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CONSUMER HARM ACTS?
AN ECONOMIC ANALYSIS OF PRIVATE ACTIONS UNDER STATE CONSUMER PROTECTION ACTS

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Abstract

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

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CONSUMER HARM ACTS?
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Henry N. Butler* and Jason S. Johnston**

I. INTRODUCTION

State consumer protection acts (CPAs) were adopted in the 1960s and 1970s to protect consumers from unfair and deceptive practices that would not be redressed but for the existence of the acts.¹ In this sense, CPAs were designed to fill existing gaps in market, common law, and regulatory protections of consumers.² Of particular concern was the lack of incentive for individual consumers to pursue small claims that were uneconomical because of the costs of litigation under the common law. To create an incentive for private enforcement as a tool of consumer protection, state CPAs deliberately opened the courthouse doors: as a general rule, state CPAs provide for attorneys fees, authorize or at least allow class actions, grant expansive remedies (often including statutory minimum damages, treble damages, and punitive damages), adopt a very broad and open-ended substantive prohibition of “false, unfair and deceptive” selling practices, and – in some states – even dispense with the requirement that a plaintiff plead and prove that she was injured by

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² But see Michael S. Greve, Consumer Law, Class Actions, and the Common Law, 7 Chapman L. Rev. 155, 156 (“While unknown before the 1970s, modern ‘consumer law’ does not govern a single transaction that is not also covered by traditional common law doctrines. However, where tort law required an actual injury as an essential element of a cause of action; consumer law dispenses with that requirement and others like it, such as inducement and detrimental reliance. Where the common law matched the seller’s duty to steer clear of fraud and misrepresentation with the contractual principle of ‘buyer beware,’ consumer law substitutes a unilateral duty of disclosure on the seller.”).
such practices.

Given the promise of expansive awards made under a relaxed liability standard offered by state CPAs, it is hardly shocking that private actions under state CPAs have become one of the great growth areas of American litigation. Over the period 2000-2007, all reported decisions involving a state CPA claim in state appellate courts increased by over 43%, while those decided in federal courts almost tripled. According to leaders of the tort reform movement, this massive upsurge in state CPA litigation does not reflect some new wave of false and deceptive consumer marketing practices, but rather a tide of at best highly doubtful claims brought by private class action attorneys seeking a big payday, a tide of litigation that is symptomatic of the broader litigation crisis. One such case has indeed achieved worldwide notoriety: the $54 million action under the District of Columbia CPA brought in 2006 by a (then) administrative law judge against a dry cleaner for losing a pair of pants.

To some commentators, the upsurge in CPA litigation is not only of little concern, but is actually a sign that state CPA laws are succeeding in their stated goal of protecting consumers. One leading consumer advocate, for example, has described CPAs as “popular,” and even suggested that the reasoning and interpretation of state CPAs should be applied more broadly to expand the common law’s understanding of fraud. On the other extreme, a leading law and economics scholar has questioned the need for any form of CPA liability, arguing that consumers do not need the kind of specific information about products that consumer advocates demand that sellers to disclose, and that market forces such as a seller’s desire to acquire and maintain a reputation for honesty and quality sufficiently discipline and drive out false and

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3 Searle Civil Justice Institute, State Consumer Protection Act Pilot Study 17 (draft of March 10, 2009). As this study notes, id at n. 47, the increase in federal court state CPA actions accelerated in 2005, when the Class Action Fairness Act pushed many class actions into federal court.


7 Braucher, supra note 3, 48 Ariz. L. Rev. at 830.
deceptive selling practices.8

In this Article, we develop and support an intermediate position, taken by some leading tort reform advocates, that state CPAs can serve a very useful and indeed economically justified role in supplementing the protection offered to consumers by the market, the common law, and federal consumer protection regulation, but only if those statutes are reformed and sensibly interpreted by the courts.9 We apply the tools of economic analysis to identify where state CPA law, as currently interpreted by the courts, has probably gone wrong from the point of view of optimally deterring socially undesirable deceptive selling practices, and we recommend changes in both statutory structure and judicial interpretation that will make state CPAs an instrument of market efficiency, rather than a source of inefficient and socially harmful litigation.

Part II provides an overview of state CPAs in which we identify the two economically crucial features of the current CPA landscape: statutory provisions that have created a process that offers enormous potential rewards even to very dubious lawsuits that are brought often simply to secure a settlement; and a vague substantive standard of liability that has been interpreted so expansively by the courts that even the most seemingly straightforward and informative marketing practices and communications can trigger potential CPA liability. Part II also develops an economic framework in which we analyze the impact of these two crucial features of state CPA law on seller behavior. As we argue, state CPA law as currently configured is likely to significantly over-deter the targeted practices. The CPA liability regime likely often attaches liability even to socially desirable selling practices, and thereby creates an incentive for sellers to withhold socially valuable information from consumers. But as sellers may incur liability under state CPAs

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both by saying too much and saying too little, the most certain economic impact of overly expansive state CPA liability may be to effectively impose an excise tax on every sale of a consumer good or service, thus increasing prices and lessening consumer welfare, all with no benefit in terms of deterring socially undesirable seller behavior.

In Part III, we situate state CPA liability within the broader landscape of institutions for consumer protection. These institutions include the market, the common law, and federal consumer protection regulation by the Federal Trade Commission. We analyze how the market, as supplemented by the common law of fraud and warranties, does indeed provide significant checks against deceptive consumer selling practices and advertising.10 However, we note two serious shortcomings – from the point of view of optimal deterrence – in the market/common law regime: imperfect determination of liability, and costs of liability determination that are disproportionate to the loss suffered by an individual consumer. These shortcomings of the market/common law regime provide an economic justification for regulation (either federal or state) that balances the benefits and costs of such intervention. However, as we explain, as currently implemented, state CPA liability is likely to actually weaken the incentives against consumer deception provided by the market and common law.

The Federal Trade Commission now enforces the FTC Act’s prohibition of “false, unfair and deceptive” practices under guidelines for deceptive and unfair practices which seek to balance the costs and benefits of regulation.11 The FTC’s consumer protection mission is guided by a consumer welfare standard.12 However, enforcement of state CPAs through private litigation rarely reflects the economic

12 Despite early jurisprudential and academic uncertainty as to the intended purpose of the federal antitrust laws, the Supreme Court has adopted the majority position that consumer welfare is the central policy underlying the Sherman, Clayton and FTC Acts. See Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979); Robert H. Bork, The Antitrust Paradox 51 (2d ed. 1993), and Charles J. Goetz & Fred S. McChesney, Antitrust Law: Interpretation and Implementation 51-52 (3rd ed. 2006).
sophistication of the FTC in implementing the consumer welfare standard. For this reason, we conclude that whatever may be the shortcomings of consumer protection regulatory enforcement by the FTC, state CPAs as currently structured and interpreted have encouraged private actions that go far beyond what is necessary to optimally supplement the FTC enforcement regime.

Part IV sets out the implications of our analysis for the reform of state CPAs and their interpretation by the courts. First, courts and legislatures should recognize that many provisions of CPAs are redundant. Many CPA provisions are designed to make it easier and more economical for individual consumers to recover for losses, yet many of these provisions are not necessary to give plaintiffs adequate incentives with consumer class actions. Thus, courts and legislatures should recognize the fundamental differences between the two types of actions. Second, just as a common law plaintiff must show reliance, causation and harm, so too should consumer protection class action plaintiffs be required to plead and prove these basic elements. Third, private class actions should be required, as a threshold matter, to satisfy a consumer welfare standard akin to that under which the FTC operates in enforcing the FTC Act. In applying a consumer welfare standard to CPAs, state courts could rely on FTC interpretations for guidance. Finally, consumer welfare would be enhanced if legislatures amended their CPAs to limit the scope of private actions to those that satisfy a consumer welfare standard.

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

CPAs have recently received harsh criticism by business groups and tort reform advocates. The core of this critique is that the broad language of state CPA statutes and liberal judicial interpretations have led to massive amounts of litigation, disproportionately large damage awards and settlements for unharmed plaintiffs, and overcompensation for plaintiff’s attorneys. Later in the paper, we provide an economic foundation for this critique. But to do so, we must first set out the salient

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structural features of state CPAs. The first set of features are statutory provisions that have the general effect of opening the courthouse doors to private CPA lawsuits. These might be called procedural. The second vital aspect of CPA litigation is substantive, and has to do with the way that courts have interpreted the generally vague statutory CPA prohibition of “false and deceptive” practices so as to allow even the most seemingly straightforwardly informative marketing communications to trigger potential CPA liability.

A. **Historical Background and Purpose of State Consumer Protection Acts**

Every state in the nation has some kind of state consumer protection statute, and many have more than one statutory framework for consumer protection. About thirty states have in place legislation that tracks the Uniform Deceptive Trade Practices Act or Uniform Consumer Sales Practice Acts. These laws typically have rather long and detailed lists of prohibited practices (such as advertising goods with the intent not to sell them as advertised). Nine states have “consumer fraud” statutes that make unlawful broad categories of acts including “fraud,” “deception” and “false promise” in the “sale or advertisement” of goods when done with an “intent that others rely” upon the act. Finally, encouraged by the Federal Trade Commission, and in tune with the explosive growth of federal regulation during the 1970s, “Little FTC Acts” – which typically contain identical language to the FTC Act forbidding “unfair competition and deceptive acts and practices” – were adopted in every state by 1981. These statutes are typically very short, broadly prohibiting conduct that is “false or deceptive” and granting private parties very broad standing to sue. Importantly, these statutes often overlap. California, for example, has both an Unfair Competition

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14 Alan S. Brown and Larry E. Hepler, Comparison of Consumer Fraud Statutes Across the Fifty States, 55 FDCC Quarterly 263, 266 (2005).
15 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 266-267.
16 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 268.
18 Id.
19 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 269. California Business and Professions Code Section 17200, for example, prohibits “any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising.”
Law\textsuperscript{20} modeled after the FTC Act and an Unfair Practices Act\textsuperscript{21} that tracks the Uniform Deceptive Trade Practices Act. There is a long list of public interest reasons\textsuperscript{22} for the adoption of CPAs,\textsuperscript{23} including:

1. The costs for individual consumers to litigate these matters in state courts were often prohibitive;
2. Difficulty for consumers to prevail in state common law actions for fraud, misrepresentation and warranty, as discussed above;
3. Disparity in bargaining power between consumer and businesses;
4. Neither the federal government nor the states could enforce all actions, so private attorneys general – empowered by the ability to recover costs, attorney fees and multiple damages – were necessary to supplement the public enforcement actions; and
5. Private enforcement actions may be necessary to carry out the legislative intent when pro-business (or anti-consumer) interest groups control the executive branch.\textsuperscript{24}

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

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

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

\begin{footnotesize}
\begin{enumerate}
\item Cal. Civ. Code §17200 et. seq.
\item Cal. Civ. Code §1770 et. seq.
\item The enactment of CPAs is often described in terms of a logical gap filling made necessary by the inability of the common law to deal with problems of a mass marketed national economy. Such public interest rhetoric should be met with skepticism. Perhaps the intent of CPAs should be inferred from their effect. Attorneys who file actions on behalf of consumers are vocal opponents of reform efforts. However, the fact that they expect to be losers if CPAs are reformed does not demonstrate that they were the intended winners when the acts were passed. Regardless, even if the CPAs had a more benign intent, it is clear that they have created interest groups in their wake.
\item This argument is similar to the argument used for private actions under state and federal environment statutes.
\end{enumerate}
\end{footnotesize}
1. Broad Private Standing to Sue with No Injury or Causation Requirement

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

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

Although a seeming countervailing force to the “no injury” cases can be found in the expansion of the economic loss rule to state CPAs, there has not been strong advocacy of application of the doctrine. For example, Professor Braucher identifies the case of Werwinski v. Ford Motor Co. where the Third Circuit applied the economic loss rule to

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25 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 270, Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __. Only Iowa relies exclusively on its attorney general to enforce the state’s consumer protection laws. See Molo Oil Co. v. River City Ford Truck Sales, Inc., 578 N.W.2d. 222, 227-28 (Iowa 1998).
26 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 272, Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __.
27 Schwartz & Silverman, supra note 4, at 22.
29 Id. at 486.
Pennsylvania’s CPA, yet subsequent Pennsylvania state and district courts refuse to follow the holding. The disparate outcomes in Pennsylvania are indicative of the courts’ ability to expand the economic loss doctrine or not in this unsettled part of the law.

Hence under many state CPA statutes, a private party can bring suit in a purely private attorney general role, alleging only that certain practices were likely to harm the general consuming public, without any requirement of proving actual injury or causation. people who may have been harmed. This private enforcement is a substitute for administrative enforcement, and it is often suggested that private enforcement is relied upon because states do not adequately fund consumer protection agencies. This assertion begs the question of why state legislatures do not provide adequate funding. Regardless, private actions under CPAs often do not require a public interest impact as is required of the FTC under the FTC Act.

2. Potentially Expansive Remedies

The remedy available to a successful CPA plaintiff varies greatly, not only across the states but also across different types of state CPA. Under California’s Unfair Competition Law, and the Uniform Deceptive Trade Practices Act of several other states, only equitable relief is available. Equitable relief, however, includes not only injunctions but also restitutionary, restorative money awards, and, at least in California, restitution is “not limited to the return of money or property that was once in the possession of the person,” but is “broad enough to allow a

33 See, Jeff Sovern, Private Actions Under the Deceptive Trade Practices Acts: Reconsidering the FTC Act as Rule Model, 52 OHIO ST. L. J. 437, 448 (1991) (“State and local consumer agencies lack sufficient resources to pursue every consumer fraud vigorously, and so, like the FTC, face strong incentives to confine their activities to cases likely to have a broad impact. To plug the holes in consumer fraud enforcement, nearly every state has now extended to injured consumers the power to sue merchants who engage in deceptive practices.”).
35 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 277, Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note ___ at __.
plaintiff to recover money or property in which he or she has a vested interest.” 36

In a few other states, a CPA plaintiff’s remedies are limited to the recovery of actual damages. 37 Much more commonly, however, state CPAs give the option of choosing the greater of actual or statutory damages. Generally, these statutory damages are in the range of $100 to $500, but in New Hampshire they are $1000 and in Kansas $5000, while for flagrant or repeated violations in Idaho, the plaintiff’s statutory damages are $1000 plus punitive damages. 38

In addition to statutory damages, state CPAs that allow plaintiffs to recover actual damages also typically authorize the recovery of treble damages. 39 About two-thirds of state laws provide for treble damages to punish a defendant for wrongful conduct. 40 Several states double or treble damages regardless of the egregiousness of the defendant’s conduct 41 and in another nine states treble damages are available if the defendant acted intentionally, willfully, knowingly, or in bad faith. 42 In New Jersey and Ohio, and under California’s Deceptive Practices Act, treble damages are actually mandatory. 43 And in Colorado, the District of Columbia and Hawaii, the plaintiff can choose the greater of treble damages or statutory damages. 44

36 Juarez v. Arcadia Fin., Ltd., 61 Cal.Rptr.3d 382, 400 (2007). See also Lozano v. AT&T Wireless Services Inc., 504 F.3d 718, __ (9th Cir. 2007)

37 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 278, Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __.

38 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 278-279 Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __.

39 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 280-281 Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __.

40 See generally, Schwartz, supra, note 2.


43 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 280, Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __.

44 Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note __ at 281, Schwartz and Silverman, Common Sense Construction of Consumer Protection Acts, supra note __ at __.
Consistently with treble damage provisions, most states have CPAs that at least permit punitive damages.\textsuperscript{45} Many state CPAs require that in order to recover punitive damages, the plaintiff must show a heightened level of fault, such as a showing of malicious or aggravated fraud.\textsuperscript{46} Still other state CPAs cap punitive damages.\textsuperscript{47}

3. Class Actions and Attorney’s Fees

While some state CPAs explicitly prohibit class actions, the laws of at least fourteen states and those of the District Columbia expressly permit class actions.\textsuperscript{48} State CPAs modeled after the FTC Act are silent on the availability of class actions, but courts have commonly found that class action relief is available under such statutes.\textsuperscript{49}

As for attorneys’ fees, state CPAs are a dramatic exception to the default “American” rule, under which each party bears their own attorney’s fees. Nearly half the state CPAs require an award of reasonable attorney’s fees to the prevailing plaintiff, and there are indeed only a few states that follow the “American” rule in CPA cases.\textsuperscript{50}

C. The Economic Consequences of the State CPA Process

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

\textsuperscript{45} Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note ___ at 279, Schwartz and Silverman, \textit{Common Sense Construction of Consumer Protection Acts}, supra note ___ at ___.
\textsuperscript{46} Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note ___ at 279, Schwartz and Silverman, \textit{Common Sense Construction of Consumer Protection Acts}, supra note ___ at ___.
\textsuperscript{47} Brown & Hepler, Comparison of Consumer Fraud Statutes, supra note ___ at 279, Schwartz and Silverman, \textit{Common Sense Construction of Consumer Protection Acts}, supra note ___ at ___.
\textsuperscript{48} Albeit sometimes with specific limitations on the form of relief that may be obtained. See Schwartz and Silverman, \textit{Common Sense Construction of Consumer Protection Acts}, supra note ___ at 29.
relative to some other sort of case. The fundamental economics of private litigation predicts that the key state CPA procedural features we have highlighted above will have systematically distorted private incentives so that CPA lawsuits will be brought that have very little to do with deterring socially harmful deceptive consumer practices.

Consider first the impact of eliminating or lessening the requirement that the plaintiff must show injury, reliance and causation – that she saw or heard the defendant’s communication, and relied upon it in deciding to buy the defendant’s product. Observe that this means that the plaintiff need not stand in any particular relationship to the product or the alleged false or deceptive practice: all she needs to allege is that some consumers were likely to be misled by the false or deceptive practice, not that she even saw or heard it.\(^\text{51}\) This is a major change in the law, and a step that the FTC has been unwilling to take.\(^\text{52}\) At least under those state CPAs where class actions are permitted, eliminating the requirements of injury and reliance (causation), essentially makes actionable almost any seller communication if that communication is sent to a large enough number of consumers. This is because state CPAs almost uniformly authorize attorney’s fees. With the prospect of

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\(^{51}\) Unsurprisingly, as the plaintiff need not stand in any particular relationship to a state CPA defendant, many state courts have held that traditional common law defenses are not available, including: the statute of frauds, see, e.g., McClure v. Duggan, 674 F. Supp. 211, 224 (N.D. Tex. 1987) (statute of frauds not applicable under Texas deceptive trade practices act); warranty disclaimers, see, e.g., Ataway v. Tom's Auto Sales, Inc., 144 Ga. App. 813, 242 S.E.2d 740 (1978); the doctrine of substantial performance, see, e.g., Smith v. Baldwin, 611 S.W.2d 611, 614 (Tex. 1980) (“A primary purpose of the enactment of the DTPA was to provide consumers a cause of action for deceptive trade practices without the burden of proof and numerous defenses encountered in a common law fraud or breach of warranty suit.” at 616); the parol evidence rule, see, e.g., Teague Motor Co. v. Rowton, 84 Or. App. 72, 733 P.2d 93 (1987) (parol evidence may be used in Oregon consumer protection cases), Weitzel v. Barnes, 691 S.W.2d 598, 600 (Tex. 1985) (parol evidence may be used in Texas consumer protection cases), Capp Homes v. Duarto, 617 F.2d 900, 902 n.1 (1st Cir. 1980) (parol evidence may be used in Massachusetts consumer protection cases); the common law merger doctrine, see generally Note, DTPA Precludes Use of Merger Doctrine and Parol Evidence Rule in Breach of Warranty Suit: Alvarado v. Bolton, 41 BAYLOR L. REV. 373 (1989); contractual limitations on liability or remedies, see, e.g., International Nickel Co. v. Trammel Crow Distrib., 803 F.2d 150, 155-56 (5th Cir. 1986) (contractual limitations inapplicable in suit under Texas “Little FTC Act”), Corral v. Rolling Protective Service. Co., 240 Kan. 678, 732 P.2d 1260 (1987) (same under Kansas law), and Reliance Universal, Inc. v. Sparks Indus., 688 S.W.2d 890 (Tex. Ct. App. 1985) (same under Texas law); and privity of contract requirements, see generally Note, The DTPA and Privity: Let the Buyer Beware Becomes Let the Buyer Recover, 39 BAYLOR L. REV. 787 (1987).

\(^{52}\) As discussed above, the FTC requires reasonable reliance in its definitions of both unfair and deceptive practices.
recovering attorney’s fees for succeeding merely in showing that some consumers might well have been misled by a challenged practice, the typical incentive of a class attorney to select cases based at least in part on the amount of harm suffered by the individual plaintiffs is significantly weakened. Instead, regardless of whether any consumer actually suffered harm due to a practice challenged as false or deceptive, plaintiffs’ attorneys will have an incentive to roll the dice and bring class actions simply on the chance that they might succeed in showing that some consumers were misled by a particular practice and then be entitled to attorney’s fees.

This problem is far from theoretical. California’s Unfair Competition Law provides only equitable remedies and does not permit the recovery of damages. However, that same law authorizes attorneys fees and equitable relief, and prior to the passage of reform legislation in 2004,53 did not require plaintiffs to show that they had suffered injury. By the time of the 2004 legislative reform, California’s Unfair Competition Law had acquired national notoriety as breeding litigation that the State Attorney General himself eventually called “extortionate.”54 In a mounting cascade of litigation, plaintiffs’ attorneys had sued defendants large and small, bringing class action suits based on allegedly deceptive practices that seemingly harmed no one: against software makers for putting software in boxes that were “too big,” allegedly tending to deceive consumers into thinking that there were more than just one or two disks;55 against auto shops for years-old technical regulatory violations – such as failure to give a customer a copy of an estimate – that had not resulted in fines but which were still recorded on the Bureau of Automotive Repair’s website;56 against nail salons for allegedly deceptively using the same bottle of nail polish on multiple customers, a practice regarded by the State Board of Barbering

54 See Jonathan D. Glater, California Says State Law Was used as Extortion Tool, New York Times, April 5, 2003, People of the State of California v. Trevor Law Group, LLP (Complaint for Injunction, Restitution and Other Equitable Relief, filed __, available at __).
55 Civil Justice Association of California, Examples of Unfair Competition Lawsuits Filed by Private Attorneys, available at www.cjac.org/newsandresearch/prop64/.
56 John H. Sullivan, California’s Notorious “17200” – Written by Lewis Carroll, Adapted by Stephen King? (October 24, 2002), available at [CJAS]. See also Glater, California Says State Law Was used as Extortion Tool, supra note __.
and Cosmetology as standard in the industry; against grocery stores for putting tags with both the actual and suggested retail price on cosmetics, watches and wallets. According to the California Attorney General, many such lawsuits reflected a pattern in which plaintiffs’ firms would file complaints and simultaneously send letters demanding settlements from the targeted defendants.

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

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

58 From Civil Justice Association of California, Examples of Unfair Competition Lawsuits Filed by Private Attorneys, available at www.cjac.org/newsandresearch/prop64/.
59 After Proposition 64, Bus. & Prof. Code §17204 now provides that “[a]ctions for any relief pursuant to this chapter shall be prosecuted…by any person who has suffered injury in fact and has lost money or property as a result of such unfair competition.” The corresponding provision of the False Advertising Law, Bus. & Prof. Code §17535, was amended to require that “[a]ctions for injunction under this section may be prosecuted by…any person who has suffered injury in fact and has lost money or property as a result of this chapter. Any person may pursue representative claims or relief on behalf of others only if the claimant meets the standing requirements of this section and complies with section 382 of the Code of Civil Procedure.”
actions will be relatively attractive to plaintiffs’ attorneys. As we also show, the incentive for suit would be even greater in a regime that granted compensatory relief and punitive or treble damages.

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

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

As we discuss in more detail below, this problem – inadequate private incentives for suit – is a real one, and it can indeed lead to underdeterrence of marketing practices that are truly fraudulent and deceptive (in that they fool consumers into buying things that they would not buy if they knew their true quality and characteristics). Ironically, however, during almost precisely the same time period when states were passing their little FTC Acts – 1967 to 1972 – states were also following the standard set by Federal Rule of Civil Procedure 23 by promulgating rules authorizing class actions in state court. The class action procedural device allows the aggregation of precisely the kind of small consumer claims that would otherwise not be economically viable. Provided that successful plaintiffs’ attorneys can receive either court awarded attorneys fees or a share of the total award recovered on behalf of the class as a whole, by aggregating the small damages suffered by many plaintiffs into a single recovery fund, the class action itself provides very strong incentives for plaintiffs’ attorneys to bring

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consumer protection suits. That is, to make consumer protection suits viable and ensure adequate deterrence, there is no need for the statutory or enhanced – trebled or more general punitive – damages that are found in a large number of state CPAs.

Under CPAs as currently structured, plaintiffs’ attorneys stand to reap large expected payouts by pursuing even those CPA suits that have a very low probability of success. Given the oftentimes very broad interpretation of “harm” under state CPAs, even a formal requirement that the plaintiff plead and prove that she was harmed by the defendant’s conduct does not guarantee that plaintiff actually was made worse off by virtue of the defendant’s allegedly false or deceptive practice. And, of course, a plaintiffs’ attorney has no obligation whatsoever to ensure that the CPA cases she pursues are in the public interest in any sense. Indeed, studies of private class actions have made it unmistakably clear that class actions achieve deterrence that would otherwise be lost, but at a cost – potentially collusive settlements between class attorneys and defendants that transfer large sums to class attorneys (but relatively little to actual class members) while letting defendants get off the hook with total liability that is small relative to the harm they have caused.63

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

[A] principal concern regarding the operation of class actions is that the certification of a class itself, often based upon satisfaction of relatively undemanding procedural requirements, will bludgeon a defendant into a massive settlement. . . . Commentators unanimously concede that virtually every mass tort class action that have been successfully certified has settled out of court rather than been litigated to judgment. . . . We have recently observed

63 See Deborah R. Hensler, e al, Class Action Dilemmas: Pursuing Public Goals for Private Gain 79-99 (2000) (discussing evidence for, and varieties of such collusive settlements). Theodore Eisenberg & Geoffrey Miller, Attorney-Fees in Class Action Settlements: An Empirical Study, 1 J. EMPIRICAL LEGAL STUD. 27 (2004) reviewed class action awards from 1993 to 2002 and found that the average award was $139 million and that the average award in the top ten percent of awards was $1.08 billion. There are several reasons to believe that the Eisenberg-Miller numbers underestimate the true magnitude of class action judgments and settlements. See GEORGE L. PRIEST, WHAT WE KNOW, AND DON’T KNOW ABOUT MODERN CLASS ACTIONS: A REVIEW OF THE EISENBURG-MILLER STUDY, MANHATTAN INSTITUTE CIVIL JUSTICE REPORT 9 (2005).
settlements in class actions at enormous sums of money
where there appears to be no substantive basis for defendant
liability.64

In this unfortunate strategic game – what we call the settlement holdup
game – defendants settle even cases that they would probably win on the
merits. The game is played, successfully, against both large and small
companies. Small companies often settle when they believe they have a
good chance of winning at trial because they cannot risk the potential
loss of their business and everything they own; large firms because
settlements remove the specter of potential liability that depresses market
value.65

As noted earlier and explained in more detail below, the FTC Act
requires the Commission to consider the public interest (which is now
manifest in the consumer welfare standard) in deciding whether to
challenge a practice as false or deceptive. By contrast, only a few states
attempt to discipline the incentives of private attorneys by including a
public interest requirement for private CPA actions.66 However opaque

decisionmakers are confronted with the implacable arithmetic of the class action: even a
meritless case with only a 5% chance of success at trial must be settled if the complaint
claims hundreds of millions of dollars in damages.” Citing testimony of John L.
McGoldrick, Esq., Senior Vice President and General Counsel, Bristol-Myers Squibb
Company, Hearing before the Subcomm. on Courts and Intellectual Property of the
House Comm. on the Judiciary, "Mass Torts and Class Action Lawsuits" (March 9,
1998).) [add Merck/Vioxx settlement example and refer back to small business UCL
cases].
66 See Hall v. Walter, 969 P.2d 234 (the practice challenged by an individual under
Colo. Rev. State. § 6-1-113 (1998) must significantly impact the public as actual or
potential consumers); Zeeman v. Black, 156 Ga. App. 82, 84, 273 S.E.2d 910, 915
(1980) (stating that unless the defendant’s actions had or has potential harm for the
consumer public they are not directly regulated by the FBPA, O.C.G.A. § 10-1-3-0 et.
seq.); Ly v. Nystrom, 615 N.W.2d 314 (Minn. 2000) (public interest must be
demonstrated to state a claim under the private A.G. statute – relating to the CFA,
Minn. Stat. § 325F.68 et. seq.); Nelson v. Lusterstone Surfacing Co., 258 Neb. 678, 605
N.W.2d 136 (2000) (to be actionable under the CPA the unfair/deception act must have
§ 39-5-20, unfair or deceptive practices must adversely affect the public interest);
Hangman Ridge Training Stables, Inc. v. Safeco Title Ins. Co., 105 Wn.2d 778, 719
P.2d 531 (1986) (private litigant must establish a public interest impact to establish a
prima facie case under the CPA, Rev. Code Wash. § 19.86.010 et. seq.).
may be the mix of professional and political concerns that motivate FTC Commissioners, private attorneys who enforce state CPAs are simply not bound by the same practical and legislative constraints that apply to FTC regulators. The great divergence in incentives in filing suit between private and public law enforcers is strikingly illustrated by California’s experience with the allegedly extortionate practice engaged in by some notorious class action firms of suing hundreds or even thousands of small businesses for technical regulatory violations (e.g. auto shops sometimes forgetting to give customers copies of their estimates, nail salons using the same nail polish bottle more than once). As the regulatory net has become increasingly dense and overwhelming for business, there are more and more technical regulatory violations that typically lead to little or no harm. Presumably one reason why the legislatures of California, and other states, have vested direct regulatory enforcement authority in public agencies is because those legislatures trust the agencies to use their discretion in the public interest, refraining from enforcing against violations that cause de minimus harm and truly are technical in nature. Private class action attorneys are not guided by the same principles of discretion, and indeed are incentivized by the restitutionary remedial schemes and the prospect of recovering attorneys fees offered by state CPAs to bring CPA actions that are grounded in precisely the sort of technical regulatory violations that public regulators would overlook. Such private actions carry with them a very real likelihood of inefficient over-enforcement: enforcement that is not justified by the value of deterring the practices that are targeted for enforcement, because those practices cause little or no harm.

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

Although it is conceivable that the private interests of CPA class action litigants will further the public interest as if guided by an

67 See, e.g., Sovern, supra, note 20, at 452.
68 As aptly put by Stephen B. Burbank, Aggregation on the Couch: The Strategic Uses of Ambiguity and Hypocrisy, 106 Colum. L. Rev. 1924, 1930 (2006), “[a]lthough the concept of inefficient overenforcement is a tool of economic analysis of law, when applied to a particular statute, it surely must start with the level of enforcement sought by the legislature, which may be inferable from the legislature’s attention or inattention to the background or ancillary rules and institutions that determine the real value of legal rights.”
“invisible hand,” achievement of such a public interest goal obviously hinges in large part ultimately on what kinds of practices can trigger liability under a state CPA. Assuming – as we do throughout this part – that some form of CPA liability is necessary to supplement common law and market forces that discipline deceptive and misleading practices in marketing consumer goods, it remains important that the CPA liability process effectively focuses liability on truly misleading and deceptive practices. From the point of view of optimally deterring false and misleading consumer marketing practices, problems arise both from an under-inclusive CPA liability regime – one that attaches liability to too few such practices – and one that is over-inclusive – threatening CPA liability even for marketing and advertising which is on balance informative and socially desirable (or at least innocuous).

As currently interpreted by the courts, the problem of over-inclusive CPA liability is we believe very real, with potentially seriously deleterious consequences not only for companies that make and market consumer products and services but for consumers themselves. In the FTC Act and “little FTC” acts, both Congress and the state legislatures left the definitions of “unfair” and “deceptive” vague, but they chose different paths to determining the meaning of the terms. Congress empowered the FTC to use its expertise to determine the meaning of unfair and deceptive,\(^69\) while most state legislatures have chosen to not have effective administrative agencies to develop expertise in the definition and enforcement of illegal acts. Instead, state legislatures have relied on judicial interpretation through private litigation to define the terms. The FTC has by regulation adopted a method of determining whether a practice is “false, unfair and deceptive” that takes account of the costs and benefits of regulatory relief and quite openly seeks to maximize consumer welfare.\(^70\) State courts are highly unlikely to exhibit the same degree of expertise in interpreting statutory language as a specialized federal agency.\(^71\) Yet, many states seem to have ignored this crucial difference and did not provide the courts – and, perhaps more importantly, businesses – with needed guidance as to what constitutes an


\(^{70}\) See discussion infra notes __ to __.

\(^{71}\) See, e.g. Muris, supra note , at 16 (“[A]dministrative agencies, like the FTC, have developed areas of expertise, such as interpreting implied claims in advertising, that provide an advantage over courts when ruling on consumer matters involving certain complex issues.”).
unfair or deceptive practice. The result of this drafting is a freewheeling set of interpretations that are difficult to reconcile with consumer welfare. In section, we provide examples of some such interpretations, and then explain in more detail the adverse economic consequences from these interpretations.

1. The Expansive Interpretation of “Unfair and Deceptive” under State CPA’s

The types of lawsuits filed under state CPAs are the stuff of newspaper headlines and nightly news stories: former administrative law judge Roy Pearson Jr.’s $54 million suit – brought under the District of Columbia CPA – against a family-owned dry cleaning store for losing his pants, thereby causing its “Satisfaction Guaranteed” sign to constitute a false and deceptive practice, 72 a suit – also under the District of Columbia’s CPA -- on behalf of people who consumed milk without knowing that they were lactose intolerant alleging that it was false and deceptive for sellers of milk to fail to warn them of the adverse effects that lactose intolerant people suffer when they drink milk, 73 suits brought under California’s CPA against auto dealers for technical regulatory violations, such as using the abbreviation “APR” instead of “Annual Percentage Rate,”; 74 a suit alleging that a Fresno, California fast food restaurant engaged in an unfair practice by placing a restroom mirror an inch higher that is permitted under the federal Americans with Disabilities Act. 75 The allegations in these and many other such suits depict either trivial regulatory violations, marketing communications that are very general and imprecise and unlikely to deceive any typical consumer (“Satisfaction Guaranteed”), or a failure to communicate information that should be obvious to any consumer who knows his or her own personal characteristics (that lactose intolerant people will suffer adverse effects if they drink regular milk). They seem clearly to fall short of meeting almost any sensible standard of what might constitute a “false and deceptive” practice.

To their credit, courts have often dismissed such lawsuits on their

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74 ATR, Private Consumer Protection Lawsuit Abuse, supra note __ at 9.
75 ATR, Private Consumer Protection Lawsuit Abuse, supra note __ at 9.
pleadings, refusing to permit plaintiffs to get anywhere near a jury. Yet dismissals of even such seemingly egregious cases are at least sometimes appealed. And such appeals are far from frivolous, because it is easy to find cases that are just as far-fetched on their factual allegations that have survived not only dismissal but appeal. In Johnson v. Hewlett Packard Co., for example, the plaintiff alleged that Hewlett-Packard brochures that described its printers as including a free “economy” ink cartridge were deceptive because the free cartridges contained only half as much ink as a normal cartridge, forcing consumers to have to buy replacement cartridges sooner than they expected. The trial court granted summary judgment for the defendant, finding that the company had truthfully disclosed that the free cartridge was an “economy” cartridge, but the appellate court reversed on the ground that there was a triable issue of fact over how most buyers would have understood the phrase “economy cartridge.”

Similarly, in one of the most highly publicized recent CPA cases in California, Benson v. Kwikset Corp., the plaintiff alleged that although the deadbolts, doorknobs and door handle sets (a category referred to as “locksets”) sold by Kwikset were assembled in its U.S plants, because some of Kwiksets products included some screws or pins made in Taiwan and a latch part made at its plant in Mexico, labels on Kwikset product stating “Made in U.S.A.” or “All American Made” constituted an “unlawful” and “unfair” business practice under the California CPA. This claim made it to a bench trial, where the plaintiff

76 See, e.g., Mills v. Giant of Maryland, and Pearson v. Chung, supra note __. See also Bivens v. Gallery Corp., 134 Cal. App. 4th 847 (2006)(upholding dismissal of complaint alleging that a newspaper advertisement for twin matteresses showing a woman on a mattress, stating a unit price, and also stating both “TWIN EA. PC” and “SOLD IN SETS ONLY” was misleading because it failed to give the total price for twin sets.)

77 See cases cited supra note 65.


79 This description is taken from Richard Craswell, Taking Information Seriously, 92 Va. L. Rev. 565, 614-615.


81 In particular, California’s Unfair Competition Law, Civ. Code §§17200 et. seq. that create a right to restitutionary and injunctive relief against any “unlawful, unfair or fraudulent business practice or practice…” Plaintiff also alleged that such labels violated a provision of California’s false advertising law that makes in unlawful to sell products that are labeled with “the words ‘Made in U.S.A.,’ ‘Made in America,’ ‘U.S.A.’ or similar words when the merchandise or any article, unit, or part thereof, has been entirely or substantially made, manufactured, or produced outside of the United States.”
presented witnesses who testified that because they interpreted a “Made in U.S.A.” label to mean that “all of the parts and all of the labor used to manufacture the product occurred” in the U.S., they felt deceived by the labels on Kwikset products. The trial judge found that “a lockset incorporating a latch assembly that was sub-assembled in Mexico is deceptively labeled with either designation” and that “locksets that incorporate only a few screws or pins made in Taiwan are not deceptively labeled with a ‘Made in U.S.A.’ label, but are deceptively labeled with an ‘All American Made’ label.” The trial court enjoined Kwikset’s use of the supposedly misleading labels, ordered it to allow retailers to return the “mislabeled” locksets for either a refund or replacement, and awarded plaintiff statutorily authorized costs plus attorney’s fees. Thus although Kwikset might seem to be a case that at the very least pushes the boundaries of what could reasonably be considered to be false or misleading mass market consumer communications, it is a case that the plaintiff actually won.

Although California’s Proposition 64 – establishing an injury requirement for plaintiffs to establish standing under both California’s unfair competition and false advertising laws – was passed during the pendency of the Kwikset, that Proposition seems unlikely to affect the outcome: after a trial, the judge found that at least one of the labels was misleading to consumers in general, one of whom the plaintiff could easily assert himself to be. There is little doubt that Proposition 64 has been successful to some extent, because there are already a large number of reported decisions in which Proposition 64’s injury requirement has led to the early dismissal of many patently frivolous suits that might well otherwise have proceeded through discovery. Yet in many cases that seem equally far-fetched, plaintiffs have managed to at least satisfactorily plead injury, leaving judicial interpretation and implementation of the substantive standard of “unfair, false and

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82 Benson v. Kwikset, 24 Cal.Rptr. 683, 691.
83 Benson v. Kwikset, 24 Cal.Rptr. 683, 692.
84 Benson v. Kwikset, 24 Cal.Rptr. 683, 690.
85 More precisely, in Benson v. Kwikset, 152 Cal.App.4th 1254, 62 Cal. Rptr. 3d 284, 290-291 (2007), Benson was allowed to amend his complaint so as to plead facts satisfying Proposition 64’s standing requirement.
86 See, e.g., O’Brien v. Camisasca Automotive Manufacturing, Inc., 161 Cal.App.4th 388 (Ct. App. 2008)(plaintiff alleged that license plate frames were falsely labeled as “Made in U.S.A.” but failed to plead that he ever saw such a label before he purchases his frame.)
deceptive” as the key determinant of whether such claims are dismissed quickly or instead become the fodder for the class action settlement hold-up game described above.

For example, in Paduano v. American Honda Motor Co.\textsuperscript{87}, the plaintiff said that in deciding to purchase a 2004 Honda Civic Hybrid, he read and relied upon a number of allegedly misleading claims about fuel economy made in the Hybrid sales brochure.\textsuperscript{88} These claims included a highlighted EPA estimate of 51 mpg for the manual transmission version of the hybrid, an image of text reading “51 mpg” in large yellow font, with smaller foreground text beginning “with impressive fuel economy of 51 mpg,” and statements in the brochure stating “just drive the Hybrid like you would a conventional car and save on fuel bills,” and “IS THERE ANYTHING SPECIAL YOU HAVE TO DO? You just have to love saving money and getting terrific gas mileage.”\textsuperscript{89} Since the EPA estimate for this make and model was indeed 51 mpg, and since the brochure clearly stated that this was for the manual transmission – not the automatic that Paduano bought – the trial court had no difficulty in concluding as a matter of law that there was nothing false or misleading in Honda’s advertising statements that identified the EPA estimated mileage.\textsuperscript{90} However, the trial court found that there was a triable issue of fact was raised by Paduano’s assertion that Honda had misled him by stating that a consumer could achieve the EPA mileage just by “driv[ing] the Hybrid like…a conventional car.” These fact issues were raised, according to the trial court, by evidence introduced by Paduano that a Honda representative told him that the mileage tests used to derive EPA estimates “were developed over 30 years ago and do not reflect real driving situations, let alone driving habits of consumers in the modern day” and that another Honda representative told him that to get the high advertised fuel efficiency, “one would have to drive a hybrid vehicle in a manner quite different from the manner in which one would drive a conventional vehicle.”\textsuperscript{91} Remarkably enough, on appeal, the trial court

\textsuperscript{87} 169 Cal. App. 4\textsuperscript{th} 1453, 88 Cal. Rptr. 3d 90 (Ct. App. 2009).
\textsuperscript{88} Paduano, supra note __ at 88 Cal. Rptr. 3d
\textsuperscript{89} Paduano, supra note __ at 88 Cal. Rptr. 3d 90, 97, 104-105.
\textsuperscript{90} Paduano, supra note __ at 88 Cal. Rptr. 3d 90, 105.
\textsuperscript{91} Paduano, supra note __ at 88 Cal. Rptr. 3d 90, 105. As the trial court explained: “[t]he tests do not take Hyrid vehicles into consideration, and Hybrid vehicle estimates are inflated ased on the test procedures. Honda told [Paduano that] Hybrid vehicles are more dramatically effected by outside influences such as air conditioning, driving habits, windows up/down, and vehicle load than normal combustion engines. Only after purchase did Honda [tell Paduano that] Hybrids require a particular driving style
decision to deny summary judgment was upheld by the majority.

What is most remarkable about the Paduano decision is that it has apparently been well known for many years that EPA mpg ratings may systematically overstate the mileage that drivers will obtain, and not just from hybrids. Moreover, apparently both Honda and Toyota had become aware – through customer complaints – that their hybrids were not getting the EPA-estimated mileage and had in fact contacted the EPA to try to get revised EPA estimates that were more in line with the mileage that customers were actually reporting. At its most essential level, the Paduano case got past summary judgment on the strength of the argument that Honda failed to tell drivers that hybrids were new and different and that methodology used by the government to get its mileage estimates would not necessarily be accurate. But as the dissenting appellate judges (Haller and O’Rourke) in Paduano powerfully argued, this is far cry from allowing to find that what Honda did say was misleading or deceptive:

“…the Honda brochure’s assertion as to driving the Hybrid conventionally and saving on fuel bills is true and basically definitional. By its nature, a hybrid vehicle ‘saves on fuel’ (i.e. gasoline) because there are times while driving that the gasoline engine cuts off. The brochure itself points out that the electric motor adds its power to the output of the gasoline engine while accelerating, and also that ‘At a stop, the engine cuts of automatically under most conditions to reduce fuel use and emissions, thanks to the idle-stop feature. It restarts itself when you’re ready to go’ Paduano himself admitted in his deposition that any car’s gas mileage would decrease with aggressive driving. His own deposition testimony bolsters the conclusion that Honda’s suggestion about driving the hybrid Civic like a conventional car is not likely to mislead a reasonable consumer….the statement ‘just drive the car like you would a conventional car and save on fuel bills’ relates not to driving style (aggressive versus non-aggressive driving) but to the absence of any need to plug the car into an outlet.

93 88 Cal. Rptr. 3d 90, 97.
Nevertheless, the majority’s theory – that the brochure is misleading because it suggests a person can drive the car in a ‘normal’ or conventional manner and still get fuel economy close to the EPA estimate...necessarily depends on plaintiff’s reliance on the accuracy of the EPA estimates set forth in the brochure. But as the majority holds, such a claim is not actionable!"\textsuperscript{94}

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

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

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

\textsuperscript{94} 88 Cal. Rptr. 3d 90, 127-128.
amount to an inescapable but risky tax that accompanies any mass market consumer communication.

a. The Model of Precautions\textsuperscript{95}

We begin by reviewing some of the basic law and economics of tort law incentives. At one extreme, one can imagine an economically ideal fault-based liability system. Such a system is one in which the manufacturer would face a 100 percent chance of liability if its behavior was economically suboptimal, and a 0 percent chance of liability if its behavior was economically optimal. At the other extreme, one can imagine a regime of absolute fault, in which the manufacturer is liable for damages in the event the consumer suffers harm regardless of what the manufacturer said or did.

One of the early and most fundamental results in law and economics is that both regimes – economically ideal fault-based liability and absolute liability – create an incentive for potential injurers to take optimal care to lower the probability of accidental harm.\textsuperscript{96} Essentially, under either regime, the manufacturer internalizes the full social costs of its choices if it takes less than optimal care, and so both regimes equate private and social costs for less than optimal care. The difference between the two regimes comes in the distribution of the cost of accidents given optimal care by the manufacturer: under absolute liability, the manufacturer bears the cost of accidents even if it takes optimal care, while under ideal fault-based liability, the manufacturer takes optimal care but, given that choice, is never found liable and so victims are left bearing their own costs.

These two regimes – ideal fault-based liability and absolute liability – are highly simplified, theoretical liability regimes. Fault-based liability is not, of course ideal. Rather than a regime in which the manufacturer perceives 0 chance of liability if it takes optimal care and a 100 percent chance of liability if it fails to take optimal care, the more realistic situation is likely to be one in which a manufacturer perceives


that there may always be some positive probability of liability, no matter what it does, but that the probability of liability will fall, the more careful was its actual ex ante behavior. Such a regime is, from an economic point of view, imperfect, but it is nonetheless rational, in that the more careful the ex ante behavior, the lower the chance of ex post liability. However rational, such a regime creates too strong an incentive for manufacturer precautions. The reason is that under such a regime, the manufacturer (or more generally, injurer) gets what is in effect a double marginal benefit from care-taking: it lowers the probability that a consumer suffers harm, and it also lowers its chances of being found liable if such harm occurs. Economic theory predicts that under very general conditions, this double marginal benefit leads to excessive precautions. This theoretical prediction has, moreover, been confirmed by empirical work in the medical malpractice area that has found evidence that uncertain malpractice liability has caused physicians to practice defensive medicine: excessive levels of treatment that are ordered primarily to lower the risk of liability, rather than to improve patient outcomes.

Importantly, such imperfect fault-based liability regimes are quite similar to strict liability, in that they generally leave a manufacturer facing some positive probability of liability no matter what its choice. Like strict liability, therefore, the incentive effects of fault-based liability regimes are highly sensitive to the damage measure. In an ideal fault-based liability regime, where a manufacturer is sure that it will not be held liable if it does the “reasonable” thing, the measure of damages is—in equilibrium—irrelevant, because the manufacturer’s ex ante behavior is always economically optimal (which is equivalent to legally “reasonable” in an economically optimal legal regime) and therefore the manufacturer doesn’t pay damages anyway. But in a more realistic, imperfect fault-based regime, the manufacturer is generally too careful, but also generally still faces a positive chance of liability. Hence under

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98 See Daniel P. Kessler & Mark B. McClellan, Do Doctors Practice Defensive Medicine?, 111 Q.J. Econ. 353, 356, 385-88 (1996) (concluding that, absent limitations on liability, doctors provide excessively costly treatment)
such an imperfect regime, the prospect of paying extraordinary damages (statutory damages greater than actual harm, double or treble damages, or punitive damages) will add to the risk of overdeterrence. Only if one is sure that there is little or no risk that economically reasonable behavior will be punished with punitive damages can one assume that imposing punitive damages in an imperfect fault-based regime will not lead to significant overdeterrence.

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

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

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

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

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

Consider next the model of precautions as applied to consumer communications. Here the problem is that there is potential CPA liability for saying too much – as about the EPA-estimate mph for Honda hybrids – and saying too little – as in failing to warn lactose intolerant people that they will suffer adverse physical effects if they drink milk. Moreover, there is also potential liability if statements are insufficiently complete – as in saying that a door knob is “Made in the U.S.A.” when it contains screws made in Taiwan. The standard case presumed in the economic model of precautions is one in which by taking more precautions, the actor lowers the risk of both social harm and that it will incur private liability. But with CPA liability, firms do not necessarily lower their liability by saying more in their consumer communications. Nor do they necessarily lower their liability by saying less, or even by saying nothing (since there may be a duty to disclose under the CPAs). Perhaps it is only by making extremely detailed and highly cautionary disclosures – to the effect that certain consumers may find that the...
product or service is not to their liking, for various and sundry enumerated reasons – could a seller actually shape its marketing communications and advertising so as to lower its risk of CPA liability. The problem confronting a seller who is honestly trying to devise advertising disclosures that inform but do not mislead consumers is a hard one: recent studies have shown, for example, that prominently disclosing one product attribute may reduce consumers’ understanding or recall of other information disclosed in the very same ad.\footnote{Craswell, Taking Information Seriously, supra note __, 92 Va. L. Rev. 565, 583.} Consistent with this evidence from the marketing literature, as we explain in more detail in the next section, in an economically relevant sense, such highly qualified and conditional seller communications may actually lessen the dissemination of useful information to consumers.\footnote{For an analysis that suggests that a CPA statute that broadly defines “deceptive” and “unfair” behavior may excessively restrict the dissemination of useful information to consumers. Thomas Holdych, Standards for Establishing Deceptive Conduct Under State Deceptive Trade Practices Statutes That Impose Punitive Remedies, 73 OR. L. REV. 235 (1994) (“[A]pplying a pure negligence standard to determine the liability of an information source for causing false beliefs to be derived from ambiguous or vague communications may result in overdeterrence and reduce the amount of information produced or cause excessive care.”). When a statute fails to clearly distinguish between deceptive and non-deceptive conduct, the latter may be punished when to do so would be inappropriate. The fear that consumer protection statutes will deter useful commercial activity has led some courts to become hostile to consumer protection claims. See Jeff Sovern, Private Actions Under the Deceptive Trade Practices Acts: Reconsidering the FTC Act as Rule Model, 52 OHIO ST. L. J. 437, 457 (1991). Critics argue that a statutory regime that imposes punitive remedies for offenses defined so broadly is too harsh. Merchants who engage in false advertising by virtue of an honest mistake or typographical error may be punished unduly. See, e.g., Geismar v. Abraham & Strauss, 439 N.Y.S.2d 1005 (N.Y.Dist.Ct. 1981). Also, see Muris, supra note at 33 (“Unduly expansive principles of deception can impede vigorous competition …”).} To our knowledge, there is no systematic empirical evidence that details the extent of such a chilling effect of potential CPA liability on consumer communications and advertising. However, there are well-known cases in which CPA liability has had precisely the effect that we predict. Perhaps the most famous is Nike v. Kasky.\footnote{Nike v. Kasky, 539 U.S. 654 (2003). is a prime example of consumer protection statutes being used to infringe on a merchant’s right to free speech. Theodore B. Olson, then Solicitor General, argued to the Supreme Court that the fundamental principle of free speech was put in jeopardy when the “self limiting principles” of common law actions are disregarded. See Brief for the United States as Amicus Curiae Supporting Petitioners, Nike v. Kasky, 539 U.S. 654 (2003) (No. 02-575) at 12, available at http://www.usdoj.gov/osg/briefs/2002/3mer/lami/2002-0575.mer.ami.pdf} In the late 1990’s, Nike was besieged with accusations that its products were manufactured in overseas sweatshops. Nike responded with a flurry of press releases,
letters to the editors and also commissioned a former U.N. ambassador to write a report on the labor conditions in Nike’s overseas factories. Labor activist Mark Kasky filed a suit against Nike under California’s Unfair Competition and False Advertising laws on behalf of the general public, alleging that Nike’s statements about its treatment of its workers amounted to a violation of California’s deceptive trade practices law. Nike argued that the application of these California CPA laws to its commercial speech infringed the First Amendment. This challenge was rejected by the California Supreme Court, and although the Supreme Court of the United States originally took certiorari on the First Amendment issue, a majority of the Court then changed their minds and reversed the grant. After this, the case settled, with Nike agreeing to pay several million dollars to a D.C. based international labor rights nongovernmental organization. For present purposes, what is most important about Nike v. Kasky is the immediate chilling impact it had on Nike’s communications: as soon as the case was filed, Nike stopped issuing its annual Corporate Social Responsibility reports and making claims regarding its labor and environmental practices. This self-imposed speech moratorium lasted several years, and when Nike resumed communications regarding its labor practices, it was careful not to assert anything about labor conditions, but instead simply posted online a list with its suppliers’ names and locations.

Another example of the chilling effect of potential CPA liability on communications with consumers is provided by Benson v. Kwikset. As soon as Benson filed his CPA suit in 2000, Kwikset ceased “all use of the USA designations on their locksets.” As we explain below, when firms are deterred by CPA liability from communicating information to consumers, both firms and consumers suffer adverse consequences in the

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104 In Nike v. Kasky, 123 S.Ct. 2554, 2568, Nike asserted without contradiction that due to Kasky’s suit, it had already begun to restrict “severely” its communications on social issues that could reach “California consumers,” refused “dozens of invitations...to speak on corporate social responsibility issues,” delayed release of its annual Corporate Social Responsibility Report, and decided against trying to get its stock listed on the Dow Jones Sustainability Index (an index used by socially responsible and “green” mutual funds in screening stocks for inclusion in their portfolios).
106 62 Cal. Rptr. 3d 284.
107 62 Cal. Rptr. 3d 284, 292.
form of lost sales that would have generated positive gains from trade for both.

There is a final impact of potential CPA liability under the expansive construction of “false and deceptive” that becomes clear when we recognize that in the case of consumer products and services, precautions are two-sided. It is not only what the seller says or how it markets its goods and services that determines what consumers know or do not know about the product before they buy it; consumers also have an opportunity to in effect take precautions by becoming informed about the product or service, about the seller, and about the seller’s reputation before they make a purchase. There is a fundamental tradeoff between providing remedies to allegedly deceived consumers and giving consumers the incentive to investigate and protect themselves.\textsuperscript{108} If consumers expect to be made whole when ill-advised decisions have bad consequences, then they have less incentive to be reasonably cautious.\textsuperscript{109} The FTC clearly recognizes these concerns in its definitions of unfair and deceptive. Unfortunately, there is no mechanism to tradeoff costs and benefits under state CPAs.

c. The Impact of Uncertain CPA Liability on Consumer Welfare

From the previous discussion, there are at least two serious impacts of expansive and uncertain potential CPA liability on the market for consumer goods and services: first, the imposition of what is effectively a tax on every good or service sold to consumers; second, the

\textsuperscript{108} See Hadfield et al., p. 26 (“Other contract doctrines protective of consumer interests generate tradeoffs in terms of the creation of incentives for consumers to become informed. Consumer information up front may be a more efficient way to avoid bad bargains than ex post relief and yet relief for various forms of mistake and misrepresentation may create inadequate incentives for consumers to bear the costs of becoming informed.”).

\textsuperscript{109} Hadfield et al., near note 25 (“Perhaps the most important insight coming from the analysis of information in markets again relates to transactions costs. Information is costly so consumers rationally make choices between being better informed and settling for a less-informed but less (transaction) costly option. Consumer protection policy that is intended to alleviate the information problems that run through consumer markets, then, must address this underlying tradeoff. Protective measures that are as costly as the self-protective measure of gathering more information do not go to the heart of the problem; nor do regulatory techniques in which the cost of regulation (both direct costs and the indirect costs implied by the strategic response to the regulation) exceeds the cost of becoming informed and thus, by hypothesis, the value to a consumer of a more informed choice. In general, the transaction cost insight is that information costs are endemic to both markets and regulatory techniques; wise regulation must be designed with a clear understanding of the relative costs of the problem and the solution.”).
imposition of potential liability for consumer communications and advertising, liability that may well have the effect of either chilling informative communication and/or inducing sellers to make such communications both much more detailed and much more cautionary and discouraging. In this section, we trace the consequences for consumer welfare of these two effects.

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

First, and most simply is the direct impact CPA liability has in imposing what is essentially an excise tax on each and every consumer sale. Generally speaking, excise taxes are imposed on luxury goods (airplanes, boats) and on goods whose consumption the government wishes to reduce, such as cigarettes. The reason is that excise taxes increase seller costs, which leads to an increase in price and reduction in quantity demanded and consumed. In the case of competitive markets, the excise tax has two consequences for the economic welfare of sellers and consumers. These consequences are depicted in Figure 1 below. Figure 1 depicts the consequences of imposing expected CPA liability in the amount L on every sale of a generic good or service.\(^{110}\) As shown by Figure 1, the market effects of imposing this liability/tax is to reduce the equilibrium market quantity consumed from Q to Q\(_L\) and to increase the equilibrium price from P to P\(_L\).

\[\text{Figure 1 About here}\]

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

The second consequence of CPA liability for consumer welfare is that consumers are now worse off because they have to bear part of the price increase due to the increase in seller costs due to CPA liability. More precisely, consumers who remain in the market and continue to buy the good are now worse off by an amount equal to the increase in price (P\(_L\) - P) multiplied by the quantity consumed with CPA liability

\(^{110}\) This analysis was classically presented by Robert L. Bishop, The Effects of Specific and Ad Valorem Taxes, 82 Quart. J. Econ. 198 (1968).
costs, $Q_L$. This element of consumer loss depends upon the slope (more precisely, elasticity) of the demand curve: if demand were perfectly inelastic (perfectly vertical in Figure 1) – meaning roughly that the good or service is akin to a necessity without substitutes for a certain category of consumers – then consumers would bear the entire liability increase. If demand were perfectly elastic – meaning consumers have no willingness to pay more than a particular price – there would be no increase in the prices paid by consumers, but there would still be a reduction in supply at that price, as only some suppliers could remain in business.

Since virtually any product or service sold to consumers carries with it the risk of CPA liability, at least with respect to items for which consumer demand is in the short run inelastic, it is consumers who are likely to bear the bulk of the cost of CPA liability, not firms. Especially for everyday goods and services – for which consumers do not shop out of state or online – states that have especially egregious CPA liability regimes are likely to be imposing most of the cost right back on the very same consumers whose welfare is supposed to be furthered. Moreover, it is well established in the public finance literature that excise taxes tend to be regressive – lower income consumers pay a larger portion of their income in excise taxes than do higher income consumers.111

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

111 As explained in The Encyclopedia of Taxation and Tax Policy ___ to ___ (Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, eds. 1999), depending upon the purchase decisions of consumers of differing income, excise taxes can also be highly regressive, tending to tax the poor more than the rich. The tendency for private CPA actions to be filed against businesses that provide very basic goods and services – such as auto repair – and which are likely to make up a bigger share of poor consumers’ spending, tends to suggest that CPA liability may amount to a highly regressive excise tax.
precisely those sellers who are most stable and enduring in the marketplace who are most at risk from CPA liability.

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

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

To understand how consumer welfare can suffer when CPA liability chills sellers’ incentive to advertise and communicate with consumers, it is necessary to review briefly the economics of advertising. There are a number of different economic explanations for advertising.112 On one set of theories, advertising is simply directed to persuading consumers to buy a particular brand over others by influencing consumer tastes or preferences. On these theories, advertising usually tends to be socially wasteful, as it is simply a zero-sum game where firms compete for a fixed set of consumers that ends up only increasing costs and creating barriers to entry.113 Other economic theories explain how by conveying information to consumers, advertising can have the socially desirable effect of lowering consumer search costs and/or facilitating mutually beneficial market transactions that would otherwise not occur.114 Economists have furthermore recognized that advertising can convey information about products both directly – through content that provides information about product characteristics,

\[\text{112 For an excellent overview of the historical evolution of economic theories and evidence about advertising as well as a detailed exposition of the most recent theoretical approaches, see Kyle Bagwell, The Economic Analysis of Advertising (version of August, 2005).}\]

\[\text{113 See Bagwell, supra note } \_ \_ \text{ at 9-16, and for an influential analysis of the negative welfare consequences of such taste-altering advertising, see Avinish Dixit and Victor D. Norman, Advertising and Welfare, 9 Bell J. Econ. 1 (1978).}\]

\[\text{114 The foundation for theories of advertising as information was provided by George J. Stigler, The Economics of Information, 69 J. Pol. Econ. 213 (1961).}\]
location, function or price – and indirectly.

That advertising can be indirectly informative is a consequence of the general effect of advertising in expanding demand for the advertised product. When high quality firms also are efficient, with low marginal cost and therefore more to gain by investing in demand-expanding costly advertising, and consumers know this, then advertising signals high quality.115 Another content-independent mechanism by which advertising can convey information to consumers is especially important for experience goods, where the consumer learns the actual quality of the good after buying and using it, and where consumers can be repeat buyers. For such goods, the value of an initial sale is likely to be higher for high quality firms, because consumers who buy the high quality good will become repeat purchasers. In such a market, high quality firms gain more from advertising than do low quality firms, and therefore high quality firms will use high advertising expenditures to distinguish themselves. Advertising content per se is not important in such a model.116

A final and especially important way that advertising can be informative is by helping match consumers with varying tastes to products with varying characteristics. While such matching is not strictly dependent upon advertising content (it can under some circumstances be accomplished by targeting costly advertising only at particular types of consumers117), most match-type advertising has content that informs consumers about the product characteristics, function and location.

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

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115 This theory of how advertising may be informative, as well as the germ of virtually all the main theories of informative advertising, may be found in Philip Nelson, Advertising as Information, 82 J. Pol. Econ. 729 (1974). For an exegesis of the conditions under which advertising has the indirect or signaling effect, see Bagwell, The Economics of Advertising, supra at 84-90.


117 See the discussion in Bagwell, supra note __ at 95-100.
buy the product she thereby reveals to the firm that she has a very strong preference for the product—there is a good match between her preferences and product characteristics—information that the firm will wish to use by charging a high price. Informative advertising content thus has two fundamental but conflicting effects: it generates better consumer/product matches and bigger markets, but also reduces sales due to higher prices.\footnote{118} Essentially, firms are faced with a dilemma: if they provide too fine-grained information about the product, then consumers know that they will have to pay a relatively high price for the product (as the ad has told them so much that the only consumers who show up to buy perceive that the product is really what they want). If they provide too little and it is costly for consumers to search and shop, then too few consumers will show up to purchase. The profit maximizing solution for the firm is to provide some information about product characteristics, but not such extensive or detailed information about product characteristics that only consumers with a very high willingness to pay arrive to buy the product.\footnote{119} Somewhat non-intuitively, it is when search costs are high and the firm’s profit maximizing price is low relative to search costs that a (monopoly) firm’s private interest in attracting consumers can correspond perfectly with the social interest if which a consumer buys if and only if trade results in consumer surplus that exceeds her search costs. For lower search costs, the firm’s price is high relative to search costs so some consumers may not buy even though their value is above the cost of search.

The crucial result in this recent economic literature on advertising is that both consumers and firms can benefit from mass market communications that convey only partial or incomplete information. CPAs, however, put firms in the position of either saying virtually everything that they can imagine about a product, or else saying nothing.\footnote{120} For example, the dairy industry has been attacked under

\footnote{118} For this terminology and a summary of the advertising as matching models, see Bagwell, supra note __ at 95-98.
\footnote{119} This result is established by Simon P. Anderson and Regis Renault, Advertising Content, 96 Amer. Econ. Rev. 93 (2006).
\footnote{120} Consumers are forced to either make a less-informed choice when purchasing a product or engage in a protracted and costly inquiry in order to acquire information regarding product or service attributes such as price, quality, service, and warranties. In many cases, consumers require little or no information at all when contracting for the purchase products or services, sometimes relying on price alone to inform their decision. Consumer protection statutes that require certain disclosures or present a threat of liability motivate sellers to devote additional time and resources toward providing extensive information to consumers, in order to ensure statutory compliance
CPAs for stating that milk products can promote weight loss while failing to label dairy products with warnings of the effects of lactose for those who are or may become lactose intolerant.\textsuperscript{121} Automobile insurers have similarly been sued under CPAs for failing to tell consumers that they were requiring automobile repair shops to use generic (non-OEM) auto replacement parts, this despite state regulations allowing (and even sometimes requiring) the use of generic parts.\textsuperscript{122} Cases such as these tell firms that unless they convey virtually every piece of discouraging information about a product that can imagined, then they face possible punitive liability. In other words, CPA liability tells firms that they face liability unless their marketing communications disclose every characteristic that could possibly cause a consumer to revise downward her willingness to pay for the product. Even worse, as in the examples just proffered, such information pertains to product characteristics – the unsuitability of milk for people who are lactose intolerant, the use of generic parts – that are very obscure, in the sense that a consumer may not understand precisely how the presence or absence of such a characteristic really impacts her likely utility from consumption.

There is no hard evidence about how such forced negative disclosure affects different types of consumers. In terms of the theoretically relevant distinctions, there are two possibilities. One possibility is that the negative disclosures have their greatest impact on

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\item [\textsuperscript{121}] Cases discussed and cited in Schwartz \& Silverman, supra note 9, at 4, n. 203. One must wonder if any regulations can protect lactose intolerant individuals who have not figured out that they have a problem with milk.
\item [\textsuperscript{122}] Avery v. State Farm Mutual Automobile Insurance Co., 746 N.E.2d 1242 (Ill. App. 2001) [reversed on appeal to Illinois Supreme Court] Avery v. State Farm Mut. Auto. Ins. Co., 835 N.E.2d 801 (Ill. 2005). Also see insurance cases where supposed the life insurance illustrations were deceptive, such as In Re Great Southern Life Ins. Co. Sales Litig., 192 F.R.D. 212 (N.D. Tex. 2000) (where failure to disclose the methods behind financial projections used in a marketing tool for a “vanishing premium” policy was a basis for a claim) and Boswell v. Liberty Nat. Life Ins. Co., 643 So.2d 580 (Ala. 1994) (where misrepresentation that new policy provided additional coverage was basis for a claim).
\end{enumerate}
\end{footnotesize}
the search and purchase decisions of consumers who based on the match information that the firm voluntarily advertises have already decided not to actually shop for the product. In this case, the disclosures induced by the risk of punitive CPA liability would have little impact on market equilibria because they would merely reinforce the firm’s interest in deterring low value consumers from incurring search costs. But if the negative disclosures that CPA liability essentially forces are most likely to impact the search and purchase decisions of consumers who otherwise would be high value, causing them perhaps incorrectly to downwardly revise their expected value from the product, then CPA liability will have seriously impacted the economic function of match advertising. If firms cannot send partial information in their advertising, but must include bizarre negative information of unclear meaning or relevance to consumers or else incur potentially large liability, then firms may not provide any product characteristic information. For goods with low search costs, the social loss will be relatively low: consumers will search for such goods even if they don’t know very much about whether the product really suits their preferences. But for goods with higher search costs, the impact of CPA liability in deterring advertising may be such that there is too little information to justify consumers in incurring search costs, and markets with such high search costs may unbundle.

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

The economic analysis of state CPAs presented in the previous part of this Article has shown that the current state CPA regime likely has seriously adverse consequences for the welfare of the very group that such laws are designed to help – consumers. But showing that the current regime is fundamentally flawed does not by itself indicate what should be done to fix it. From an economic point of view, the prescription for fixing the state CPA mess begins by understanding the proper role for CPA liability within the broader institutional landscape of consumer protection. In other words, the proper role for and design of state CPA liability cannot be determined unless one understands the role played by CPA liability as a supplement to other institutions of consumer protection. As aptly put recently by Professor Timothy J. Muris, former Chairman of the U.S. Federal Trade Commission, these institutions are interdependent:
One can envision the American system of consumer protection as a three-legged stool: a first leg of competition based on free enterprise with a second leg the legal structure of contract, property and other private law that largely focuses on the relative rights of particular parties. A two-legged stool will not be very stable. Likewise, markets and private legal rights, while indispensable to the American economic system, may falter in key respects. These legs can better support the American economic system when buttressed by a third leg. Public agencies – entrusted to promote consumer welfare by preserving competition and protecting consumers – work as this third leg, reinforcing the other two.\textsuperscript{123}

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

A. Market Forces for Consumer Protection – And How Private Litigation under State CPAs Interfere with Those Forces

Even if there were no laws or regulations protecting consumers against false and misleading seller practices, under certain conditions, the market itself generates strong incentives for sellers to inform consumers about product quality. Most straightforwardly, consumers have every incentive to become informed about not only the goods that they buy but about the sellers from whom they buy them, and sellers have strong incentives to develop and maintain a reputation for making truthful and informative claims about the goods and services that they sell. A traditional – indeed in some sense the traditional – economic criticism of consumer protection regulation whether by the FTC or CPAs is that market forces such as reputation can have a stronger, and more

\textsuperscript{123} Muris, supra note 12, at 4-5.
precise, disciplining effect on seller misbehavior than any lawsuit.\textsuperscript{124} We agree with the argument that market forces for consumer protection are much stronger than many advocates of consumer protection laws tend to believe. However, the role of the market is much more nuanced than some law and economics scholars seem to assume. As we now explain, the strength of market incentives for consumer protection depends upon both seller and buyer type: upon the ability of repeat sellers to identify their product to consumers via pricing, branding and advertising; upon the extent to which consumers are repeat purchasers and the cost and speed with which consumers obtain information about product quality. As we also explain, in their current form, state CPA’s may actually hinder rather than assist market forces for consumer protection.

\section{The Lemons Market Problem}

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

Once we move to the more realistic case – where at least some consumers are at best imperfectly informed about the product or service – imperfect information has potentially serious consequences for consumer welfare. If consumers can acquire perfect information about all product characteristics, including price, but have a positive cost of search, then market prices will generally exceed the competitive level.\textsuperscript{125}

\textsuperscript{124} As argued recently by Omri Ben-Shahar in delivering the annual Coase Lecture at the University of Chicago. See Student Blogger – The Myths of Consumer Protection Law, February 26, 2009, available at http://uchicagolaw.typepad.com/faculty/2009/02/the-myths-of-consumer-protection-law.html#more. See also Hadfield et al., supra note \_ (arguing that in many consumer markets there are “well-developed reputation mechanisms permitting other consumers to monitor the extent to which a merchant lives up to its promises.”)

\textsuperscript{125} More precisely, there is a general tendency for market prices to increase to the monopoly level, as consumer search costs increase. See A. Sadanand and Louis Wilde, A generalized model of pricing for homogeneous goods under imperfect
With incomplete consumer information about product quality, market existence itself becomes an issue. In the standard model of such markets, it is assumed that information is asymmetric, in that while sellers of goods or services know the actual quality of the goods or services they sell, buyers only know average quality. Under such informational conditions, if high quality sellers cannot credibly identify themselves, so that buyers effectively think every seller’s good is of average quality, then buyers will not pay more than the value of average quality. If high cost–high quality sellers cannot charge more than this average-quality price, then they cannot make a profit. But when the very highest quality sellers drop out of the market, then the average quality falls, and now the new highest quality sellers may be losing money, causing them to leave the market, and so on, leading to the non-existence of market equilibrium. This result—that asymmetric information can cause markets to unravel, with low quality goods in effect driving out high quality goods—is known as the lemons market problem (with name corresponding to the problem caused by automobiles that are poor quality “lemons.”)\textsuperscript{126}

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

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

seller type perfectly and exactly reveals quality, causing the next highest quality seller to also perfectly reveal quality, and so on, in a process where seller private information completely unravels and rational consumers are fully and completely informed about product quality.\textsuperscript{127} Such voluntary disclosure eliminates the lemons market problem, because since good sellers can easily distinguish themselves from bad sellers just by making truthful and fully informative disclosures, good sellers will enter the market and effectively drive out the lowest quality sellers.\textsuperscript{128}

The world posited by the unraveling result is one in which consumers are perfectly rational (in that they fully understand the relevant incentives and can deduce market equilibria) and can perfectly and costlessly verify seller statements about product quality. In such a world, the question is not whether sellers will lie about product quality – they cannot, by assumption – but how much they will reveal about product quality.\textsuperscript{129} The unraveling result is that in such a world, rather than issuing vague statements about product quality – such as “fish weighing at least ten and as much as twenty pounds” – sellers will issue precise statements about product quality – such as “fish weighing 11.2 pounds.”

The assumptions underlying the unraveling result are severe, and although some assumptions turn out not to be crucial to the result of full quality disclosure (e.g., the result holds under monopolistic as well as competitive product markets)\textsuperscript{130} others are required.\textsuperscript{131} In particular,

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  \item This is known as the “unraveling” result on quality disclosure, and was developed independently by Sanford J. Grossman, The Informational Role of Warranties and Private Disclosure About Product Quality, 24 J. Law & Econ. 461 (1981) and Paul R. Milgrom, Good News and Bad News: Representation Theorems and Applications, 12 Bell J. Econ. 380 (1981). The result is explicated and its limitations discussed in Joseph Farrell, Voluntary Disclosure: Robustness of the Unraveling Result, and Comments on Its Importance, in Antitrust and Regulation 91 (Robert E. Grieson, ed., 1986).
  \item See J. Howard Beales et al., The Efficient Regulation of Consumer Information, 24 J.L. & Econ. 291, 502 (1981).
  \item An observation made by Grossman, The Informational Role of Warranties, supra note ___ at 462.
  \item See Grossman, The Informational Role of Warranties, supra note ___.
  \item If, for example, disclosure itself is costly, then sellers disclose if any only if quality is above some threshold level.Boyan Jovanovic, Truthful Disclosure of Information, 13 Bell J. Econ. 36 (1982). SIMILARLY, IF IT IS costly for sellers to become informed about their product quality, then sellers become informed only if the cost of doing so is low, and disclose only if the information that they learn is favorable. See, for example, Farrell, Voluntary Disclosure, supra note ___ and Steven Shavell, Acquisition and Disclosure of Information Prior to Sale, 25 Rand J. Econ. 20 (1994).
\end{itemize}
when a sufficiently large number of consumers cannot understand the disclosure – because it contains somewhat technical data regarding the product, for example – then voluntary disclosure of quality may not occur.\footnote{Michael J. Fishman and Kathleen M. Hagerty, Mandatory versus Voluntary Disclosure in Markets with Informed and Uninformed Customers, 19 J. Law, Econ. & Org. 45 (2003). Additionally, when firms sell differentiated, multi-attribute products to consumers with varying preferences over those attributes, firms may not voluntarily disclose because disclosure may increase the price elasticity of demand with respect to some products. V. Joseph Hotz and Mo Xiao, Strategic Information Disclosure: The Case of Multi-Attribute Products with Heterogeneous Consumers, NBER Working Paper No. W11937, January, 2006.} As we argued earlier, the very expansive and uncertain construction of what might constitute an “unfair” or “deceptive” practice under state CPA laws actually creates an incentive for sellers to make precisely the kind of long and technically detailed disclosures – precisely the kind that many consumers cannot understand, and which may destroy the possibility of avoiding lemons market problems through voluntary disclosure. This is, indeed, an extraordinarily perverse result – private litigation under state CPAs (by reducing voluntary disclosure) may trigger calls for mandatory disclosure.

\section*{3. Consumer Search and Product Use, and Seller Reputation}

As explained below, when we cannot rely on voluntary disclosure because seller claims about product quality cannot be costly and perfectly verified by consumers, the common law of contract, and fraud, become important supplements, and adjuncts, to market incentives for product quality disclosure. But of course consumers need not rely solely on seller statements for information about product quality. Consumers may learn about product quality by searching for and observing products (trying on a coat, for example) before purchase, or after they purchase and use the good (buying and then using a television). Consumer search, observation and product use are all very important market mechanisms that not only restore equilibrium in markets with imperfectly informed consumers but also discipline deceptive selling practices.

In the economics literature, goods whose quality the consumer can identify by simply examining the good are known as search goods, while goods whose quality can be determined by consumers only after purchasing and using the good are known as experience goods.\footnote{See, e.g., A. M. Spence, Job Market Signaling, 87 Quarterly Journal of
search goods, consumers can learn about quality, and reward high quality providers with higher prices, if the cost of searching and observing quality is sufficiently low that they will continue to search – moving on to another store – if they observe unexpectedly low quality. ¹³⁴ Indeed, with search goods, high prices may themselves signal high quality, since provided that search costs are not too high, consumers will always continue to shop if they observe low quality but high prices at a particular seller. ¹³⁵

With experience goods, it is generally much more costly for the consumer to actually judge quality, since judging quality requires buying and using the product for some time period. For durable goods, moreover, the required period of use may be quite long. ¹³⁶ With experience goods, the power of the market as a force disciplining low quality sellers depends crucially on how long it takes consumers to actually learn the quality of the good or service through consumption. As one would expect, therefore, existing empirical evidence shows that consumer experience good learning varies with the type of good. For some goods, such as laundry detergent, it seems that consumers already


¹³⁵ For this result, see Paul W.J. De Bijl, Entry deterrence and signaling in markets for search goods, 16 Intl. J. Indus. Org. 1 (1997). More generally, when some consumers are informed about product quality and some are not, high and declining prices may be a credible signal of high quality. The reason is that the loss of sales volume caused by high prices is relatively less costly to high cost – high quality sellers, and the loss of sales volume is in any case greater for low quality sellers, who lose more sales from informed consumers. See Kyle Bagwell and Michael H. Riordan, High and Declining Prices Signal Product Quality, 81 Amer. Econ. Rev. 224 (1991).

¹³⁶ For this reason, the composition of the consumer pool for an experience good changes over time following the introduction of a new good, and sales generate not only revenue for sellers, but also an increasingly large number of informed consumers. In light of these two effects, economists have shown that pricing for experience goods is generally dynamic, with prices sometimes starting high and then falling (with so-called mass market goods, where most consumers are quite sure even before consumption that they value the good highly), and sometimes starting low and then rising (for so-called niche goods, where consumers are not as optimistic about the value of the good ex ante). For this result, and a very clear summary of the theoretical literature on experience good pricing with imperfectly informed consumers, see Dirk Bergemann and Juulo Välimäki, Dynamic Pricing of New Experience Goods, 114 J. Pol. Econ. 713 (2006).
know everything at the time of purchase (such goods are actually search goods).\textsuperscript{137} For other goods and services – yogurt and (some) pharmaceuticals, and auto vehicle inspections – empirical evidence shows that consumers learn quickly about product quality and quickly adjust their purchases according to what they learn.\textsuperscript{138} For a final category of goods – automobile insurance – it seems that the opportunities for consumer experience learning are too infrequent, and switching costs perhaps too high, for experiential learning to have much of an impact on consumer buying behavior.\textsuperscript{139}

Thus for experience goods – a large and important category that includes many or perhaps most consumer durable goods – the ability of consumers to learn about quality and then base their future purchase choices on such information is likely to vary systematically with the type of good, and in particular with the speed at which consumers learn information about quality and the cost to them of switching purchases. In other words, the ability of repeat customers to punish sellers who have deceived them by simply taking their business elsewhere is indeed a market force favoring high quality experience goods and deterring deceptive claims about such goods, but its strength is not likely to be the same for all kinds of experience goods.\textsuperscript{140}

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


\textsuperscript{139} Mark Israel, Services as Experience Goods: An Empirical Examination of Consumer Learning in Automobile Insurance, 95 Amer. Econ. Rev. 1444 (2005).

\textsuperscript{140} See, e.g., Lester G. Telser, A Theory of Self-Enforcing Agreements, 53 J. Bus. 27 (1980).
quality products.141

Strictly speaking, however, the withdrawal of possible repeat business is not always sufficient for such reputational sanctions to effectively drive out cheating or disreputable sellers. Reputation can provide a perfect discipline against low quality or deceptive sellers only if all future buyers (including those who do not have first-hand experience) have knowledge of a seller’s failure to deliver on its promise of high quality.142 Some such general reputational information is provided by the increasingly important word-of-mouth communication conduit. But consumer demand for information about past seller performance elicits more than queries of other consumers. To satisfy this demand for information, the market itself, through sources such as “Consumer Reports” and “Angie’s List,” provides information about sellers to consumers. Such profit-driven information intermediaries provide the information about product quality that is necessary for market reputation to discipline and restore equilibrium in consumer markets for experience goods.143

Such intermediaries are an even more important market response to imperfect consumer information with another category of goods and services called “credence goods.” Credence goods are goods for which quality cannot be determined by the consumer even after consuming the product.144 For example, even repeat purchases and consumption cannot determine the accuracy of a seller’s claim that their dark chocolate reduces one’s chance of cardiovascular problems. As this example indicates, for many credence goods and services, expert providers often know more about the quality of good that a consumer needs than does the consumer, and because of this extreme form of information


142 As explained by W. Bentley MacLeod, Reputations, Relationships and Contract Enforcement, 65 J. Econ. Lit. 595, 614 (2007).

143 For examples of other intermediaries, see MacLeod, Reputations, Relationships and Contract Enforcement, supra note ___ at 614.

144 See Michael R. Darby & Edi Karni, Free Competition and the Optimal Amount of Fraud, 16 J. L. & Econ. 67, 68-69 (1973)(“Credence goods are those which, although worthwhile, cannot be evaluated with normal use. Instead the assessment of their value requires additional costly information. An example would be the claimed advantages of the removal of an appendix, which will be correct or not according to whether the organ is diseased. The purchaser will have not different experience after the operation whether or not the organ was diseased. A similar example would apply to replacement of a television tube, certain automobile repairs and the like. The line between experience and credence qualities of a good may not always be sharp, particularly if they will be discerned in use, but only after the lapse of a considerable period of time.”)
asymmetry, it is possible for disreputable providers to charge the consumer for goods or services never provided, or providing the wrong quantity or type of goods or services to the consumer (under under- or over-providing). 145 Credence goods are like experience goods for which the consumers’ experience provides no information to the consumer about the quality of the good or service or the truth of the seller’s statements about her needs, unless first analyzed and interpreted by a third party expert. Indeed, because the consumer can be perfectly satisfied with the observed outcome and yet have received the wrong good or service or been mislead as to the good or service, direct consumer sanctions – such as failing to buy again from or bad-mouthing a particular seller – are inherently limited in the case of credence goods. 146

For this reason, it is perhaps unsurprising that the market alone suffices to discipline credence good suppliers if and only if a number of very restrictive conditions are met. 147 Still, while it is in general more difficult for third parties to evaluate and provide information to consumers about the quality of credence goods and services than to evaluate and provide information about experience goods and services, it is not impossible. In the medical service area, for example, a number of states have recently begun to provide so-called “medical report cards” that give consumers accessible information about crucial medical outcomes (such as mortality rates) at different hospitals. While it is unclear whether such report cards are having their impact on patients – who choose to stay away from hospitals with bad report cards – or hospitals – who either terminate poor-performing physicians or encourage them to alter their practice patterns – there is evidence that such reports have significantly improved outcomes at the low quality hospitals in particular. 148

145 This description of credence goods is from Uwe Dulleck and Rudolf Kerschbamer, On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods, 64 J. Econ. Lit. 5, 5-6 (2006).
146 See Dulleck and Kerschbamer, On Doctors, Mechanics, and Computer Specialists, supra note __ at 11.
147 Including observability or verifiability, neither of which is likely to hold in the typical credence goods situation. See Dulleck and Kerschbamer, On Doctors, Mechanics and Computer Specialists, supra note __ at 12-17.
148 See David M. Cutler et. Al., The Role Of Information In Medical Markets: An Analysis Of Publicly Reported Outcomes In Cardiac Surgery, 94 Amer. Econ. Rev. 342 (2004), who studied the impact of the oldest medical report card system in the U.S., the Cardiac Surgery Reporting System (CSRS) in New York State. Using data on the distribution of risk-adjusted mortality rates across hospitals over the period 1991-1999,
In concluding this discussion of experience and credence goods, it is important to emphasize the very real welfare consequences of consumer deception. The weaker the ability of consumers to verify quality through experience or outside certifiers, and the less informative is seller reputation, the greater the probability that a consumer will buy a poor or deceptively low quality good. Prices will send the wrong signals for the allocation of productive effort and capital, and because they will sometimes pay more than a product is worth to them, consumers will be hesitant to buy at all. While not as extreme as the lemons market non-existence result, the practical consequence of consumer deception is to shrink the market in a socially undesirable way. 149

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

The primary mechanism underlying market forces for consumer protection is accurate and verifiable information. However they obtain it -- whether through search, product use, or third party evaluators – it is such information that allows consumers to discipline sellers who engage in deceptive practices by taking their business elsewhere, and to reward with their continuing business sellers who establish a reputation for honesty and quality. From the point of view of supporting these positive market forces, the key question about the current CPA regime is whether or not the signal sent by CPA liability adds to the amount of useful information possessed by market participants, or instead detracts from it. Our earlier analysis of both the CPA process and the substantive standard for CPA liability strongly suggests that the current CPA regime may significantly blur the information that consumers have about producers, thus hindering rather than supporting market forces.

The primary defect of the CPA regime as currently configured is that it creates incentives for class action attorneys to bring suits in order to obtain settlements from defendants whose conduct was almost surely neither deceptive nor misleading in any meaningful way.

Cutler et. Al. found evidence indicating that the system especially improved the performance of low-quality hospitals. Hospitals labeled as high mortality initially decreased bypass surgery volume by about 10 percent (for an average-sized hospital), with the decrease almost entirely among the healthiest patients (who presumably did not need the surgery at all in many cases).

Announcements of settlements of claims that are actually meritless may convey false information to consumers. More importantly, for sellers who are selling precisely the goods that they claim to be – honest sellers – the prospect of being sued and ending up paying potentially large class actions settlements lowers the return from such honest behavior relative to the return from opportunistic behavior. To be blunt, if a seller is going to be sued under a state CPA and made to pay roughly the same amount regardless of whether or not she has tried to increase her sales and profits by deceiving consumers, then why would she rationally give up the extra profits obtainable through deception? By both confusing consumers and confronting honest sellers with a risk of CPA liability, the current CPA significantly interferes with market mechanisms for consumer protection.

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

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

1. The Power of Contractual Commitment

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

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

2. Common Law Fraud and Information Disclosure

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

In practical terms, the way in which such market disclosure works is elegantly simple. Simply by asking sellers to describe the various attributes of the good for sale, consumers elicit either vague answers – at the extreme, the answer of “we don’t know, it could be

150 See Grossman, The Informational Role of Warranties, supra note __ at 470-477.  
151 See Wernerfelt, Selling Strategies for Search Goods, supra note __.  
152 See, for example, Grossman, The Informational Role of Warranties and Private Disclosure, supra note __. See also See, e.g., Paul H. Rubin, Regulating Deception, 10 Cato J. 667, 679 (1991)(“There is much support in the recent literature for the proposition that, as long as deception is not allowed, there are incentives for sellers to disclose even the negative attributes of their products. This is because consumers will rationally assume that any advertisement which omits a critical piece of information (say, the durability of a product) will imply that the value of that attribute is the lowest level.”)
anything” – or precise answers. A perfect fraud rule confronts sellers with certain large penalties if they make a false precise statement. Hence with such a fraud rule in place, sellers either make an accurate precise statement about product quality, or a vague statement. But this is precisely the set of options that generates the unraveling result: high quality sellers precisely reveal product quality, and consumers rationally infer the lowest quality consistent with a vague seller disclosure, causing all sellers to precisely reveal product quality. Thus if consumers know that the common law fraud doctrine prevents sellers from lying to them about product quality, then consumers themselves can elicit full disclosure even about multi-attribute items simply by asking sellers to describe the various attributes of the goods for sale.

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

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

The various costs and errors of common law litigation mean that legally enforceable promises can be exploited by opportunistic sellers and consumers. An opportunistic seller can provide a warranty without any intention of honoring the warranty should the product fail. To the extent that some buyers will rely on the warranty, those consumers are harmed. Moreover, such a phantom warranty can cause a competitive imbalance by giving an advantage (perhaps only temporary) to the dishonest sellers. In the extreme, a lemons market can develop.  

153 Of course, legitimate sellers also have an interest in removing honest sellers
Conversely, opportunistic consumers might well take advantage of liberal and legally enforceable return policies to use and then return non-defective durable goods, essentially obtaining a free rental. Similarly, opportunistic consumers might claim breach of warranty for quality defects due not to anything that the seller did, but to the consumer’s own mis- or overuse of the product. Such consumer opportunism causes sellers to limit the range of legally enforceable promises that they make to consumers, making it more difficult for high quality, reputable sellers to signal their type to consumers, and ultimately hurting honest but imperfectly informed consumers.154

The primary “consumer law” provisions of the common law — actions for fraudulent misrepresentation or negligent misrepresentation — are similarly far from the ideal market support mechanisms.155 A common law action for fraudulent misrepresentation generally required the plaintiff to show that the defendant intentionally and knowingly deceived the plaintiff regarding a material fact and that the plaintiff justifiably relied on the misstatement which caused the plaintiff’s financial loss.156 It was difficult for consumers to prove these elements. Even when a plaintiff could prove all of the elements, common law actions were viable only when the plaintiff’s damages were large enough to justify the cost of suing, something that was not often the case in typical consumer fraud actions.157

The common law of fraudulent misrepresentation was gradually supplemented by negligent misrepresentation which allowed recourse even when the defendant did not knowingly misrepresent a material fact from the market. They often achieve this through enactment of special interest legislation limiting entry into the market.


156 Restatement (Second) of Torts § 525 (1977).

but did so because of lack of reasonable care in ascertaining the truth.\textsuperscript{158} Specifically, a plaintiff had to show that the defendant made a false statement because of lack of reasonable care in determining the facts or in the manner of expression or an absence of skill or competence expected in a given industry or profession.\textsuperscript{159} The plaintiff also had to show that it was reasonable to rely on the defendant’s statement and the statement caused the plaintiff’s injury.\textsuperscript{160} These last few requirements gave plaintiffs the same problems that abounded with fraudulent misrepresentation, mainly that the common law had no form of recourse to punish the defendant before the plaintiff went through with the transaction and that the cost of bringing the suit far outweighed the actual damages. Contract law was equally unhelpful because businesses were often able to make false claims in their advertising materials without actually entering into a contract.\textsuperscript{161}

\textbf{4. The Common Law’s Shortcomings: A Role for Federal and State Consumer Protection}

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

i) Imperfect Determination of Liability: the general imperfection the common law process in determining whether warranties and similar promises have been breached and in determining whether a false statement had been knowingly or negligently made;

ii) Disproportionate Costs of Liability Determination: the tendency for individual costs of bringing suit to be greater than the loss from seller deception about product quality.

These analytical conclusions tell us what a consumer protection regulatory system (whether federal or state) would look like if, as its proponents originally intended, it were truly designed to supplement the shortcomings in the consumer protections provided by a market system subject only to the common law.\textsuperscript{162} Such a system would indeed need to

\textsuperscript{158} Restatement (Second) of Torts § 552 (1977).
\textsuperscript{159} Id.
\textsuperscript{160} Id.
\textsuperscript{161} Restatement (Second) of Contracts § 26 (1981).
\textsuperscript{162} See Muris, supra note __, at 14 (“Consumer protection policy also has a vital role in supporting markets. It helps ensure that consumers can make well-informed decisions about their choices and that sellers will fulfill their promises and not increase sales by lying about their products. Thus, prevention of deception helps consumers in
locate a procedural device for overcoming the lack of viability of individual suits. The class action is such a device. But it would not need to supplement the class action with statutory, enhanced or punitive damages. And most importantly, it would need to send a signal that is very clear ex ante as to precisely what kinds of seller conduct and seller communications run afoul of the statutory standard. As we have argued, the current CPA regime of private enforcement does not do this.

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

As described earlier, in supplementing market and common law forces for consumer protection, CPAs do not stand alone, but against the background provided by FTC regulation. Such regulation is indeed the traditional (and sometimes economically recommended) response to a perceived inadequacy of markets and the common law.\(^{163}\) On the view that the purpose of state CPAs are to supplement optimally the gaps in deterrence already achieved by the market and the common law, as well as federal enforcement, the logical question to ask is whether and how the FTC regulatory regime needs to be supplemented at all.

1. Key Aspects of the FTC Enforcement Regime

Perhaps the most direct, market-oriented regulatory strategy to two ways: first, most obviously, by deterring deceptive sellers; and second by making it easier for honest sellers to make credible claims about their products.

\(^{163}\) In addition to state and federal consumer protection law, the federal antitrust laws, embodied in the Sherman Act and Clayton Act, provide another constraint on business activities. While consumer protection law is aimed at protecting consumers directly, antitrust law governs the interaction between competitors in the marketplace. Specifically, antitrust law controls the supply side of the market, by proscribing collusive and exclusionary tactics among competitors or unilateral action by a firm aimed at curbing competition. Consumer protection, on the other hand, regulates the market on the demand side, ensuring that consumers make well-informed decisions and that sellers provide accurate and reliable information. Nonetheless, consumer protection and federal antitrust law complement one another, by serving the common purpose of improving consumer welfare. There is, however, an overlap between these two means of market regulation. Whereas, consumer protection law directly governs transactions between buyers and sellers, it indirectly governs competition between sellers. For example, when a seller uses deceptive methods in order to generate sales, those sales come at the expense of lost sales to honest sellers. Furthermore, unfair and deceptive business practices of one or a handful of sellers may spread ill will throughout an entire industry, impacting all competitors in the industry by reducing the primary demand in general for a certain product or service.
protect consumers from exploitation due to incomplete, asymmetric information is for the government to simply require sellers to disclose certain information to consumers. This has been the predominant approach of federal securities regulation since its inception in 1933, and other federal agencies adopt a similar strategy for at least part of their regulatory function (e.g., Consumer Product Safety Commission, Food and Drug Administration, and Occupational Health and Safety Administration). Another regulatory strategy is for government regulators to promote competition through antitrust policy on the belief that “robust competition in a strong market is the primary bulwark of consumer protection.”

Congress expanded and clarified the FTC’s consumer protection function in 1938 when it amended the FTC Act to grant the Commission the power to regulate all “unfair or deceptive acts or practices in commerce” regardless of whether the act affected competition between businesses or merely the communication between a business and consumer. The Wheeler-Lea Act of 1938 left the task of determining what constituted “unfair or deceptive” to the Commission. It has been suggested that the difficulty in pinning down a definition of “unfair or deceptive” and the evolving nature of the terms explains why Congress delegated that duty to a bi-partisan expert commission and empowered it with the tools to stop unfair and deceptive trade practices. Those definitions continue to develop through agency guides, FTC rulemaking and through administrative adjudication and

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164 Muris, supra note __, at 3.
166 The Federal Trade Commission was originally created to prevent monopolistic activity within the business community. See Federal Trade Commission Act, Pub. L. No. 62-203, 38 Stat. 717 (1914) (codified and amended at 15 U.S.C. §§ 41-58 (2000)) (establishing the FTC). Specifically, Congress charged the FTC with preventing “[u]nfair methods of competition.” § 5, 38 Stat. at 719. Later, when the FTC attempted to regulate product advertising, the Supreme Court held that Congress only granted the FTC authority to regulate anti-competitive activity and therefore the agency could not regulate things such as deceptive advertising aimed at consumers. See FTC v. Raladam Co., 283 U.S. 643, 654 (1931) (holding that the FTC had no authority to regulate an advertisement promoting a supposedly ineffective weight loss product where only consumers were harmed).
168 Schwartz & Silverman, supra, note 9, at 11.
case law.\textsuperscript{169}

The current FTC definition of an unfair act is one that “causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or competition.”\textsuperscript{170} As applied, the definition of unfairness is determined by a comparison of benefits and costs of the action.\textsuperscript{171} The definition of a deceptive act currently involves the examination of a series of factors: “First, there must be a representation, omission or practice that is likely to mislead the consumer. . . . Second, we examine the practice from the perspective of a consumer acting reasonably in the circumstances. . . . Third, the representation, omission, or practice must be a ‘material’ one.”\textsuperscript{172} Under contemporary regulatory practice, the FTC decides whether an advertisement is false or misleading by looking at the “percentage of consumers who interpret the ad as making a given claim, often relying on empirical tests...that involve showing the disputed ad to a representative sample of consumers.”\textsuperscript{173} As explained by Richard Craswell, framing the question this way has allowed the FTC (and federal courts) to look and apply a “sliding scale, in which the number of consumers affected and the seriousness of their potential losses are both taken into account.”\textsuperscript{174} Under this approach, the greater the importance of the product attribute advertised – and the injury that would therefore be done if consumers were mislead about it – the smaller the threshold proportion of consumers that are mislead about it for the FTC to deem the ad misleading.\textsuperscript{175}

\textsuperscript{169} The law authorizes the FTC to circulate general rules, as well as rules declaring certain practices to be “unfair or deceptive” when it thinks they have become prevalent. 15 U.S.C. § 57a (2000). The FTC also issues informal guides but they do not have the same weight as official Commission rules.


\textsuperscript{171} See J. Howard Beales III, The FTC’s Use of Unfairness Authority, Its Rise, Fall, and Resurrection (May 30, 2003), \url{http://www.ftc.gov/speeches/beales/unfair0603.shtm}.


\textsuperscript{174} Craswell, Taking Information Seriously, supra note __, 92 Va. L. Rev. 565, 597.

\textsuperscript{175} Craswell, Taking Information Seriously, supra note __, 92 Va. L. Rev. 565, 596.
As further observed by Professor Craswell, even though the FTC has not often explicitly recognized that its decisions about whether or not a seller communication is deceptive are based on such a cost-benefit calculus, “a good deal” of cost-benefit analysis in fact underlies such decisions. Thus even though the FTC does not need to show that the defendant intended to deceive, that anyone was injured, or that the defendant even made a false statement, its practice has increasingly bee guided by a consumer welfare standard, and the agency eschews bringing actions where technical or inconsequential violations have not resulted in meaningful harm to consumers.

Another feature of the FTC enforcement regime that distinguishes it from the state CPA regime is the enforcement process and remedy. Very often, the FTC issues an administrative complaint, and such complaints have over the years generated hundreds of decisions by FTC administrative law judges and thousands of consent agreements. In addition to the administrative law process, the FTC now “frequently” uses the additional enforcement authority given to it in 1975 to go directly into federal court, where the remedy is usually a cease and desist order, injunction or settlement.

2. State CPAs Fail to Optimally Compliment FTC Enforcement

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

Suppose first that the FTC is doing precisely what it should be doing on economic grounds. We call this the faithful agent model. This is not a fanciful case: in our view, the FTC’s cost-benefit approach to

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determining whether a selling practice or advertisement is false or misleading is based on sound economic principles. In other words, on the faithful agent view, the FTC is doing what it says it tries to do—focus its law enforcement resources on practices that cause the greatest consumer harm—and so has the economically correct enforcement target. Like every regulatory agency, however, the FTC’s budget is limited and it must therefore prioritize cases on its enforcement agenda. Undoubtedly, some false or deceptive consumer practices escape FTC enforcement simply because of the agency’s budget constraint. There is no way to know for sure how often truly deceptive practices escape FTC enforcement, but we can be sure that the probability that the FTC detects and takes remedial action against any given deceptive practice is in general less than one. If the FTC is behaving as a faithful agent, then it also seems plausible that the more widespread and serious the harm from a deceptive practice, the more likely it is that the FTC will take action to stop it, and the sooner that such action will be taken. Companies that are marketing and selling well known products and services on the national market would, we expect, be squarely and continuously on the radar screen of the FTC as faithful agent. On the other hand, firms that sell in more limited markets, for shorter time periods, may escape FTC detection and enforcement.

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

The problem of the inadequacy of FTC sanctions alone is likely to be most severe for firms that are smaller and operate on limited geographic markets (or, more generally, smaller markets) and which therefore are less likely to be on the FTC’s enforcement radar screen. If the point of state CPA laws is to offset the inadequacy of FTC sanctions alone, then state CPA enforcement should be targeted against these and other any other identifiable category of firms that are unlikely to be enforced against by the FTC.

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

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The incentive of class action attorneys filing actions under CPAs is in general to bring actions against those firms and practices that they believe will settle quickly and on relatively generous terms. As argued earlier, ideal targets for private lawsuits may include a mix of both small, risk-averse firm and large publicly traded corporations subject to potential stock market impacts. While some small firms may indeed be likely to escape FTC enforcement—and therefore ought on economic grounds to be targeted by state CPA enforcement—private class action attorneys may have an even stronger incentive to pursue large multinational companies that are especially likely be under more or less continuous scrutiny by the FTC. Unlike the faithful agent FTC, moreover, private class action attorneys have every incentive to persuade courts to expansively interpret the substantive “false” or “deceptive” liability standard to encompass selling practices which the FTC would not find to be violative of its own cost-benefit understanding of that standard. Hence, as currently configured, state CPA liability certainly supplements FTC enforcement, but it goes far beyond what would be justified on optimal deterrence grounds.

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

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182 See, e.g., Jean Braucher, Deception, Economic Loss and Mass-Market Customers: Consumer Protection Statutes as Persuasive Authority in the Common Law of Fraud, 48 Ariz. L. Rev. 829, 851 (2006)(“Concerning its deception power, the FTC has issued a particularly lucid, and conservative, statement of principles about why it will act.”)
anything, the FTC may be a bit too zealous at times, especially in its scrutiny of the largest and most visible firms. If this is so, then this further supports the argument that state CPA’s may be used much too frequently against such firms.

3. National Markets and Federalism Concerns

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

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

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

184 A recent and typical multi-state consumer protection class action illustrates this point. In April of 2006, owners of Teflon-coated pots and pans brought a suit against Dupont alleging that the company concealed information from the government that indicated that Teflon-coated cooking utensils released harmful toxins when heated past a certain temperature. David Pitt, Class-Action Status Sought in Teflon Suit, Washington Post, April 20, 2006. The plaintiffs sought to certify a class that included potentially millions of Teflon-coated pan owners in a $5 billion dollar suit. The sheer logistics of identifying, locating and contacting every owner of a non-stick pan in a single state would be impractical and, moreover, locating them in several states would be prohibitively expensive. While there are other legally acceptable forms of notice, they are not anywhere near as effective. See generally, Todd B. Hilsee, Shannon R. Wheatman, Ph.D., and Gina M. Intrepido, Do You Really Want Me To Know My
State CPAs raise the same type of federalism challenges faced by many other areas of regulation in a federal system. State tort law, and its interaction with federal health and safety regulations, has been a particularly vexing problem in recent years. Our civil justice system benefits from diffused economic and political power, but it is surely comes with its costs. The static inefficiency caused by CPAs must be balanced against the dynamic benefits of jurisdictional variety and the “laboratory” of the states. A challenge is to design institutions that maximize the net value of federalism in the face of pressure for centralized control. Although it is tempting to advocate federal domination of consumer protection because of the inefficiencies of the current system of CPAs, such centralization must be evaluated in terms of the reality that federal enforcement of consumer protection has gone through some rough times of its own. Moreover, our analysis in the preceding subsection suggests an economically sensible demarcation of federal and state consumer protection enforcement actions that allows for capturing the strength of both systems of enforcement – state CPA enforcement should be targeted against identifiable categories of firms that are unlikely to be effectively monitored by the FTC.

IV. POLICY IMPLICATIONS: REMOVE REDUNDANT “SOLUTIONS”

State CPAs are intended to complement the consumer protection policy of the FTC, and the FTC is intended to complement the consumer protection attributes of markets and the common law. Former FTC Chairman Timothy Muris has characterized the institutions of consumer protection policy – markets, common law, and regulation – as a three-legged stool. Muris cautions about the need to keep the leg of the stool balanced. Our analysis suggests that private actions under state CPAs have unbalancing negative consequences for all three legs of the consumer protection stool: Markets are distorted by the perverse incentives to either disclose too much or too little information, while news of extortionate settlement sends inaccurate signals to consumers. The common law has been distorted to the point that private CPA litigation is stacked in favor of plaintiffs as CPAs have been interpreted

by courts to limit the common law protections that reflected a balance of seller and consumer interests. And, regulation at the state level is managed by a decentralized and uncoordinated decision making by private plaintiffs attorneys who are not in any manner constrained by the traditional public interest requirements of government regulation.\footnote{For general comments on the development of such regulation through litigation, see W. Kip Viscusi, Regulation Through Litigation (2002) and \url{http://en.wikipedia.org/wiki/Regulation_through_litigation}.} Clearly, consumer protection policy is knocked out of balance by the current regime of state CPAs.

CPAs were designed to solve two simple economic problems: 1) individual consumers often do not have the incentive or means to pursue individual claims against mass marketers who engage in unfair and deceptive practices; and, 2) because of the difficulty of establishing elements of either common law fraud or breach of promise, those actions alone are too weak an instrument to deter seller fraud and deception. The most striking lesson of our analysis is that the typical state CPA – with relaxed rules for establishing liability, statutory damages, damage multipliers, attorneys fees and costs, and class actions – solves the basic economic problem that CPAs were intended to address several times over. The effect of this redundancy in solutions is that CPAs can deter the provision of valuable information to consumers and, thus, harm consumers. That is, as currently applied, state CPAs harm consumers. This need not be the case.

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

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

**A. Different Rules for Class Actions versus Individual Actions**

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

**B. Class Actions Should Meet a Consumer Welfare Standard**

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

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

At a common sense level, it seems obvious that CPAs should be interpreted to promote consumer welfare. The FTC’s consumer protection mandate is now interpreted to be the promotion of consumer welfare. In some states, the CPAs explicitly instruct judges to consider and give weight to FTC precedent. In fact, Florida, Hawaii, Idaho and Tennessee, among others, require direct consistency with federal precedent. And even without explicit mandate, many state courts will often defer to FTC precedent in construing the language of their CPA statutes. Finally, some CPAs create private rights of action against violations of the separate antitrust laws in that state (sometimes referred to as “mini-Sherman” or “mini-Clayton” Acts), which can allow more direct adherence to the standard of promoting consumer welfare by prohibiting anti-competitive practices. However, numerous judicial interpretations have opened the door to actions that may harm consumer

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189 See Bauer, supra note , at 148, Table 1.


191 Bauer, supra note , at 146-47.

welfare. The so-called “no loss” cases provide a perfect example of the type of action that would not be allowed under a consumer welfare standard. If a loss is so remote or so difficult to prove, perhaps it should not be actionable.

The current state of judicial interpretations may be a classic example of the law of unintended consequences. The judges may simply be carrying out what they perceive as the legislative intent. However, the multifaceted penalties in CPAs suggest that a better approach would be for the judges to be constrained by requiring the plaintiffs to make a credible story of how the action would promote the consumer welfare – beyond simply alleging that it is a violation of the public policy as reflected in the relevant CPA.193

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

The FTC’s expertise in consumer protection far exceeds what can be expected of state courts. As discussed above, the FTC’s definitions of unfair and deceptive practices reflect a consumer welfare standard and the balancing of costs and benefits of intervention that is simply not a part of the typical consumer action – individual or class – under state CPAs. It is logical and reasonable for state courts to rely on the expertise and experience of the FTC in consumer protection matters. First, the FTC actually played an active role in encouraging the adoption of the “Little FTC Acts.” The FTC helped create this leviathan, so perhaps it should help solve the problem. Second, state courts initially deferred to FTC interpretations,194 but recent applications under CPAs have strayed far from that original relationship. Indeed, it is clear that

193 If actual damages are greater than statutory damages, then the presumption should be that the concerns about a case not being worth bringing have been satisfied. The expected recovery and the incentive to sue have been sufficiently increased by the CPA to solve the access to the courts issue, and certainly to provide increased deterrence, and thus judges should not further expand access to the courts through liberal interpretations of other aspects of the case – such as intent and reliance. That is, if the deterrence has been increased by the statute, there is no need for judges to add to the statutory incentive structure.

many actions under CPAs would not be entertained by the FTC. Third, the FTC has developed a great deal of expertise in consumer protection and brings thousands of consumer protection complaints every year. If a complaint would not be pursued by the FTC, then a similar complaint should not move forward in state court. Fourth, in general, neither state agencies nor state courts have developed the expertise to analyze consumer protection issues.

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

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

The FTC consumer protection function logically extends to attempting to influence private litigation that threatens to harm consumer welfare. A proactive role by the FTC would be for the Bureau of Consumer Protection to file amicus briefs with its staff’s analysis of the likely impact of the case on consumer welfare. Another approach would be for the FTC, possibility at the suggestion of the judge hearing the case,\textsuperscript{195} to file a simple statement that similar practices have been investigated by the FTC and deemed to not contradict the FTC standards for unfair and deceptive.

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

The availability of the class action procedural device overcomes the problem of inadequate individual incentives to seek relief for false or

\textsuperscript{195} Judges may request the FTC’s advice on the economics of various practices. The FTC staff routinely response to FTC requests.
deceptive seller practices and also provides very strong incentives for plaintiffs’ attorneys to discover and then pursue claims against sellers who have engaged in false or deceptive practices. The attorneys fee incentive in pursuing class litigation gives plaintiffs’ attorney a very strong incentive to monitor and investigate seller communications. For this reason, the class action device itself increases the probability that false and deceptive seller practices are detected and trigger liability. While the probability of detection and liability may rarely be equal to one, in class action CPA litigation, it will generally be sufficiently high that punitive damages are not necessary for optimal deterrence. When punitive damages are awarded, the multiplier should rarely exceed one.

F. Regulatory Compliance Defense

When a business has complied with state regulatory mandates, compliance with such standards should be an absolute defense to private CPA actions under that state’s law. Yale Law Professor Alan Schwartz has argued that such compliance should exculpate compliant firms as a matter of law.\textsuperscript{196} The “regulatory compliance defense” – which is also called the “regulatory standards defense”\textsuperscript{197} – would allow manufacturers and service providers a reasonable degree of certainty in acts and practices. One implication of the regulatory compliance defense is that courts court put a quick end to cases such as Avery v. State Farm Mutual Insurance Company where State Farm was hit with a billion dollar punitive damages judgment for using generic replacement parts when the state insurance regulations encouraged them to use such parts to save money for policy holders.\textsuperscript{198} Moreover, it seems totally reasonable to insulate businesses from punitive damages awards when they comply with relevant regulations.

Adoption of these modest proposals would be major steps toward reducing the corrosive effect of private actions under state CPAs. Many of these steps are consistent with what Victor Schwartz and Cary

\textsuperscript{196} Alan Schwartz, Statutory interpretation, capture, and tort law: the regulatory compliance defense Schwartz, 2 Am Law Econ Rev. 1-57 (2000).

\textsuperscript{197} See, e.g., Victor E. Schwartz and Cary Silverman, Punitive Damages and Compliance with Regulatory Standards: Should a Manufacturer or Service Provider Be Punished When It Follows the Law? Washington Legal Foundation, Legal Backgrounder, Vol. 12, Number 1 (September 2005)

\textsuperscript{198} See note supra.
Silverman call “common sense interpretation” of the statutes.\footnote{See note 9, supra.}

V. CONCLUSION

Just as unintended consequences resulted from the states’ desires to empower consumers, any reform of state CPAs will equally need to be cognizant of reaching beyond the policy objectives of restoring balance to this area of the law. The framework developed in this article demonstrates that a relatively simple and straightforward set of policy reforms can make state CPAs a valuable tool for deterring socially harmful false and misleading seller practices while preventing the threat of massive CPA liability from chilling the communication of socially valuable product information. These reforms recognize the deterrent power of class actions lawsuits, but discipline such suits by looking to federal regulatory standards for the substantive regulatory standard and by eschewing procedural devices (such as attorney’s fees and damage multipliers) that the class action makes unnecessary. Properly reformed state CPA’s can advance the interests of both consumers and sellers in providing information to and driving fraud from consumer markets.
APPENDIX. THE ECONOMICS OF PRIVATE ACTIONS UNDER STATE CPAs

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

1. Clarifying the Economic Rationale for Attorney Fee Shifting and Damage Multipliers: The Defendant’s Incentives

We begin with the defendant’s incentives. These are a function of: the sanction that the defendant expects to pay in the event that it is sued, which we call $D$; the cost to the defendant of taking actions that lower its risk of having to pay the sanction, which we denote by $x$ (equal also to the level of precautions with normalized per unit cost of 1) and three probabilities: that harm occurs, which we denote by $h$; that it is sued given that harm occurs, which we denote by $s$; and the probability that it has to pay the sanction $D$ if sued, which we denote by $q$. Consider a simple case where the defendant is risk neutral, and either takes the action and reduces its probability of harm and suit to zero, or does not take the action. In this case, the defendant’s choice is:

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

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

$$\min \{hH, x\}, \quad (2)$$

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

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

\[hsqD = hH,\]

or simplifying and solving for \(D\), we have that:

\[D = H/sq.\] (3)

Equation (3) gives the basic economic rationale for punitive damages.\(^{200}\) Whenever the probability of suit and sanction are less than one, a rational, cost minimizing defendant will have too weak an incentive to take costly harm-averting action. To equate the social and private benefit of taking care, the optimal sanction must be multiplied up by a multiplier that equals the inverse of the probability of suit times the probability of liability. For example, if the probability of suit is .5, then even if the probability of paying damages \(D\) when sued is very high, say .9, damages must be set equal to \(H/(.9)(.5)\) or roughly 2.2 times \(H\) in order to restore optimal incentives.

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

\(^{200}\) See A. Mitchell Polinsky and Steven Shavell, Punitive Damages: An Economic Analysis, 111 Harv. L. Rev. 869 (1998). Amicus briefs based on this economic model of deterrence have been filed by each side in both of the most recent Supreme Court cases on punitive damages – State Farm v. Campbell and Philip Morris v. Williams. See Brief of Amici Curiae of A. Mitchell Polinsky, Steven Shavell, and the Citizens for a Sound Economy Foundation in support of Petitioner, State Farm Mut. Automobile Ins. Co. v. Campbell, 123 S.Ct. 1513 (2003) (No. 01-1289); Brief of Keith N. Hylton as Amicus Curiae in Support of Respondents, State Farm, 123 S.Ct. 1513 (2003) (No. 01-1289); Brief of Amici Curiae of A. Mitchell Polinsky, Steven Shavell, and the Cato Institute in Support of Petitioner, Philip Morris USA v. Williams, 127 S.Ct. 1057 (2007) (No. 05-1256); Brief of Amici Curiae of Professors Keith N. Hylton et al. in Support of Respondents, Philip Morris USA v. Williams, 127 S.Ct. 1057 (2007) (No. 05-1256). A recent application of this model to punitive damages is Judge Richard Posner’s opinion in Mathias v. Accor Economy Lodging. 347 F.3d 672 (7th Cir. 2003).
actual harm, then the defendant will invest far more to lower the probability of liability than is socially optimal to reduce just the probability of harm.

There is, however, an important qualification to equation (3), one that in fact explains why American law generally awards punitive damages against a defendant only if the plaintiff can show a very high degree of defendant fault. Equation (3) essentially assumes that $q$, the probability of sanction given suit, is less than one only because sometimes careless or faulty defendants somehow escape liability. But this is of course only part of the story. A defendant’s behavior may be reasonably careful, and yet the defendant may face a positive risk of liability $q$ even when it in fact did nothing wrong. If the law routinely awarded punitive damages according to the formula in (3), then punitive damages would be higher, the lower is the probability that the defendant will be found liable for such damages. Assuming that the legal process is imperfect but nonetheless rational, a lower probability of liability for punitive damages means that the defendant’s behavior was less, rather than more, culpable. Optimal incentives require that liability falls as culpability falls, not the opposite.

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

$$D = \frac{H}{s} \equiv mH,$$

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

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

As our focus is not on issues relating to risk and uncertainty, we shall assume that consumers are risk neutral with respect to the decision whether or not to bring suit. We shall also assume away agency cost problems, and presume that the consumer controls the level of effort and hence cost of any lawsuit that she were to bring, so that costs are optimally chosen, given the probability of success in a particular type of claim and possible payout.\(^2\) This means that consumers value their risky right to bring suit by its expected value, net of the cost of suit. Assuming that plaintiffs are economically motivated and rational in a very basic sense – in that they will undertake suit only if they perceive that suit has a positive net expected value – an injured consumer will bring suit if and only if her expected payout is bigger than her expected cost. Using the notation just defined, the consumer will bring suit if and only if:

\[
qD \geq c, \quad \text{or,} \\
q \geq \frac{c}{D} = q^T.
\]

Inequality (5) defines a threshold probability of success in getting a payout from suing, \( q^T \), below which the plaintiff expects a negative net expected return from suing and therefore will not sue. From (5), we can see that this threshold probability \( q^T \) is higher – and suit less likely to be in the plaintiff’s interest – the higher are the plaintiff’s costs \( c \) and the lower is the plaintiff’s expected payout \( D \). In the classic consumer deception case that CPAs were intended to address, any individual plaintiff suffers only very small, economic harm and therefore expects a

\(^2\) As our focus is on types of claim, we presume that the probability of success and magnitude of payout is determined solely by the claim type, rather than by the effort level of the plaintiff’s attorney. In a more complete model, the effort level would be chosen optimally so as to solve the problem \( \max_c \{ q(c)D(c) - c \} \). The threshold probability we discuss in the text is then to be understood as the constraint that the solution to this problem generate a non-negative return.
small payout $D$, so small that such a plaintiff would not find a lawsuit to be worthwhile, even if $c$, her cost of suit, is small. In addition, as we discussed earlier, the traditional common law tort elements together worked to create a relatively low probability that the plaintiff would prevail at trial and hence also (for reasons we shall come to momentarily) a small probability $q$ that the plaintiff would get a payout either from settlement or a trial award. With no one to bring suit, ex post legal sanctions have no deterrent effect, and we have precisely the underdeterrence problem that CPAs were designed to address.

With the help of Figure 1 below, we can make these points more precise, and pave the way for analysis of the procedural changes introduced by CPAs. Figure 1 graphs a mass marketer’s perceived probability of liability: its probability of being sued for unfair trade practices and having to pay the amount $D$ in damages. This probability is given by $g$, and it is equal to the probability of being sued, which we will denote by $s$, multiplied by the probability of being found liable for damages in the amount $D$, which as above is given by $q$. What we have just shown is that for $q < q^T$, the probability of suit, $s$, and hence also the probability of liability (given by $g = qs$) is 0. Figure 1 depicts a simple case in which for $q \geq q^T$, we have $g = q$ (suit is always brought once it is economically viable, and so the probability of having to pay $D$ is simply given by $q$).
The procedural innovations made by CPAs – attorneys fees and various damage enhancers – affect the incentives depicted in Figure 1 on both the cost side and payout side. On the cost side, assuming that attorneys’ fees that are paid when the plaintiff is successful in getting a payout (either in the form of settlement or a trial award) and fully cover the plaintiff’s costs, the attorney’s fee provisions of CPAs lower the plaintiff’s expected cost of bringing a lawsuit from \( c \) to \((1-q)c\). Punitive damages, with damages equal to a multiple \( m \) of compensatory damages...
$D$, a common feature of CPAs, would of course increase the plaintiff’s payout from $D$ to $m(m+1)D$. With these two changes, plaintiffs will now find suit worthwhile whenever:

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

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

\footnote{In the more complete model, with plaintiff effort affecting both the probability of success and the magnitude of the payout, the optimal effort level would change under a CPA. And because the CPA both lowers the plaintiff’s expected cost and increases the plaintiff’s return, the plaintiff would generally choose a higher level of effort – that is, cost – under the CPA than under the common law. However, for any level of cost, the plaintiff gets a higher expected return under the CPA, and so the threshold probability would move in a model with cost endogenous as it does in our text and Figures.}
By looking back at inequality (6), we can see inherent limitations on the effect of attorney’s fees plus treble damages in a typical consumer action. The impact of these procedural innovations is limited by the relationship between the cost of suit and the actual damages $D$ suffered by the plaintiff. If the damages are very slight relative to the cost of suit, then the threshold probability for suit to be viable will remain high even under a CPA that awards attorneys fees and punitive damages. With very small individual damages, then even if successful plaintiffs get their attorney’s fees back and get treble damages, individual plaintiffs will have an incentive to bring suit only in cases that are virtually sure winners (that is, for $q \to 1$). Similarly, statutory damages of, say, $2,500$ per claim, may not solve the incentive problem.

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To see this most clearly, consider the limiting case, when $D \to 0$. In this case, as can be seen from inequality (2), the threshold probability even under treble damages remains very close to 1.
Thus, in our model, the procedural innovations of CPAs – attorneys fees, costs, and enhanced damages – by themselves fail to solve the economic problem of individual actions with small amounts at stake. On the other hand, the substantive changes brought about by CPAs – e.g., relaxation of traditional common law requirements of reliance, causation and injury – greatly increase the likelihood of success by plaintiffs. Arguably, this is precisely what CPAs were intended to accomplish – help solve the incentive problems of plaintiffs with relatively small claims. However, as shown in the following section, these salutary effects in the individual consumer cases of CPAs’ procedural and substantive innovations have a perverse effect when combined with class actions. Indeed, the logic of extending the procedural and substantive innovations that were intended to help individual consumers achieve redress to large classes is flawed.

3. Adding the Class Action to the CPA Equation

(a) Class Actions versus Individual Common Law Actions

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

\[
\max q \left( \max(rnD, c) \right) - c.
\]

A quick look at (7) shows that if the most that a class action attorney could hope for in the event of success was to get back her fees, \( c \), then she would have no incentive to pursue the action, no matter how likely,
because her expected payout would be less than or equal to zero. In general, the attorney expects a payout that is a share of the class damages (that is, \( \max \{rnD,c\} = rnD \)). In this case, the attorney pursues the class action if and only if:

\[ qrnD - c > 0, \text{ or if } q > c/rnD. \]  

(8)

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

\[ rnD > D, \text{ or if } r > 1/n. \]  

(9)

What inequality (9) says is that the larger the number of plaintiffs in the class (on behalf of each of whom, the attorney recovers an amount \( D \)), the lower is the attorney’s share of the payout sufficient to ensure that the class action will enhance the viability of suit relative to individual common law actions. For a very large class (\( n \) large), even for a relatively low share of the payout, class action attorneys will find it worthwhile to file a large range of low probability of success lawsuits that an individual plaintiff would not file. For example, even for a very small class action of only 10 plaintiffs, the attorney’s payout from filing will be higher than the individual plaintiffs’ whenever the attorney expects to get a share of the payout that is bigger than or equal to 10 percent. For a more typical large class of 10,000 plaintiffs, the attorney’s expected payout will be bigger than that of the individual class members whenever that attorney expects to get more than .0001 share of the class payout. Hence for any reasonably large class action, the attorney’s expected payout will be higher than what the individual plaintiffs would have expected, and so significantly more lawsuits will be brought simply as a consequence of the class action procedural device.

(b) Class Actions, CPAs and Overdeterrence

The only exception to this would be an attorney who would otherwise be unemployed, for such an attorney would perceive an opportunity cost less than her hourly fees – that is, she would get an hourly-based amount \( c \) if successful but her actual cost of pursuing the action would only be some fraction of her actual hourly rate (if she were certain to be otherwise unemployed, it would equal only the unemployment compensation amount, if any). Our exposition in the accompanying text is presumably the more general situation.
Under very general circumstances, the class action will make unnecessary the enhanced damage provisions of CPAs. The reason is that when both procedural devices exist – that is, CPA class actions – the threshold probability of success for suits to be brought will be even lower than with CPAs or class actions alone. Even more importantly, in terms of the deterrence effect, class actions and punitive damages are completely duplicative: they both essentially give the plaintiff’s attorney the right to enforce against the defendant a large multiple of any individual plaintiff’s damages. Therefore punitive damage multiples that essentially assume that there is no class action will be higher than the level that is necessary to optimally deter defendant’s from socially harmful behavior.

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

\[ q > \frac{c}{mnrD + c} = q^{r}. \]  

Comparing inequality (10) with inequalities (6) – (8), we can see how CPA class actions generate the lowest threshold success probability suits to be viable. This threshold probability falls, the bigger is the punitive damage multiplier \( m \). Were we to place the threshold \( q^{T'} \) in Figure 6[No Figure 6. Figure 2?], it would lie quite far to the left of \( q_{cpa}^{T} \).

What class actions CPAs with punitive damages do is to effectively give the plaintiff’s attorney the right to enforce the rights of \( mnr \) individual plaintiff (where, to recall, \( m \) is the punitive damage multiplier, \( n \) is the number of plaintiffs in the class, and \( r \) is the attorney’s share of the award.) Especially for large class actions of say 10,000 or more, even if the plaintiff attorney gets only 25 percent of the recovery \((r = .25)\), the class action alone gives the attorney a very large expected recovery. Multiplying this recovery by the punitive damage multiple \( m \) further enhances the attorney’s expected payout. All of these devices together create such a large expected payout for attorneys that they have an incentive to sue even if the probability of receiving a recovery (which we denoted earlier by \( q \)) is low. Because of this large expected payout, the combined effect of class action representation with attorneys fees and punitive damages – the CPA procedural package – is to drive the probability of suit (denoted as above by \( s \)) close to 1 even for suits with a low probability of success.
Now recall from our earlier discussion that on optimal deterrence grounds, the punitive damage multiplier \( m \) should equal \( 1/s \). If, as just argued, CPA class actions offer such a large reward to plaintiffs’ attorneys that \( s \) approaches 1, then it might seem that there should be no punitive damage multiplier: that is, \( s = 1 \) implies that \( m = 1 \). But this is a bit too simple, because as we have just seen from (10), it is the interaction of \( m \), the punitive damage multiplier; \( n \), the size of the class, and \( r \), the attorney’s share of the class recovery, that determines a plaintiff attorney’s expected reward, incentive to sue and hence \( s \). The general lesson from (10) is more complex but also more important:

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