases filed that don't have any merit take judicial resources, too—to handle them and process them. So, you'd spend a little more money at the front end.



In an early draft of this article I described how the system works in Germany, where they do this. The judges, basically, look at the case before service and decide whether or not there's enough there. They claim that it has actually reduced the demand for judicial resources in Germany in part because plaintiffs and defendants. This is a reversible analysis. This applies to defenses as well as initial claims. Lawyers internalize the rules of the game, and if the lawyers know that the case isn't going to be served then they are less likely to adapt by filing a lot of frivolous cases. I think that, on the balance, I would actually expect there would be less demand for judicial resources rather than more. But that is the main argument I've heard against it.

**AUDIENCE MEMBER:** I think my question was along those lines. It seems like economic analysis doesn't factor in the cost to the judiciary to have to go through every complaint, but, I think, from my experience with ten years on the civil bench, I've seen very few completely frivolous claims, and usually those were filed pro-se. I'm wondering as far as attorney filings, why isn't Rule 11 good enough?

**E. DONALD ELLIOT:** Well, Rule 11 isn't good enough because you all won't invoke it. It's an interesting puzzle as to why you won't. I've been practicing law for 35 years. I got Rule 11 sanctions in one case. This was a case in which the judge gave the other side, which were top-notch plaintiffs' lawyers (very rich plaintiffs' lawyers), seven chances to amend their complaint to allege federal jurisdiction. They were never able to, so he finally dismissed it. It cost my client \$160,000 and the judge awarded \$5,000 in Rule 11 sanction. I thought it was a great victory. My clients then fired me for wasting a hundred and fifty thousand dollars of their money. I think that one of the reasons that we don't make any progress here is because we don't award Rule 11 sanctions.

And the reason is that—and this is talked about in the article too—judges tend to get infused costs and sanctions. I think that if someone is required to pay for the resources that they've consumed in a profit making endeavor, that's not punishment. Another part of what Clark said in response to Fitch, back in 1937: he said Francis Fitch proposes that we punish lawyers who bring strike suits. That's not punishment. Through their activity they've imposed costs on someone else.

The question is: should a lawyer, who is engaged in a speculative activity of consuming social resources in the hope that a case would turn up, pay for the social resources that are consumed in an effort from which they're going to profit or should they have a right to impose that cost on other parties? This is an argument that Marty Redish, a professor at Northwestern University School of Law, recently made about discovery costs. He argues that, basically, principles of unjust enrichment should apply to discovery costs because, by hypothesis, it is the plaintiff and the plaintiffs'

lawyer who are going to benefit if the case pans out. If I invest in trying to invent a new technology, I am going to get wealthy if I'm successful, but I would not expect other people to pay for the cost of my investment.

**AUDIENCE MEMBER:** Have you thought about how your proposal, or theory, I should say, would apply to those who file their complaints in *pro-pia persona*? Would you use the same standard of determination? I understand that they are less common in federal court than they probably are in state court. Would you use the same standard of evaluation, because the *pro se* individual may not have the ability to articulate with specificity the grounds for his or her suit? How would you deal with that issue?

**E. DONALD ELLIOT:** I don't believe this inquiry should be inducted entirely on the papers, entirely on the complaint. I suggest that either a checklist of key evidence or oral meeting is more appropriate at this point. It is a little bit of a case-by-case inquiry before this happens. What made me start think about this is actually the situation that you talk about. In the Connecticut state courts, somebody who files a case Pro Se has to go to the clerk of court, explain to them what the case is about, and then get the clerk to sign off on it. So, at least in some state systems, we already do this. We do this in *pro se* cases, we do it in *in forma pauperis* cases. We do it in prisoner cases. We do not do it in cases that are filed by attorneys who pay the filing fee. This is actually challenged in equal protection grounds in a case called *Neitzke v. Williams*, which went to the Supreme Court showing discrimination against poor people, subjecting their complaints to greater scrutiny than that of attorneys.<sup>8</sup> It was upheld in an opinion by Justice Marshall, who basically said that attorneys are going to be subject to Rule 11 sanctions. Poor people who are judgment proof are not going to be subject to Rule 11 sanctions.

So, my proposal is either for a pre-service plausibility determination or a reliable cost of imposing cost retroactively. I make that pretty clear in the article. It is one or the other. We do not do either one at this point. So whenever you suggest doing one of them somebody suggests that you ought to be doing the other. I really don't care. I think it would be better if we had a reliable process of imposing litigation costs retroactively. There are theoretical grounds that I think suggest that that is actually better practice, because you know more about it. I would, also point out, and this is also one of the 265 footnotes, we are only one of three countries in the world in which unsuccessful litigants typically do not pay a substantial portion of the costs that they have imposed on others.

If you wanted to make Rule 11 real and really enforce it, I think that would solve the problem. But right now, the only reason the arbitrars exist

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<sup>8</sup> 490 U.S. 319 (1989).

is because people perceive the chances that they'll ever actually have to pay costs as being incredibly low. That's why there's a benefit to filing these cases. With regard to the earlier point about not seeing many frivolous cases, I agree. That's why I tried to make the point that this phenomenon is easier to see. With regard to a frivolous case, it applies equally to all cases, cases with a 10% or 20% chance of success. It's not limited to the special case of where the value is a zero.

Basically, another way to think about it is: it is a problem in any case where the process costs are disproportionate to the stakes at issue. I think that's true, in my experience, in almost every case these days. One of the things I was thinking about is changing the examples, because in my examples the number for the value of the judgment is typically greater than the process costs; in these examples like here. I see an awful lot of cases these days where it's the opposite. I see an awful lot of cases where you have \$5 million in issue and \$1 million in litigation costs.

The same phenomenon that I'm talking about would apply in that case even though it is not a frivolous case. That was the point I was trying to make with Francis Bacon but it's a little hard to say. Okay yes sir.

**AUDIENCE MEMBER:** Doesn't trying to knock out cases to give a good start to the states get into knocking out the frivolous claims?

**E. DONALD ELLIOT:** I do think it's a good start because I think it surfaces the problem. I think it focuses on the wrong place. It ought to be pre-service, but it's certainly better to do it there than not to do it at all. Unfortunately, they don't actually knock out cases. What they do is they increase the process cost because judges in the federal system are required to grant leave to amend. Most of the appellate courts, I mean the issue that's being litigated in the court of appeals now, is whether or not you have to give people two, three, or four, chances to amend when their complaint is insufficient. It's pretty well established in the court of appeals that you automatically have to give them one, so it's actually never been shown by anyone that requirements for enhanced pleading result in anything other than enhanced pleading.

If lawyers know that you have to plead more facts I think, we may very well be increasing the costs, I think it's a well-intentioned reform, but I'm skeptical to how successful it is and in particular. I'm skeptical because I agree with the spirit of the question which was asked earlier. I don't think that complaints are a good device for weeding out cases, which shouldn't be brought. We have noticed the problem is that complaints serve four or five different functions in the system, and if we adapted a device to screen whether or not this is a case that deserves to be brought, we could adapt a device to that task, rather easily.

We do it in a lot of other areas. Talk to the people who determine whether or not a prisoner complaint has a basis for it. Talk to the people

who look at these informal complaints. They don't just rely on the language of the complaint. They engage in a dialogue to go beyond it and that's what I'm talking about here. Look, just to make it concrete in an area like asbestos cases, when the complaint names a hundred plaintiffs, and a hundred defendants, one of the questions the judge should ask is: do you have any evidence of actual exposure by these companies? That's not something that's apparent on the face of the complaint, but it's really very useful. How are you going to plan to do this? If the plaintiffs' lawyer says, "Oh I don't have any evidence of that now judge but I'm going to get discovery of all of the products that were in this company, and I'm going to dismiss everybody who doesn't show up on the vendor list," you say, "That's fine I'll let you go forward."

Right now, what happens is they name all hundred and they hold them in until the end, and they coerce settlements from a large number of them based on process costs. They never come up with any evidence for a lot of those people. It's not that the entire case is frivolous, but there is a substantial value of the case that is attributable to these negligent defendants. It's not all a strike suit; it's just a strike suit with regard to 80% of the defendant and 80% of the value.

**AUDIENCE MEMBER:** A couple of questions. One is, in our state court, a high percentage of the cases are debt collection and divorce cases, where the threshold is pretty simple. You claim that a debt is owed and unpaid or you are married and you want to get a divorce. Does that affect your analysis in those cases? The second question I have is, in Utah, we have an open court provision and in the constitution making a constitutional right about being able to have access to the courts to be able to raise your concern. So the question is, is that a factor in a public utility analysis?

**E. DONALD ELLIOT:** Yes. Regarding the first question, certainly in cases with relatively simple facts like the ones you talked about, the analysis would be different. You could still imagine somebody suing someone for divorce even though they weren't married and, I guess, in that case, I would take the view that there are a lot of domestic relations cases that illustrate this because people who are in domestic relations cases tend to be very hurt or angry.

There is a wonderful case that I talk about in here called *Dear v. Rathje*.<sup>9</sup> I liked it particularly because of the name: Deer. An ex-wife continues to sue her ex-husband, his new wife, his lawyer, and the judge who had ruled against her. She does this seven times and the Seventh Circuit says that her complaint has to be served. She eventually drives her ex-husband into bankruptcy responding to these frivolous cases, over and over

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<sup>9</sup> 485 F.2d 558 (7th Cir. 1973).

again which the Seventh Circuit holds have to be abroad. The judge is involved in litigation—so she’s picketing her ex-husbands employer. The judge issues an injunction over her picketing the employers, so she turns around and actually sues the judge. Four years later, the courts office refuses to serve the complaint, indicating you can’t sue the judge. This goes to the Seventh Circuit. The Seventh Circuit reverses. They let her sue the judge. The judge is involved in litigation for four years. It’s all in the article. I don’t think that domestic relations cases are necessarily immune from this process. It’s just the motivations are different. It’s not about money. It’s about using the process of the court to punish people. I think that’s an illegitimate process as well. What was the other question? Oh yes, open courts.

Open courts provisions say you have a right to bring your case to the court. They don’t say how far into the process you’re allowed to go. I don’t think that a pre-service plausibility determination would violate an open courts provision any more that dismissing violates an open courts provision. It doesn’t say you’re entitled to go to trial. It doesn’t say you’re entitled to discovery. It’s a question of, when you bring something to the court, how far into the process are they going to allow you to go before they say you’re done? You haven’t met the hurdle that you need to get to the next step. Okay one in the back maybe. Let’s do two more because we have two people.

**AUDIENCE MEMBER:** Of these costs that you’re putting into the equation, what percentage of them are discovery costs, and why are you not making a more tailored strike at discoveries, specifically, if that’s the majority of the costs?

**E. DONALD ELLIOT:** The simple answer to your question is that it’s a different article. It’s about 80 to 90% of the costs, depending on the case, and really is what’s driving the problem. We could probably deal with the other costs if we didn’t have the discovery clause. That’s what has really made it a big problem. I have spoken, and written, and testified, in favor of the system and I think that, I was down at this discovery conference in Dallas, advocating that to the Federal Rules Committee. It has been suggested in a number of articles. Bob Cooter, an economist at Berkley, wrote a famous article in 1994 that talks about using economic incentives to manage discovery.<sup>10</sup> I think where we are going to eventually get on that is that plaintiffs are going to get a certain limited amount of discovery for free and then beyond that they are going to have to get leave of court to get discovery. The judge may condition some of the additional discovery beyond the initial amount on payment.

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<sup>10</sup> Robert D. Cooter & Daniel L. Rubinfeld, *An Economic Model of Legal Discovery*, 23 J. LEGAL STUD. 435 (1994).

That is something that some of the federal judges, including Judge Grimm, who's currently a magistrate judge, is going to become a district judge, his chair of the discovery advisory committee. He's currently already experimenting with that system in his courtroom, so I do think that there's a way to use economic incentives to reduce the cost of discovery. I wrote an article advocating that in 1986.<sup>11</sup> I got tired of waiting for people to notice. Okay last question in the back.

**AUDIENCE MEMBER:** Other than through the rule committee to re-write the rule, how would you envision a defendant who has been served and answers the lawsuit, preserving those for constitutional complaints?

**E. DONALD ELLIOT:** Oh, I'm so glad you asked that. I actually do talk about that and I've tried to convince some of the general counsels of companies to do it. What you do is file a special appearance and say: "I have not been properly served." The 1792 Process Act that requires summons to have been signed off by the judge has never been repealed.

Yes, I know that the Rules Committee in 1937 said that it had been "superseded" and therefore it's no longer in the U.S. Code, but in fact, title 28 of the U.S. Code has never been enacted as positive law. So it's still in statutes at large and if the action by the rules committee to supersede it in 1938 was invalid, either because it was unconstitutional or because it was ineffective, because it didn't go through the process of actually repealing the statute.

That's the issue that Judge Garza noted that the only way to change a statute is by passage by two houses and the possibility of presidential veto. I think it's highly questionable whether the 1938 rule was effective to get rid of 1792 Process Act. That's the place I'd start, and it's all in the article.

**MODERATOR:** Thank you. This concludes our program. Farewell.

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<sup>11</sup> E. Donald Elliott, *Managerial Judging and the Evolution of Procedure*, 53 U. CHI. L. REV. 306 (1986).



