American Enterprise Institute for Public Policy Research

GOVERNMENT BY INDICTMENT

ATTORNEYS GENERAL AND THEIR FALSE FEDERALISM

Michael S. Greve
American Enterprise Institute

AEI WORKING PAPER #110, MAY 24, 2005

www.aei.org/workingpapers
http://www.aei.org/publication22565
#18451

Executive Summary

Government by Indictment provides a critical analysis of national policymaking by state attorneys general. Increasingly, state AG investigations and prosecutions of major corporations go beyond the objective of punishing individual wrongdoing, or even of changing the conduct of corporate entities. Nowadays, many AG campaigns—which increasingly take the form of multistate actions—attempt to "reform" the internal operations and business models of major American industries. To that end, attorneys general file indictments that are designed to exact settlements from defendants who cannot afford to bet the company. "Government by Indictment" is a fitting description of this style of law enforcement.

The adverse consequences of AG activism reach beyond "mere" economics; they affect the integrity of American political institutions at all levels. Unchecked AG activism will spell:

- The re-regulation of major sectors of the U.S. economy;
- The cartelization of major American industries;
- The increased dominance of the plaintiffs' bar over American politics; and
- Substantial wealth transfers from productive enterprises to plaintiffs' lawyers and advocacy organizations with an aggressive agenda to re-regulate the economy.

Government by Indictment reviews AG initiatives in areas from antitrust and airline deregulation to the pharmaceutical and financial industries. It describes the roots of AG activism; its rise and internal dynamics; and its consequences.

Primarily, the paper emphasizes the *constitutional* dimensions of AG activism. In the aftermath of the New Deal, the U.S. Supreme Court not only expanded the powers of Congress but also, and simultaneously, authorized the states to regulate conduct beyond their boundaries. Extraterritorial regulation is the true source of AG activism. It is antithetical to constitutional federalism and destructive of sensible regulation.

First, extraterritoriality poses a grave danger that the regulating state will export the costs of regulation to citizens in other states. There will be far too much regulation, and too little state-based democratic governance.

Second, extraterritoriality inverts the competitive federalist order. If corporations and their shareholders and customers could choose an exclusive state law regime by contract (as is still the case in corporate law), they would choose a sensible regulatory regime. States would compete by offering laws that promise to maximize the number of productive transactions within their jurisdictions. In contrast, when every state can regulate transactions across the country, the most aggressive regulator—and the most

ambitious, entrepreneurial state attorney general—will dictate the terms of regulation. The inevitable result is excessive regulation.

Government by Indictment offers five pragmatic, meaningful reform options:

1. Consider extending the competitive federalism model of corporate law into other areas, especially securities regulation.

2. Overturn the 1998 "Master Settlement Agreement," through which attorneys general, trial lawyers, and tobacco firms imposed a $240 billion national excise tax and which has since become a template for multistate prosecutions and settlements.

3. Enact a Federal Compact Clause Enforcement Act, providing that multistate settlements shall require congressional approval (as the Compact Clause of Article I, Section 10 of the Constitution provides).

4. Adopt Judge Richard Posner's proposal to abolish the states' *parens patriae* authority to enforce federal antitrust law.

5. Explore means of strengthening the hands of attorneys general who dissent from the activist AG agenda.

Government by Indictment was released on May 26, 2005, at "The Role of the State Attorney General: Differing Perspectives," a conference sponsored by the U.S. Chamber Institute for Legal Reform.

TABLE OF CONTENTS

Introduction: Government by Indictment

Nary a day goes by without newspaper reports of another investigation or prosecution by attorneys general against a major corporation or industry. Many of these proceedings are quite traditional, in that they seek to punish individual wrongdoing. Increasingly, however, AG initiatives reach much beyond this objective, and even beyond the more ambitious goal of changing the conduct of corporate entities. The AG campaigns reviewed in this White Paper attempt to "reform" the internal operations and business models of major American industries. To that end, attorneys general file indictments that are designed to exact settlements from defendants who cannot afford to bet the company. The familiar phrase of "regulation by litigation" no longer captures this style of law enforcement. "Government by Indictment" is a more fitting description.

With the possible exception of the liability explosion, no development in American politics is of graver consequence to corporations and their shareholders, customers, and workers. The adverse consequences of AG consequences reach beyond "mere" economics; they affect the integrity of American political institutions at all levels. Unchecked AG activism will spell:

- The re-regulation of major sectors of the U.S. economy;
- The cartelization of major American industries;
- The increased dominance of the plaintiffs' bar over American politics; and
- Substantial wealth transfers from productive enterprises to plaintiffs' lawyers and advocacy organizations with an aggressive agenda to re-regulate the economy.

AG activism is threatening to become a permanent condition. Where did it come from and how does one deal with it beyond the level of mere crisis management? This White Paper aims to contribute to a better understanding. Chapters I – III describe the roots of AG activism, its rise and internal dynamics, and its consequences. Chapter IV explains that AG activism signals, not some temporary aberration but rather a crisis with deep constitutional roots, which will prove hard to eradicate. Chapter V provides suggestions for reform.

I. The Roots of AG Activism

False Federalism

> *States' rights are the future, and we want to do everything we can to promote them.*
>
> — Eliot Spitzer, New York attorney general[1]

State attorneys general proudly describe their exploits as federalism in action, and numerous "states' rights" enthusiasts cheer them on.[2] On this point (though not much else), the AGs' corporate targets agree with the prosecutors—while plaintively inveighing that federalism may be ill-suited to the realities of a modern economy. Both sides, however, have it wrong: AG activism is the antithesis of constitutional federalism. To borrow a felicitous phrase coined by former Solicitor General Walter Dellinger, it is a False Federalism.[3]

Constitutional federalism authorizes states to regulate their internal affairs. Justice Louis Brandeis's "laboratories of democracy" work well—often, better than uniform national regulation—*so long as states experiment on their own citizens and businesses*, not those of other states. Federalism's genius, Brandeis said, is that a single courageous state may "try novel social and economic experiments *without risk to the rest of the country*." [4] AG activism, in sharp contrast, principally extends to the affairs of other states and to the nation's affairs.[5]

Extraterritorial regulation presents a great danger that the regulating state will seek to export the costs of its policies to other states. The regulating state's citizens reap the benefits without paying anything close to the corresponding costs. Since the demand for such free-lunch fare is high, state "laboratories" become devils' kitchens that cook up clever schemes to exploit each other's citizens and businesses. There will be altogether too much experimentation and too little democracy. Economists can prove that proposition on a blackboard, and ample evidence bears them out.[6]

The idea of a "states' right" to exercise extraterritorial authority is incoherent. If equal states are to retain autonomy over their own affairs, they must refrain from regulating each other's affairs. The AGs' activism repudiates that elementary precept. Their False Federalism would have horrified the Founders—who feared its emergence and who wrote a Constitution to safeguard against it.

Means and Motives

> *"There has been this tremendous redistribution of legal power away from Washington, and who better than state attorneys general to step into the void to ensure that the rule of law is enforced."*
>
> — Eliot Spitzer, New York attorney general[7]

The AGs portray their efforts as a response to an outbreak of corporate malfeasance for which no other remedy is available. Federal regulators, they say, have failed to respond with sufficient alacrity and energy. Critics, for their part, sneer that the most dangerous place in Manhattan is between Eliot Spitzer and a TV camera, and they have identified the AGs' ambitions for higher office—famously captured in the characterization of the National Association of Attorneys General (NAAG) as the "National Association of Aspiring Governors"—as the driving force of AG activism. There is something to both of these accounts, but they do not fully explain the phenomenon.

Enron and WorldCom notwithstanding, the impression of a never-ending flood of corporate scandals is largely the creation rather than the target of AG investigations (*see* "Scandals?"). Due to globalization and increased consumer sophistication, the U.S. economy has become much more competitive in recent decades, and competition is a powerful safeguard against broad-scale corruption. And while federal regulators do fall down on the job now and then, it is unlikely that all of them should do so, all the time, in all of the arenas where the AGs have unleashed their ambitions.[8]

As for the critics' charges of AG grandstanding and lust for power, media-hungry, ambitious state politicians are as old as the republic. (In the *Federalist Papers*, Alexander Hamilton tagged them as implacable enemies of the proposed Constitution.)[9] In the Founders' parlance, the *motives* for self-aggrandizement have existed all along. What state AGs lacked until a quarter-century ago was the *means* of pursuing their ambitions for popular acclaim and higher office through nationwide anti-corporate crusades. The discovery of those means is a result of the New Deal and the repeal of important constitutional safeguards.

Side Note 1

Scandals! Scandals?

AG indictments often use isolated instances of misconduct as a lever to discredit—and then to "reform"—perfectly legal, legitimate, and often efficient business practices. General Spitzer has brought this model of law enforcement to bear on investment banks, mutual funds, and insurance brokers.

Insurance brokers solicit and negotiate insurance coverage for corporate clients. In October 2004, in a sweeping investigation of the industry, Eliot Spitzer claimed to have discovered instances of bid rigging, which is illegal. Far more broadly, Spitzer indicted the widespread industry practice of "contingent commissions"—that is, payments received by the brokers from the insurers who obtain the brokers' and their customers' business. Spitzer claimed that these commissions constitute a "kickback" that induces brokers to place business with the insurers that pay the highest commissions, rather than those that offer the most favorable terms for the brokers' clients.

The practice of contingent commissions was widely known within the industry, among the brokers' customers, and among regulators. (In the years preceding Spitzer's investigation, insurers repeatedly asked New York insurance regulators for an official ruling on the permissible scope of such arrangements.) The notion that a competitive industry could for decades sustain a practice to the detriment of a highly sophisticated customer base defies belief, and economic studies strongly suggest that contingent arrangements—in insurance and other industries—may well be efficient. Nonetheless, in response to Spitzer's *in terrorem* indictment, brokers and insurers promptly vowed to terminate contingent commissions.

Sources and References:

BRUCE JOHNSEN & STEPHEN M. HORAN, THE WELFARE EFFECTS OF SOFT DOLLAR BROKERAGE: LAW AND ECONOMICS (The Research Foundation of the Association for Investment Management & Research, 2000).

Monica Langley and Theo Francis, *Risky Business: Insurers Reel from Spitzer's Strike*, WALL ST. J., Oct. 18, 2004, at A1.

Mark V. Pauly, *The Ethics and Economics of Kickbacks and Fee Splitting*, 10 BELL J. ECON. 344 (1979).

The New Deal's False Federalism

Prior to the New Deal, the Supreme Court followed the Founders' down-to-earth understanding of government powers. Federal and state powers, according to that understanding, cannot occupy the same space at the same time. As the Supreme Court put it in an oft-quoted case, "The powers which one [government] possesses, the other does not."[10] The Commerce Clause, which authorizes Congress to regulate commerce "among the several states," was accordingly read to imply that the states must *not* regulate interstate commerce.[11] (This "negative" or "dormant" Commerce Clause forbids state interference even when Congress has declined to exercise its constitutional authority over interstate commerce.) Conversely, the grant of congressional power to regulate interstate commerce implied a lack of congressional power to regulate commerce *within* each state.[12]

This "dual federalism" compelled states to compete for business. Overregulation by one state induces business to leave that state and to locate in another, more hospitable jurisdiction. Precisely this salutary competitive dynamic prompted a wholesale attack on the constitutional order and, eventually, a constitutional transformation. The Progressives and the New Deal characterized state competition as a "race to the bottom": fearing the exit of productive enterprises, states would fail to protect workers and consumers against corporate abuses.

Modern scholarship has severely undermined the theoretical and empirical foundations of the "race to the bottom."[13] At the time, though, the idea proved immensely powerful. During the New Deal, the Supreme Court famously expanded the powers of Congress to regulate commerce within the states—in other words, to harmonize business regulation across the states and, in that fashion, to curb policy competition among them. What had once been thought to be purely local (such as workplace conditions) became national.[14]

Less famously, the New Deal Court *unleashed the states* and authorized them to tax and regulate interstate commerce beyond their borders.[15] Once thought to be inherently national, interstate commerce became the province of local regulation. The constitutional barriers to extraterritorial state regulation fell. For example, the dormant Commerce Clause ceased to operate as a subject-matter limitation ("No direct state regulation of interstate commerce"): states may now tax and regulate virtually any transaction that affects them, so long as they do not overtly discriminate against interstate commerce.[16] For another example, the state "experimentation" extolled by Justice Brandeis leapt state boundaries. A classic case in point is *Parker v. Brown*,[17] involving California's output restrictions for raisins (more precisely, the 1940 allotments for Raisin Proration Zone No. 1). At the time, California supplied some 95 percent of the nation's raisin market, meaning that the monopoly profits were reaped almost entirely in markets outside California. The Supreme Court deemed this exploitation a splendid exercise in federalism and, under the eponymous *Parker* doctrine, immunized state-sponsored cartels from challenges under antitrust and constitutional law.

This evisceration of constitutional barriers to the extraterritorial exercise of state power eroded state competition and, in its stead, created a profoundly destructive form of "federalism":

- When *every* state may regulate beyond its borders, national economic actors are subject to fifty overlapping and often conflicting regimes (as well as federal regulation). Firms and their customers no longer choose their state; instead, state officials pick their targets. A New York corporation cannot escape by moving to New Jersey or for that matter Bermuda: so long as the firm retains a single customer in New York, it will remain subject to the Empire State's jurisdiction—and to that of all other states where customers choose to do business with the firm.

- Unless firms can tailor their products to the demands of each individual jurisdiction (an expensive and, in the case of mass-marketed products, an

impossible proposition), the most aggressive state will dictate the terms of business conduct for all fifty states. State regulation will escalate.

- After the New Deal, state regulators have operated without meaningful constitutional constraint—only with the *political* constraint of federal preemption. However, Congress will often fail to monitor and discipline ambitious state regulators. As shown below, our federal political system is ill-suited to that purpose.

Side Note 2

Competition Works

Competitive federalism continues to exist in a few areas. Under corporate law, for example, corporations and their shareholders choose state law by contract. The law of the corporation's charter state governs the parties' transactions and disputes, regardless of where the parties reside. Neither the shareholder's home state nor the corporation's actual place of business has any jurisdiction over the matter. If the courts, legislature, or attorney general of, say, Delaware (where most corporations are chartered) were to embark on an anti-corporate crusade, corporations would protect shareholders' interests by re-chartering in another, more efficiency-minded state. A similar arrangement still exists in the banking sector.

Due to the continued operation of state competition, America's corporate law and its banking system are the envy of the world. However, competitive regimes persist only as a matter of statutory choice and historical accident rather than constitutional constraint. They are, moreover, rare exceptions to the general rule, under which every state may regulate any transaction that has the slightest connection to its jurisdiction.

Sources and References:

ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (2000).

Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201 (1986).

Todd Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79 (2000).

To bring the difference to a point: constitutional federalism disciplined state governments by subjecting them to competition. New Deal federalism, in contrast, empowers states by extending their regulatory reach and by blocking the exits. AG activism is a consequence of that empowerment.

The Rise of State Activism

The states' new-found powers lay largely dormant for several decades. In the 1940s and 1950s, World War II and the Cold War focused the nation's attention on Washington, D.C. In the 1960s, the Southern states' appalling civil rights policies discredited state governments. In the 1970s, the federal government launched a tidal wave of economic and social regulation, which consigned the states to a subordinate role.

The advent of the Reagan administration in 1981 changed that landscape. It heralded the beginning of federal deregulation and, more broadly and lastingly, the end of the liberal, pro-regulatory New Deal coalition that had theretofore dominated American politics. In its stead, we have inherited a long-lasting period of divided government and, consequently, regulatory deadlock.

AG activism is a response to that state of affairs. When the national government reduced the supply of regulation, the demand migrated to the states. Attorneys general, as well as legislators and courts, accommodated that demand.

II. A New Role for Attorneys General

> *For 200 years, [state attorneys general] defended the state in cases brought by outside parties or gave opinions to the governor and lawmakers on pending bills. That was basically the job. Nobody really knew who these people were. That landscape has changed forever. AGs are now major political players and policymakers. Corporate counsel need to pay attention to the new reality of multistate inquiries."*
>
> —Drew Ketterer (Maine attorney general, 1995-2001) [18]

The Changed Office of the Attorney General

The AGs' tasks were never quite so limited as the captioned quote suggests.[19] Over the past two decades, however, the AGs have amassed additional powers that would have astounded their predecessors. That sudden concentration of power in a single office has indeed changed the landscape of American politics.[20] Five characteristics stand out:

- A dramatic expansion of the attorneys' general responsibilities and authority, especially in matters affecting the national economy.
- The extensive use of the AG's powers of investigation and prosecution for explicitly regulatory and legislative ends.
- Extensive cooperation among state attorneys general offices, typically under the auspices of the National Association of Attorneys General (NAAG).
- Extensive reliance by attorneys general on the plaintiffs' bar and, in many cases, a symbiotic relation with that segment of the legal profession.
- The emergence of cooperative relations and institutional arrangements between state and federal regulators, usually on the states' terms.

These powers and practices developed in a series of AG initiatives: in the 1980s, the first coordinated responses to the federal deregulation of airlines and antitrust law; in the 1990s, a path-breaking multistate settlement between the AGs and the nation's major tobacco manufacturers—which came to serve as a template for campaigns against other industries—and, in this decade, a raft of proceedings against financial institutions.

Airlines

Prior to 1978, the federal government regulated the safety and economics of the airline industry, including setting rates and enforcing anti-fraud rules. (States also had authority to regulate airlines, but on an exclusively intrastate basis.) In 1978 Congress enacted the Airline Deregulation Act (ADA) to encourage better quality, lower prices, and greater variety of airline services. To preclude state interference, the ADA authorized federal

agencies to regulate the advertising of interstate airfares and preempted states from regulating the rates, routes, or services of any air carrier.

Responding to demands from consumer activists, state attorneys general resisted this deregulatory regime. In 1987, the NAAG issued detailed guidelines on the application of state anti-fraud laws to airline advertising and set out to regulate airfare promotions irrespective of the potential for deleterious effects on price competition. Protests by the Federal Trade Commission and the U.S. Department of Transportation, claiming that NAAG guidelines were contrary to the spirit and the letter of the ADA, went unheeded. When seven AGs informed TWA of their intent to sue to enforce the guidelines, the company responded by filing for a federal injunction. In 1992, the Supreme Court held that NAAG's advertising guidelines were preempted by the ADA.[21] Despite that setback, the airline advertising campaign proved an important chapter in the rise of AG activism:

- The campaign is an early example of concerted action under the auspices of the NAAG.

- The campaign taught the AGs the potential utility of relying on state law—in particular, loosely worded state prohibitions against fraud, deception, and unfair business practices—in countermanding federal deregulation initiatives.

Both the operation of the NAAG as a quasi-regulatory agency and AG reliance on general-purpose state laws have become permanent features of the political landscape.

Antitrust

The Reagan administration introduced sound economics to antitrust law, emphasizing market efficiency over hostility to big business. In addition to narrowing the scope of federal antitrust laws, the antitrust revolution had the incidental effect of diminishing the role of state AGs, who—along with federal agencies and private parties—enforce federal as well as state antitrust laws. Attorneys general responded promptly, defiantly, and in concert. In 1983, NAAG created a Multistate Antitrust Task Force, which soon published "Guidelines" on vertical restraints of trade (1985) and on mergers and horizontal restraints (1987). Both sets of Guidelines came close to enshrining pre-Reagan antitrust priorities as a national policy of the states, irrespective of the change in the federal government's national policy.

The NAAG Antitrust Task Force coordinates increasingly frequent multistate antitrust prosecutions, as well as state *amicus* filings in defense of state prerogatives and expansive antitrust doctrines.[22] It has played a conspicuous and highly successful role in defending "indirect purchaser" antitrust suits under state law, despite a Supreme Court decision that bars such lawsuits under federal law; in extending the reach of federal antitrust statutes to purely local, in-state transactions; and in preserving the right of states to obtain antitrust remedies (such as divestitures as a condition of merger approval) regardless of federal opposition.[23]

State antitrust activism reached its zenith (for now) in the *Microsoft* prosecution, where attorneys general insisted on additional "remedies" long after the federal government had settled its own parallel case against the company. That experience prompted knowledgeable experts (foremost, Judge Richard Posner) to demand curbs on the AGs' authority and, in particular, their *parens patriae* authority to enforce federal antitrust law on behalf of their state's citizens.[24]

Because antitrust law is fairly disciplined, it offers state enforcers fewer opportunities for free-lancing and *in terrorem* prosecutions than, say, broad prohibitions against unfair or deceptive trade practices. Still, the *Microsoft* case illustrates the potential for abuse. Beyond the confines of antitrust law, moreover, state enforcement in this area has taught the AGs valuable lessons:

- State antitrust enforcement has illustrated the possibility—and the value—of sustained, organized cooperation. The NAAG Antitrust Task Force has emerged as a de facto regulatory agency, operating alongside the Federal Trade Commission and the Department of Justice.

- The negotiation and distribution of multistate antitrust settlement proceeds has served as a template for settlements in other arenas.

- Antitrust law has shown that federal agencies and the Congress will often acquiesce in the defiant exercise of state power. The state AG's *parens patriae* authority to enforce federal antitrust law, for example, was conferred by the federal Hart-Scott-Rodino Act, which Congress could easily repeal. But despite increasingly frequent state enforcement actions at variance with federal priorities, Congress has never seriously contemplated that step. Similarly, the FTC and the Department of Justice have refrained from asserting their full authority even when state actions were inimical to federal positions (as in *Microsoft*).[25]

Tobacco

> *Had the executives of the major tobacco companies entered into such an agreement without the involvement of the States and their attorneys general, those executives would long ago have had depressing conversations with their attorneys about the United States Sentencing Guidelines.*
>
> —Second Circuit Court of Appeals[26]

The 1998 "Master Settlement Agreement" (MSA) among the AGs and the nation's leading tobacco manufacturers terminated lawsuits filed by most (not all) states against tobacco companies.[27] Notwithstanding its modest designation as a legal settlement, the MSA established a comprehensive, nationwide regime for the sale and marketing of tobacco products. The MSA further created a national cigarette excise tax, estimated at $246 billion over the first 25 years and thereafter running in perpetuity.

The settling firms' payments to the states are based on their current and future sales, not their past contributions to the alleged harms. Since higher sales entail higher payments, the MSA curbs price competition among the major producers. To preclude price competition by smaller, non-signing manufacturers, the MSA compels those firms—which had never been sued for wrongdoing, and some of which did not even exist when the MSA was signed—to make offsetting "escrow payments" to the states.

States must "diligently enforce" the agreement. A state that fails to do so may lose most or even all of its MSA payments. Enforcement is overseen by the NAAG, which periodically instructs the states to enact this or that law for the "diligent enforcement" of the MSA—or else, there goes the money. Through this scheme, economists agree, the MSA established a naked cartel to limit output, raise prices, and allocate market shares.[28]

Six-plus years after its enactment, the MSA still stands as the most innovative and dramatic example of AG activism:

- The MSA demonstrated the viability of establishing national tax and regulatory scheme through state-by-state litigation and mutual state agreement.

- The MSA established a symbiotic relation between state AGs and the trial bar. The first state tobacco suit was brought by Mississippi in 1994, at the suggestion (and later with the assistance) of Dickie Scruggs, a prominent trial lawyer. Other states soon followed suit, typically retaining resourceful plaintiffs' firms for the purpose. Those firms reaped billions of dollars, often for very little work.[29] The Texas AG cut a plaintiffs' lawyer in on the tobacco litigation in exchange for a six-figure side payment, earning the official time in jail.[30] Other AGs have obtained their rewards in the form of campaign contributions, which are legal.[31] The lawyers' fees were also channeled back into judicial elections and litigation campaigns against other disfavored industries, such as HMOs and pharmaceutical industries.

- The MSA taught the AGs how to make state legislatures dance to their fiddle. When state legislators were asked to enact implementing legislation, their AGs had already surrendered purportedly valuable legal claims against tobacco manufacturers. Hence, state legislatures had to enact MSA model statutes, warts and all—or else, leave the money on the table. Predictably, state legislators acquiesced. Legislatures and governors have since come to cherish AGs as hands-off revenue producers.

Pharmaceuticals

Contrary to post-MSA predictions that state AGs would next turn their attention to other deadly products (such as guns), the AGs instead turned on an industry that *saves* lives—pharmaceuticals. Multistate campaigns modeled on the MSA have been engineered by some of the same individuals who led the anti-tobacco campaign (see "Old Hands").

While AGs have attacked pharmaceutical firms for a variety of purported infractions (such as patent extensions under the 1984 Hatch-Waxman Act), their most aggressive campaign is directed at so-called "average wholesale prices" (AWP), which are used to calculate reimbursement rates under Medicaid and Medicare (Part B). In 2002, Nevada and Montana retained plaintiffs' firms to file suits against twenty-plus leading manufacturers. Alleging that the firms' average wholesale prices are higher than the actual transaction prices charged to doctors and pharmacists, the state suits seek relief for manufacturers' deception, fraud, racketeering, breach of contract, and Medicaid fraud, as well as punitive damages for the defendants' allegedly malicious and oppressive conduct. Some eighteen states have filed substantially identical cases against a widening circle of companies.[32]

In substance, the lawsuits seek redress for the producers' compliance with established—if not wholly sensible—federal policy. Federal and state regulators have known since at least 1967 that average wholesale prices do not represent transaction prices—and have decided to tolerate the spread in the interest of ensuring broad Medicare coverage. Doctors and pharmacists pocket the difference between the average wholesale price and the actual, lower transaction price. That system creates bad incentives: doctors stand to benefit from prescribing drugs with a high price spread, which in turn gives manufacturers a perverse incentive to quote a high average wholesale price. Still, Congress has deemed the practice essential to sustain providers' participation in the program. As recently as 1997, Congress rejected a Clinton administration proposal to reform average wholesale pricing. Unlike the MSA, the AWP litigation, however, has been aided and abetted by the federal government:

> While attempting (unsuccessfully, as mentioned) to reform AWP in Congress, the Clinton administration filed a criminal prosecution against TAP, a pharmaceutical joint venture, over the pricing and marketing of a drug called Lupron. The prosecution included credible allegations that TAP had sought to enhance Lupron sales and prescriptions by illegal means, such as financial kickbacks to doctors. Faced with financial ruin, the defendants settled for $800 million and something close to an admission that "inflated" average wholesale pricing itself amounts to fraud. The TAP settlement is Exhibit A in the pending state AWP cases.

Side Note 3

Old Hands

The National Association of Attorneys General, which helped engineer the MSA and, under its terms, functions as the nation's cigarette czar, is again playing a coordinating role in the pharmaceutical cases. The plaintiffs' groups in the AWP cases are represented by, among other firms, San Francisco's Lieff Cabraser, veterans of the tobacco wars. Nevada's and Montana's counsel includes Seattle's Hagens Berman, also of tobacco fame. William Novelli ran, in the days leading up to the MSA, a group called Campaign for Tobacco-Free Kids, which agitated for tobacco regulation through litigation. Novelli now serves as director of AARP, in which capacity he lends plaintiffs and financial organizational support to the litigation against the pharmaceutical industry.

MSA participants have learned valuable lessons. Chastened by a public relations debacle over exorbitant contingency fees in the tobacco litigation, trial lawyers have in the pharmaceutical cases accepted more modest fee-sharing arrangements. Some colorful and voracious tobacco lawyers—notably, Mississippi's Scruggs—have expressed interest in the pharmaceutical cases but have for now been sidelined. Advocacy groups too have learned. Novelli, for one, views the tobacco settlement as a sellout. While the MSA produced monopoly profits for tobacco firms and a revenue stream for the states, the ostensible purpose of reducing smoking was essentially forgotten. (Only a small fraction of the settlement proceeds has been put to that purpose.) Novelli's AARP has taken an active co-counsel role in the AWP litigation and insists that the lawsuits must be about "system change" rather than mere dollars.

Sources:

Russell Gold & Andrew Caffrey, *States Suing Drug Makers Spurn ex-Allies on Tobacco*, WALL ST. J., May 29, 2002, at B1.

Michael S. Greve, *States' Rights on Steroids*, FEDERALIST OUTLOOK NO. 14 (September/October 2002), *available at* http://aei.org/publications/pubID.14296/pub_detail.asp.

Financial Institutions: Faux GRAS

> *If the SEC had been pursuing this aggressively, then for me to have jumped in would have been wasteful and perhaps inappropriate. But there was a vacuum, [which] had to be filled in order to protect the small investor.*
>
> — Eliot Spitzer, New York attorney general[33]

State investigations and prosecutions have come to cover many sectors of the American financial economy—brokerage houses, investment banks, mutual funds, insurance brokers, and insurers. In each case, the intended effect has been the imposition of a politically determined business model on non-conforming industries.

In the Spring of 2002, General Spitzer announced an investigation of Merrill Lynch. Backed by an 80 year old state law, the Martin Act (*see* "Two of a Kind"), Spitzer's

office culled through e-mail exchanges among the firm's analysts and investment bankers, a few of which suggested that the analysts felt pressured to issue "buy" recommendations for the stocks of companies with which Merrill Lynch had a (purportedly undisclosed) investment banking relation. Within six weeks of announcing his investigation, Spitzer reached a $100 million settlement with Merrill Lynch. While admitting no wrongdoing, the firm paid that penalty in exchange for immunity from New York and all 50 states. Around half of the proceeds ($48 million) went to New York; the remainder was apportioned among other states and the North American Securities Administrators Association (NASAA). Merrill Lynch also agreed to sever analysts' compensation from investment banking operations; to create a new investment review committee and a monitor to ensure compliance with the agreement; and to increase disclosures of possible conflicts of interest.

Following the Merrill Lynch investigation and settlement, the NASAA formed a task force of state securities regulators, chaired by Spitzer, to coordinate the investigation of a dozen investment firms. In April 2003, the firms reached a settlement with the states, the NASAA, the SEC, NYSE and NASD. This so-called Global Research Analyst Settlement ("GRAS") provided for a $1.4 billion payment. A portion of the proceeds has gone to institutions engaged in investor education; another portion is dedicated to the funding of "independent research." The remainder, some $800 million, has gone to federal and state regulators, in roughly equal amounts. The settling firms also promised to separate brokerage from investment banking activities and to refrain from cutting favored clients in on initial public offerings.

Side Note 4

Two of a Kind: New York's Martin Act and Its AG

General Spitzer's enforcement of the Martin Act powerfully illustrates the dangers of coupling a loosely worded state law with broad, civil and especially criminal enforcement powers.

At the federal level, the SEC handles civil but not criminal cases, which are referred to the Department of Justice for prosecution. The principal reason for this arrangement is a fear that the SEC might abuse criminal penalties as leverage to obtain unwarranted fines or, worse yet, to regulate markets through prosecution rather than the administrative rulemaking process. For similar reasons, the great majority of states divide enforcement authority between securities regulators and attorneys general or district attorneys.

New York, in contrast, has entrusted the enforcement of securities laws to the AG and armed him with civil and criminal authority. The Martin Act enables the AG to open wide-ranging investigations whenever he is made aware of potential fraud relating to investment advice concerning stock transactions. "Fraud" under the Martin Act is far broader than under federal securities law: it requires no stock transaction, no intent to deceive, no investor reliance, and no showing of damages to anybody.

The devastating force of the Martin Act lies not only in the breadth of its substantive provisions but also in their conjunction with the statutory enforcement provisions. The act authorizes the AG to obtain so-called "Section 354" orders for a "public investigation" and *ex parte* injunctions against the defendant. These powers, too, greatly exceed the SEC's: SEC investigations are generally private so as to avoid prejudice against the target company.

When General Spitzer obtained a Section 354 order and injunction against Merrill Lynch, accompanied by a dramatic press release, he was told by defense attorneys and by the SEC—which had not been previously informed—that the order would compel Merrill Lynch to shut down much of its business, with devastating consequences. Spitzer hastily agreed to a stay of the injunction, but much of the damage had been done: within a week, Merrill Lynch lost $5 billion in market capitalization.

Spitzer's office has called the Martin Act an all-purpose "Swiss army knife" and "one of the broadest anti-fraud statutes ever devised, at least in a democratic society." A prominent New York defense attorney has called it "the legal equivalent of a weapon of mass destruction."

Sources:

Maureen Fan, *N.Y. Attorney General Takes Lead in Cleaning Up Wall Street*, SAN JOSE MERCURY NEWS, November 11, 2002, *at* http://www.philly.com/mld/philly/business/4492502.htm?template=contentModules/printstory.jsp&1c.

Roberta S. Karmel, *Government Lawyering: Creating Law at the Securities and Exchange Commission: the Lawyer as Prosecutor*, 61 LAW & CONTEMP. PROBS. 33 (1998).

Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFF., May/June 2004, *at* http://www.legalaffairs.org/issues/May-June-2004/feature_thompson_mayjun04.html.

Dennis Vacco, *Martin Act Martinet*, WALL ST. J., Apr. 12, 2004, at A18.

The initiatives against investment banks were followed by proceedings against mutual funds, principally for alleged violations of rules that bar certain trades in mutual fund assets. These investigations, too, produced substantial financial payments. The SEC responded to the state initiatives by issuing, in August 2004, new regulations on the governance structure and management of mutual funds.[34] If sustained against a pending court challenge by the U.S. Chamber of Commerce, the rules would force a reorganization of over 80 percent of all mutual funds.

In 2004, Spitzer and other state regulators turned their attention to insurance brokers and the insurance companies with which the brokers do business. Confronted with Spitzer's criminal indictment, Marsh & McLennan (the leading insurance broker) vowed to discontinue the practice of so-called "contingent commissions," which accounted for the bulk of the company's brokerage revenues and profits. Other insurance brokers, as well as insurance companies, promptly followed suit. At Spitzer's insistence, Marsh & McLennan fired its CEO and replaced him with Michael Cherkasky, a large contributor to Spitzer's electoral campaigns and his former boss in the Manhattan district attorney's office.[35]

The financial investigations and prosecutions are noteworthy for several innovations:

- The investigations pursue nothing short of a wholesale reorganization of financial industries. The consistent theme is a purportedly undisclosed "conflict of interest," which has been said to afflict equity analysts in integrated financial firms, mutual fund advisors, and insurance brokers who are compensated through contingent commissions. The consistent objective is the replacement of market-

tested business models with a business model (and, in the Marsh & McLennan case, business management) that meets Eliot Spitzer's approval.

- The financial investigations have enhanced the cooperation between AGs and trial lawyers. While trial lawyers do not participate directly in the state cases, AG investigations serve to soften up the targets and to reduce the plaintiffs' bar's search and discovery costs. In the negotiations over the Merrill Lynch settlement, Spitzer insisted that the fruits of his investigation be made public so as to provide a basis for private suits.[36] A plaintiffs' attorney described the GRAS as "a road map for current litigation, so plaintiff's lawyers can verify that they haven't overlooked any useful items during discovery."[37] If not everything has gone according to that plan (*see* "Blind, Deaf, or Indifferent"), it is not for a lack of trying. It is due to the chasm that separates American securities law from the investment world according to Spitzer.

Side Note 5

Blind, Deaf, or Indifferent

To this day (for example, a National Press Club speech in February 2005, containing the quotes in this paragraph), Eliot Spitzer insists on his version of the 2000 market collapse: driven by undisclosed conflicts of interest, Merrill Lynch and its ilk caused "tens of millions" of investors to lose money by investing in companies that the analysts knew to be worthless. "Perfidy" on that scale should require far more than Merrill Lynch's settlement payment of $100 million. Spitzer obtained that payment because *in terrorem* charges have settlement value. The fact is that there were no undisclosed conflict of interest, and there was no loss causation.

Spitzer's 2002 Merrill Lynch indictment was accompanied by a Report detailing the firm's alleged infractions. As intended, that report precipitated a flood of class action lawsuits, which were consolidated in the U.S. District Court for New York's Southern District. The court categorically dismissed the actions and, in so doing, minced no words (all page citations to *In re Merrill Lynch*, 273 F.Supp. 2d 351 (S.D.N.Y. 2003)):

> *Every complaint in this series of litigations claims it was inspired by the [AG] Report. But, nothing in that Report acknowledges, indeed it strangely omits, any reference to the overwhelming notoriety expressed before and during the bubble, of the balancing facts of business life in the investment community (not inconsistent with ordinary understanding and experience).* (382)

The opinion then cites and quotes, for a full five pages, newspaper and magazine articles over the four years predating the stock market collapse, which fully describe (and denounce) the investment firms' purportedly hidden conflicts of interests. It concludes:

> *Thus, well before the internet bubble burst in March and April 200, abundant material was in the public domain regarding the existence of widespread investment banking conflicts of interest and allegedly inflated buy ratings in Wall Street stock research, especially research related to new IPOs and technology companies. […] The plethora of public information would have required even a* blind, deaf or indifferent *investor to take notice of the purported alleged "fraud."* (388-89; emphasis the court's.)

General Spitzer has one thing right: the cause of the stock market bubble and collapse was greed. But it was not Merrill Lynch's:

> *The record clearly reveals that plaintiffs were among the high-risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance. Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino …*

Sources:

In re Merrill Lynch, 273 F.Supp. 2d 351 (S.D.N.Y. 2003)

Transcript for *Luncheon with Eliot Spitzer*, NATIONAL PRESS CLUB, Jan. 31, 2005.

III. Consequences

AG activism is driven by extraterritoriality. Suppose securities law operated on the principle of corporate law: the contracting parties choose their state, to the exclusion of any other state. If investors value Spitzerian business models, they will choose to do business with New York brokers. (The firms' willingness to subject themselves to New York's jurisdiction would operate as a "Good Housekeeping" seal of approval.) If they do not, they will flock elsewhere, and so will the brokers. But that healthy competition for sensible regulation can occur only so long as Eliot Spitzer cannot trawl after the departing firms and their customers. Under existing rules, he can. This explains why brokers continue to operate in Lower Manhattan: they have no exit. Nor do their customers.

The extraterritorial "no exit" regime has profound economic and political consequences. None of them are conducive to sensible policy, consumer interests, or the efficient operation of economic markets.

Re-Regulation

While Reagan-era deregulation never advanced much beyond antitrust and transportation industries, it left a legacy in the form of enhanced attention to the economic costs, as well as the benefits, of government regulation. That legacy has combined with broader, structural forces to impede rash and counterproductive federal regulation: the intense conflict at the national level among a wide range of interests; an increased awareness of the potentially adverse effects of U.S. regulation on the international competitiveness of the American economy; and the persistent reality of closely divided government. *AG activism and regulation under NAAG's auspices circumvent and eviscerate all those constraints and inhibitions.*

- NAAG settlements limit interest group participation to an industry operating under the threat of indictment, trial lawyers, and an occasional "public interest" interloper. This restriction on the range of conflict facilitates regulation. The MSA, for a conspicuous example, failed in Congress largely because of opposition from affected interest groups, from public health advocates to farmers. The NAAG produced agreement by sidelining those interests.[38]

  Political scientists call this policy style—constitutive of many European economies, such as Germany—"corporatism": politically designated interests (in Europe, capital and unions, here, industries and trial lawyers) meet with the government behind closed doors to hammer out a deal. All the parties emerge as winners. Everyone else loses, but the costs are spread wide enough to go unnoticed—until, as has happened in Germany, the economy stalls under the aggregate weight of successive deals.

- The NAAG regulatory "process" is uninformed by even a guesstimate of costs and benefits, let alone a serious analysis. When lawsuits drive the imposition of comprehensive regulatory regimes, lawyers, not economists or policy experts, are in charge. Compliance, not efficiency, is the lodestar. Settlement incentives, not

an informed analysis of regulatory options, dictate the outcome. Such a process yields sensible policies only by pure coincidence.

- NAAG regulation attracts parochial interest groups to parochial regulators. AGs are not and *cannot* be held responsible, individually or collectively, for the adverse consequences of their regulatory and litigation initiatives. Suppose that citizens and consumers in Oklahoma are unhappy with the result of a regulatory regime—in the form of a multistate settlement—that was set in motion by the attorney general of Connecticut or California: what are they going to do about it? Whom are they going to throw out of office?

- While partisan division exists at the AG level as well as in Washington, it yields very different results. Iowa AG Tom Miller, the Eliot Spitzer of the Midwest, has stated the reason: "Even five to 10 AGs, if they have the resources and drive, can go ahead if they have a good case."[39] He could have added that the remaining AGs, whose constituents will bear a portion of the costs of any multistate settlement regardless of whether or not their state participates, have no viable choice but to join the campaign.[40] Federal legislation must conform to the inconvenience of democratic, constitutional government—the requirement of an actual majority. The NAAG process has a radically different calculus of consent: something close to unanimity is required to *stop* a regulatory project launched by a few AGs.

The lack of checks on AG-sponsored government by indictment has begun to induce a breakdown of federal discipline. The most comprehensive congressional intervention in economic markets over the past decade, the Sarbanes-Oxley Act of 2002, is a direct result of federal legislators' eagerness to demonstrate that they, no less than the AGs, are "serious" about corporate misconduct. A perceived necessity to out-demagogue rival decisionmakers is not a recipe for sound policy.

AG activism induces such conduct not only in elected officials but also in administrative agencies. Notably the SEC, eager to get a step ahead of Eliot Spitzer and to avoid the appearance of a "toothless," "captured" agency, appears to have concluded that economic analysis is superfluous at best and a hindrance at worst. In the aftermath of the Spitzer-led campaigns against investment banks and mutual funds, the SEC promulgated governance and disclosure regulations without serious analysis and without a shred of evidence that the regulations would do more good than harm.[41] In considering a (since imposed) requirement that fund boards must be chaired by an independent director rather than by the fund advisor, the only empirical evidence before the SEC showed that funds chaired by supposedly conflict-ridden advisors actually *outperform* independently chaired funds. The SEC chairman dismissed that evidence on the grounds that "there are no empirical studies that are worth much. You can do anything you want with numbers."[42] From that observation, the SEC concluded that it can do anything it wants *without* numbers. If imitation is the sincerest from of flattery, General Spitzer has reason to gloat.

Industry Cartelization

Under some circumstances, liability defendants can use legal settlements for purposes of industry cartelization.[43] AG investigations and indictments pose an extreme risk of such conduct.

Overwhelmingly, the AGs' targets—tobacco, integrated investment firms, pharmaceutical firms, insurance brokers—exhibit a high degree of market concentration. The AGs' aim to reform entire industries is most easily achieved when the industry can be assembled in a large conference room. Industry, for its part, will seek to pass the costs of any settlement (fines as well as regulatory compliance costs) on to its customers, meaning that any settlement must neutralize the pricing advantage that non-settling competitors might enjoy. These designs match the AGs' incentives. Eliot Spitzer has no desire to ruin the financial industry: what he wants is a series of protectorates, run by compliant CEOs.

The MSA, as noted, embodies these imperatives by compelling offsetting "escrow payments" for non-participating firms. But the protective barriers may also take more subtle forms, such as implicit protections against private litigation for firms inside the cartel umbrella, or the infliction of compliance costs that are bearable for the big, settling firms but not for their smaller competitors (*see* "A Big Fat Settlement?").

To be sure, the cartel threat can be overstated. Cartel arrangements often produce disappointing results. The MSA has failed to protect the participating manufacturers from private class actions, including a $10 billion judgment in Madison County. (Attorneys general supplied an *amicus* brief on behalf of the defendants in that case, but the MSA signatories were hoping for somewhat more muscular AG protection.) Non-participating manufacturers have garnered well over ten percent of market share and put the brand manufacturers under acute pricing pressure. Depending on future developments, other industries may come to view the MSA as a specter rather than a model.[44] Still, for industries that are dying a death by a thousand regulatory cuts, the prospect of operating as a public utility under the AGs' tutelage may seem terribly tempting.

Side Note 6

A Big Fat Settlement?

The specter of comprehensive obesity regulation—a bad joke only a few years ago, but now a distinct possibility—illustrates how a credible threat of regulation may, in an era of False Federalism, induce preemptive industry attempts to cartelize under an AG umbrella.

Once an industry becomes convinced that regulation is coming, it will pursue a cost-minimizing deal. Congress is an unlikely forum for that initiative. First, a multitude of rival and competing interests makes it very hard to control the legislative agenda and to strike an acceptable bargain. Second, federal legislation would likely fail to preempt actions by plaintiffs' lawyers and by state AGs under state law. By comparison, the NAAG process is more tractable and predictable, and the AGs can deliver, if not finality, then at least some measure of protection against plaintiffs' lawyers and additional regulation.

Regulation by multistate lawsuit may offer advantages especially for the market leaders who are bound to be the AGs' principal targets. For example, a settlement mandating (along with the obligatory financial payment) increased disclosure of truthful nutritional information will favor large chains, relative to smaller competitors. A company that can make a burger in Moscow, Idaho taste precisely the same as a burger in Moscow, Russia can also standardize carbs and calories across sales location. Five guys with fifty outlets may neither have nor even want that luxury. (Their market niche is that their product is *not* standardized.) Those smaller market participants would pay the price of an industry-wide settlement either in the form of disproportionate compliance costs or disproportionate litigation exposure. For the major producers, this cartelization effect would offset some of the settlement costs.

Corporations owe their shareholders a duty to minimize regulatory impacts. The AGs' False Federalism compels them to do so under an institutional regime that systematically mobilizes industry incentives to cartelize.

The Plaintiffs' Bar and the AGs

Over the past decade, the plaintiffs' bar has emerged as an entrepreneurial, highly sophisticated litigation industry and as a cohesive, stupendously resourceful political force. AG activism is inextricably linked with that development.

With the lone exception of asbestos litigation, the 1998 MSA generated the single largest cash infusion into the plaintiffs' bar. The sums are far too large to dissipate into Gulfstreams, yachts, and Jaguars. They are largely devoted to two uses: venture capital for litigation campaigns against other industries and the purchase of state judges, legislators—and attorneys general. Many AGs are themselves former members of the plaintiffs' bar, and most count trial lawyers among their largest contributors. For the plaintiffs' bar, those investments promise handsome returns.

The incestuous relation between the trial bar and the AGs is not a healthy development. It amounts to an institutionalized form of the liability explosion, which will prove substantially harder to check than the plaintiffs' bar's unassisted exploits.

Giving Money Away

> *The reason I did not seek to get a restitution fund was that we don't have the capacity to distribute it. There would be 50,000 people calling within ten minutes, saying, 'I want my money back.'*
>
> — Eliot Spitzer, New York attorney general, commenting on the Merrill Lynch settlement[45]

Multistate settlements often provide for payments in the form of penalties rather than restitution for allegedly harmed consumers or investors. While the AGs argue that distribution of the proceeds is sometimes precluded by state law and, moreover, administratively cumbersome, they have failed to provide restitution even where it is feasible. As noted, the GRAS provides for roughly equal payments ($400 million each) to the states and to the SEC. The SEC, under judicial supervision and with the assistance of

an outside expert, has established a compensation formula for the distribution of the federal payment. States could easily piggyback on that mechanism, but none have chosen to do so, preferring instead to collect and retain their share in the form of penalties.[46]

The difficulties of restitution pale against the systemic risks of alternative, "public" uses of settlement proceeds. Allowing the AG's office to retain settlement proceeds perversely incentivizes AGs to turn their offices into self-financing operations. Reversion of the funds to the general state treasury diminishes that risk—but commensurately increases the risk that the legislature will come to look to the AG as a general-purpose revenue producer. (See IV. below.) Either way, AGs slip the reins of legislative oversight and budgetary control that serve as vital safeguards against prosecutorial abuse.

Many settlements dedicate proceeds to unnamed third parties, especially non-profit organizations. The money may go to service providers who work on the "issues" or infractions that produced an investigation or settlement.[47] Very often, settlement funds are designated for the "education" of investors (some $80 million under the GRAS alone), homeowners, smokers, car owners, and countless other constituencies. The ostensible premise is that perceived abuses were due at least in part to a lack of consumer information, but there is rarely evidence that this is true. (*See* "Blind, Deaf or Indifferent," *supra* p. 21). No attempt is made to assess whether the funded educational activities have the slightest effect on consumer behavior or industry practices. Many institutional recipients of AG largesse have no intention to enhance consumer autonomy; their stated mission is to build public "awareness" of abuses that demand further government action. The AGs stand ready to provide that action.

The connecting theme, and the only ascertainable effect of payments to third parties, is the accumulation of IOUs in the AGs' hands. Such private constituency-building on the public's nickel is troublesome even when it does not take the form, as sometimes it has, of overt self-dealing (*see* "AG Grantmaking").

Side Note 7

AG Grantmaking: Let a Thousand Sunflowers Bloom

In the late 1990s, Blue Cross/Blue Shield plans in a number of states converted from non-profit to for-profit status. State plans merged, became stock-issuing companies, or were acquired by larger for-profit health insurance companies. As non-profits, the Blues had received favorable tax treatment, which probably accounted for some portion of the companies' assets. The proposed transfer of those assets into private hands, it was argued, would entail an unwarranted windfall. To preclude that result, many state AGs and insurance commissions reached settlements with the Blues, whereby the Blues would endow a non-profit foundation to "promote" health care for the states' citizens.

Former Kansas AG Carla Stovall persuaded Blue Cross and Blue Shield of Kansas to create the Sunflower Foundation, endowed with $75 million from the Blues. The Foundation is governed by a nine-person board. The Blues appoint one member; the AG, the remaining eight. Stovall also appointed a nine-member Community Advisory Committee to make nominations for future board vacancies. From these nominations, board members will be selected by…the attorney general.

Since its inception, Sunflower's assets have risen to $85 million, and the foundation has given out around $5 million in grants. Its stated focus is on "access to health care," with a particular emphasis on prescription drugs, "capacity building" for non-profits, and obesity. Not coincidentally, prescription drugs and obesity top the priority list of non-profit advocates and plaintiffs' lawyers.

One state has noticed that the appropriation of funds recovered on behalf of the state is a legislative prerogative. Mississippi's 1997 settlement with the major tobacco manufacturers provided that a large portion of the proceeds ($20 million of the most recent annual payment of $116 million) be paid to the Partnership for a Healthy Mississippi, a private anti-smoking organization. The Partnership promotes public health by, among other activities, publishing paid advertisement congratulating Mike Moore on receiving a public health award from Harvard University. Mr. Moore is the attorney general who negotiated the settlement. Now in private law practice, he is the chairman of the Partnership for a Healthy Mississippi. The state has sued the Partnership to seize control of the funds on the grounds that the Mississippi Constitution invests the legislature with exclusive spending authority. Mr. Moore has called the suit "frivolous."

Sources:

John Fuquay, *Medicaid to Seize $20M From Anti-Smoke Group*, JACKSON CLARION-LEDGER, Feb. 11, 2005, at 1A.

$75 Million BCBS Settlement to Fund New Kansas Foundation, INSURANCE J., Aug. 23, 2000, *available at* http://www.insurancejournal.com/news/south/2000/08/23/11793.htm

http://www.sunflowerfoundation.org

IV. Madison's Constitution, Upside-Down

> *"There's no political fix."*
>
> — Tom Miller, Iowa attorney general, commenting on corporate America's options in arresting coordinated AG campaigns[48]

AG Miller may well be right: there is no political fix for AG activism, at least no easy one. But that is not something an elected official in the United States should crow about. Our constitutional system is designed to provide avenues for "fixes"—more precisely, veto points to the unbridled exercise of governmental power. "In the compound republic of America," Madison famously wrote in *Federalist Paper* No. 51, "the power surrendered by the people, is first divided between two distinct governments [federal and state], and then the portion allotted to each subdivided among distinct and separate departments. Hence a double security arises to the rights of the people. The different governments will control each other; at the same time that each will be controlled by itself." The lack of a "fix" illustrates that Madison's double security has collapsed with respect to state AGs. At the state level, the separation of powers is on its last legs. Congress and the federal Executive, for their part, lack the means of constraining state AGs, and the federal judiciary is AWOL. In short, state AGs operate without any effective control.

The Cardinal's Virtues

> *Mr. Spitzer probably has done more to stabilize the state's finances in the last few years than any other elected official. By refusing to look the other way as C.E.O.'s and financial institutions ripped off New Yorkers, he helped bail out the state during a difficult financial crisis.*
>
> —*New York Observer*, "Eliot Spitzer: Two Billion Dollar Man" (unsigned editorial, May 26, 2004).

State attorneys general have emerged as the Cardinal Richilieus of American politics.[49] They have found out a way to raise revenue without the inconvenience of an elected legislature (and to spend it without the equally noisome technicality of legislative appropriations). Unlike the clever cardinal, moreover, whose scheme had the ultimately fatal flaw of taxing subjects under France's own jurisdiction, the state AGs have designed the still-cleverer scheme of taxing the citizens of *other* states. The MSA is the purest but, as noted, not the only example of that strategy.

The AGs' boasts about "enforcing the law" when no one else will are demagogic nonsense. The full enforcement of *any* law, from speed limits to environmental regulations, would shut the country down in an instant. The dangers of excessive enforcement and prosecutorial abuse are particularly acute under the vaguely worded laws (such as New York's Martin Act) that are the AGs' stock in trade. The most effective means of guarding against those risks is the budgetary process, which subjects

the enforcers to legislative scrutiny and, moreover, checks their zeal by constraining their resources.[50] These controls, however, are on the verge of collapse. Contrary to time-honored principles of representative government, which presume legislative control over taxing and spending decisions, the AGs' ability to obtain lucrative settlements under open-ended laws means that they send money the legislature's way, rather than the other way around. When offered a free ride, legislators will take it. The political branches have failed to rein in AGs in large measure because they can no longer afford to do so.

Alternative means of control have likewise been disabled. Since the AGs' *in terrorem* charges are usually settled at a safe distance from any courthouse, judicial supervision is no antidote. Nor do electoral constraints answer to the task. We do not normally grant public officials a dispensation from constitutional constraints merely because they were elected. As James Madison memorably put the point, "an *elective despotism* was not the government we fought for."[51] Moreover, to the considerable extent that AG activism rests on exploiting citizens and businesses in other states, rational voters will often find it to their advantage to elect zealous AGs—if only because a failure to do so amounts to a kind of unilateral disarmament against the zealous AGs of other states.[52]

Among the States

AG activism exports regulatory costs to other states. But why don't those other states resist the imposition? Why have notoriously ornery states—and AGs with widely differing viewpoints, interests, and ambitions—managed to exhibit such an exceptional level of cooperation and unanimity?

Part of the answer is that there are fifty states, rather than two. When one state chooses to regulate for its own benefit and to the detriment of all others, each state will bear only a fraction of the losses. In other words, the benefits are concentrated, while the costs are dispersed.

Another part of the answer is that the benefits of exploitation are far more visible than the costs. The *New York Observer* has celebrated General Spitzer's two-year, $2 billion "take" as a valuable contribution to solving the state's fiscal crisis. The $2 billion were paid by corporations—in other words, by workers, shareholders, and consumers. If those people all live in New York, they treated themselves to a tax hike by their AG (rather than the legislature they elected for the purpose of determining tax policy). More probably, productive citizens in Washington, California, and elsewhere paid a large chunk. But one will not read that in the *Seattle Times* or the *Sacramento Bee*. Those papers paraphrase and print *their* AGs' press releases, touting the AGs' contributions to their own states' fiscal solvency.[53]

The fiscal illusion reflects the insidious dynamic of AG activism. The shell game of mutual exploitation in the guise of multistate settlements leaves all citizens worse off. (We cannot become wealthier by expropriating one another.) But the game leaves all state AGs *better* off—much better off than under a set of rules that, like the Constitution we once had, forbids the reach across state borders.

A symmetry of incentives has produced a bargain among state AGs: you let me exploit your citizens and businesses, and I shall grant the like privilege to you. The MSA, whereunder the AGs imposed a quarter-trillion tax on each other's consumers, makes that bargain explicit. But it is implicit in every multistate settlement, and it accounts for the otherwise inexplicable degree of consensus and cooperation among the AGs.[54] The NAAG is the institutional face of the arrangement. It facilitates the bargains, distributes the proceeds, and monitors the parties' performance. In other words, it organizes mutual exploitation.

The Pathology of Preemption

The Supremacy Clause of the Constitution provides that "the Laws of the United States" shall be "the supreme Law of the Land," "any Thing in Constitution or Laws of any State to the Contrary notwithstanding." This clause is commonly viewed as the source of Congress's power to "preempt" state laws, provided that the enactment of the preemptive law falls within the enumerated powers of Congress. To the very considerable extent that the AGs' activities interfere with interstate commerce and inflict costs on sister-states, Congress could plainly preempt them. The power, however, has proven difficult to exercise and, moreover, often ineffective.

AG government by indictment will always move faster than Congress. Attorneys general are more mobile than a fractious legislature, and the 'process' they have invented reduces the range of interest group conflict to two or three constituencies. Congress, in contrast, is slow and cumbersome. The multiplicity of interests, coupled with institutional hurdles (such as bicameralism and the presidential veto), perennially confront legislators with the painful recognition that high transaction costs can ruin a good day. The Founders wanted it that way because a good day for legislators and their interest group clientele is usually a bad day for the rest of us. Institutional obstacles may prevent a few beneficial measures, but "the injury which may possibly be done by defeating a few good laws, will be amply compensated by the advantage of preventing a number of bad ones."[55]

The great difficulty with this ingenious solution is that it fails when the situation calls for prompt, decisive federal action. In that event, the obstacles to legislative action, so advantageous in the ordinary course of events, turn into huge liabilities. For Madison, who saw this difficulty most clearly, the paradigm of that situation was the prospect of rapacious state legislation.[56] In a long letter to Thomas Jefferson after the close of the Convention, Madison bitterly complained that the delegates had left the union nearly defenseless against divisive and exploitative state laws. True: the Constitution empowers Congress, within the limits of its powers, to enact "prohibitory legislation," or what we now call preemption. More clearly than his contemporaries, however, Madison realized that states have every incentive and opportunity to evade, eviscerate, and circumvent federal strictures.[57]

The federal courts of the nineteenth century gradually fashioned rules, inferred from the constitutional structure, to keep state power within its proper sphere *without* resort to

federal legislative action. (The dormant Commerce Clause is the best-known example.) One and all, those rules reflected Madison's recognition that federalism requires a constitutional limit on what states may do to one another. The political branches, by their very design, are ill-equipped to provide that check.

A few decades after the New Deal liberated the states from constitutional constraints, the political weakness at the center became transparent. Congress can bribe the states into compliance, as it has done in conditioning the receipt of federal funds on the observance of federal anti-discrimination laws. Congress can temporarily out-regulate the states, as it did in the 1970s. Forcible preemption, however, will always be partial and haphazard. Increasingly, the states and especially the AGs have come to recognize that reality. From merely circumventing federal law, they have moved to asserting a kind of joint preemption in reverse (*see* "Preemption in Reverse").

Side Note 8

Preemption in Reverse

In June 2002, when Eliot Spitzer's campaign against investment banks hit its zenith, industry leaders descended upon Washington, imploring Congress and the SEC to preempt Mr. Spitzer and to prevent the impending "balkanization" of the securities markets. Instead of the desired preemption, the CEOs received federal laws and regulations on top of those contemplated by Spitzer and his fellow attorneys generals—but without preemptive force. Section 501 of the Sarbanes-Oxley Act of 2002 commands the SEC to issue regulations governing not only the internal organization of integrated financial service firms—the principal subject of Spitzer's Merrill Lynch settlement—but also additional matters, such as analyst disclosures in public appearances. With respect to the settlement issues, the SEC subsequently pronounced its intent to promulgate rules that are "at least as strict" as those agreed on between the states and the investment banks.

Matters did not rest there. In 2003, out of increasing concerns to protect federal prerogatives in regulating the financial markets, the House of Representatives considered the so-called Baker amendment to federal securities laws, which would have sharply preempted state regulators' powers and, moreover, provided that penalties obtained by the states for securities laws violation would be payable to the SEC for distribution through a victims' benefit fund. In a shrill June 10, 2003 press release urging Congress to drop the proposal, General Spitzer denounced the amendment as "particularly outrageous" and as "an attack on the 75 percent of Americans who own stock."

It was when and because Congress failed to heed that warning with sufficient promptness that Spitzer moved against mutual funds. Spitzer's insistence that he is forced to fill a vacuum left by captured federal regulators rings particularly hollow here: mutual fund practices had been under active SEC investigation for well over a year. In launching a preemptive state investigation, Spitzer chiefly sought to teach federal legislators and regulators that he could make them look bad on any given day.

The "Back Off" message hit home. A revised version of the Baker amendment, which died with the 108th Congress, would have authorized (rather than compelled) states to contribute penalty payments to an SEC-administered restitution fund. And instead of preempting the states, the revised amendment would have directed the SEC "to seek to produce a joint study with representatives of State governments concerning improved coordination, cooperation and communication between the SEC and State securities regulators."

Sources and References:

Kathleen Day, *SEC Rules to Target Analysts, Officials Say*, WASH. POST, September 10, 2002, at E2.

John W. Schoen, *SEC Knew About Dicey Fund Pricing, at* http://msnbc.msn.com/id/3072548/.

Judicial Abdication

AG activism, to repeat, is a legacy of the New Deal, which empowered states to legislate, regulate, and adjudicate on an extraterritorial basis. The contemporary Supreme Court has no inclination to revisit that constitutional revolution. With the lone exception of Justice Clarence Thomas, the justices view the New Deal as a done deal. That being the judicial predisposition, constitutional limitations will remain unenforced.

To illustrate the dismaying extent of this judicial abdication and its intimate connection to unhampered AG activism, consider the MSA. The Compact Clause of the Constitution says that "*No* State shall, without the Consent of the Congress, … enter into *any* Agreement or Compact with another State." The MSA is plainly an agreement among states: it bears the AGs' signatures, and it conditions the payment of tobacco funds on the states' performance of specific duties. Equally plainly, the MSA never received the consent of the Congress; in fact, it was hammered out after Congress had *rejected* a very similar proposal.[58] Even so, some federal courts have sustained the MSA against Compact Clause challenges, largely on the basis of a 1978 Supreme Court decision that, read for all it is worth, seems to hold that *no* state agreement shall require the consent of the Congress.[59]

At the root of this wholesale perversion of the constitutional text lies a facile identification of federalism with "states' rights"—put differently, the false belief that anything the states may wish to do is *ipso facto* "federalism." While the Rehnquist Court has, within limits, attempted to rehabilitate federalism, its exclusive focus has been to re-empower states against national intrusions into local affairs. The justices have shown no recognition that state intrusion into national affairs—and into each other's affairs—is also a federalism problem, and a far more urgent one.

The rehabilitation of serious constitutionalism—of a constitutional rather than a False Federalism—is not a hopeless proposition. Well-chosen, properly argued lawsuits may help to advance that objective; one suggestion is briefly described below. It is, however, a long-term proposition. There is ample reason to consider additional reform measures.

V. Reform: Five Not-So-Easy Pieces

The analysis of this White Paper suggests two conclusions. The first, blazingly obvious, conclusion is that no individual industry, let alone an individual firm, can on its own mount effective resistance to enterprising AGs. Industries that already operate under the AGs' tutelage exalt Eliot Spitzer as their master and savior. Industries that have been or will soon be investigated are trying to survive and, if given a chance, cut themselves a deal. Industries that have so far managed to stay off the AGs' radar screens keep mum for fear of attracting attention and retribution. Effective resistance, then, can only materialize under a very broad corporate umbrella, which in turn requires an antecedent recognition that the benefits of concerted, common action far exceed the near-term, parochial benefits of cutting separate deals with the AGs. United business action make take many forms—broad-based reforms that would curb the AGs' powers across the board; electoral support for AG aspirants with an appreciation of a competitive economy; support for nonprofit advocacy groups or for an individual firm or industry that by happenstance finds itself able and willing to fight the AGs. Far more important than the precise form of action is the recognition that corporations must hang together or hang separately—and the resolve to act on that recognition.

Second, the constitutional dimension of AG activism may seem to suggest that nothing much can be done about the problem. Since another constitutional transformation lies beyond anyone's reasonable time horizon, adaptation and crisis management seem the best part of wisdom. Between feckless, ad-hoc responses and revolutionary illusions, however, one can identify pragmatic and meaningful reforms. This chapter sketches five options.

1. Restore Real Federalism

The most elegant, effective, and principled reforms would substitute real federalism for the AGs' False Federalism. Under securities law, commercial transactions are governed by the laws of the customer's home state (unless they are preempted by federal law). It is that choice-of-law rule that permits General Spitzer to operate as a national securities tsar: no one can escape his jurisdiction. Under corporate law, in contrast, shareholders and companies choose the state law that will govern their mutual transactions, to the exclusion of any other legal regime. This corporate or "Delaware" model provides a splendid model of competitive federalism, which could be fruitfully applied in a wide range of areas.

Yale professor Roberta Romano, one of the nation's leading authorities on corporate and securities transactions, has proposed to extend the corporate law regime to securities law, especially disclosure and accompanying anti-fraud provisions.[60] Corporations would for securities' purposes designate an exclusive state law regime (or, under Romano's proposal, the law of the SEC). Investors will favor corporations that choose an efficient state law regime. Corporations that make that choice will command a premium in the stock market. Over time, corporations will gravitate toward states whose laws maximize

shareholder value. The most efficient state law will dominate, just as Delaware dominates corporate law.

Proposals along these lines would restore state competition and regulatory good sense to fields that are now driven by indictments, settlement incentives, and indifference to real-world consequences. General Spitzer has claimed credit for restoring financial integrity, investor confidence, and indeed the recovery of the stock market.[61] These lofty claims are purely conjectural: the only *known* consequence of Spitzer's indictments is the large-scale destruction of shareholder equity. A competitive Delaware regime would put Spitzer's claims to the test.

Due in no small part to AG activism, the recent trend has been toward centralization, either through multistate settlements or federal legislation. Most regrettably, the 2002 Sarbanes-Oxley Act imperils competitive federalism even in its core domain of corporate law.[62] Moments of threat, however, are also moments of opportunity. Sarbanes-Oxley will have to be re-opened in any event. On that occasion, a well-developed proposal to extend the competitive federalism model might prompt a more open and educated debate about consumer protection, federalism, and AG activism.

2. Undo the MSA

The MSA stands to this day as the AGs' most expensive and corrupt achievement. Undoing this devilish bargain through well-targeted lawsuits would reverberate far beyond tobacco regulation. It would undermine the MSA's value as a model for AG activism, erode the AGs' claims to legitimacy, and give tempted (and beleaguered) industries second thoughts about the wisdom of locking themselves into the AGs' cartels. The passage of time since the MSA's enactment is an argument for, not against, a serious legal challenge, as it would tend to demonstrate that no closure can be had on bargains of this sort.[63]

While legal challenges to the MSA have so far remained unsuccessful, none of the adverse decisions preclude more muscular attacks. Compelling legal arguments are not hard to come by. One line of attack is antitrust law. The MSA's naked output restrictions are criminal under federal law. As a panel of the federal Second Circuit Court of Appeals has intimated, had the tobacco producers and their lawyers contrived the arrangement on their own, they would all be in jail.[64] The only plausible defense of the MSA is that it constitutes a "state action" that is immune from antitrust review—and even that putative defense rests on an extremely shaky foundation.[65]

Another potent challenge arises under the Constitution—specifically, the aforementioned Compact Clause, which categorically forbids state agreements without congressional consent.[66] If the MSA does not require congressional consent, *no* conceivable state agreement will ever require it. When presented with a forthright, well-argued challenge, the courts will be hard pressed to accept the conclusion that the Compact Clause means the opposite of what it says.

3. A Federal Compact Clause Enforcement Act

As noted, the MSA is merely an unusually explicit agreement among state AGs. In substance, *all* multistate settlements effect such an agreement—for example, on the distribution of settlement proceeds and the cessation of further enforcement actions.

The creation of national regulatory regimes, often in derogation of the regimes established by Congress and federal agencies, is not a suitable role for the states, nor one adumbrated by the Constitution. To curb the NAAG's operation as an ersatz Congress, the actual Congress could provide that no multistate settlement shall go into effect without the prior approval of the Congress or of a federal administrative agency to which Congress may delegate that power.

The AGs would denounce such a proposal as an egregious interference in the states' affairs, but that absurd protest has ready answers. First, multistate settlements directly regulate interstate commerce, a power that the Constitution grants to the Congress rather than the states. Second, the Compact Clause explicitly requires congressional approval for *any* multistate agreement. That plenary language entails, among other things, that it is up to Congress (rather than the courts, let alone the AGs) to decide what does and does not constitute a state "agreement" for constitutional purposes.

A "Federal Compact Clause Enforcement Act" need not be particularly specific; it could simply replicate the language of the constitutional provision and define its range of application. Alternatively, Congress could grant general, *ex ante* approval of multistate settlements so long as financial payments (other than restitution) are made to the U.S. Treasury or to the SEC, rather than states or third parties.[67] The original version of the aforementioned Baker Amendment contained commendable language to this effect. The details warrant careful thought, without distracting from the broader purpose of restoring a semblance of constitutional order.

4. Abolish State Antitrust Enforcement

Prompted by the *Microsoft* antitrust litigation, where states held out for additional "remedies" even after the federal government had decided to settle the case, Judge Richard Posner and others have argued that we should revoke the antitrust enforcement authority of state attorneys general.[68] That call should be heeded. While state antitrust practice may be less problematic than the enforcement of loosely worded consumer protection statutes, *Microsoft* shows that state antitrust enforcement has dangerous potential. And while state enforcement may not do much harm in the general run of cases, no one has found it to do much good, either.

Congress should eliminate state antitrust enforcement because it can. The crux of the problem is the AGs' *parens patriae* authority to sue on their citizens' behalf. With respect to the enforcement of state law, that authority is conferred by state constitutions or statutes, which Congress can neither amend nor preempt. The AGs' authority to enforce *federal* antitrust law, in contrast, is conferred by the federal Hart-Scott-Rodino

Act of 1976. That was a mistake, which a more levelheaded Congress should hasten to undo.

5. Split the States

As described earlier, AG cooperation and unanimity are often more apparent than real. When Messrs. Spitzer et al. launch an initiative, dissident AGs who view that initiative and its prospective outcome as bad politics or bad economics have no effective means of resistance. The deal will go forward with or without them, and non-acquiescence has no consequence except a loss of settlement proceeds for the dissident state. Opinion leaders might not look quite so kindly on AG activism, and judges might be less inclined to confuse the AGs' False Federalism with the real thing, if this exploitative logic were clearly exposed.

One possible vehicle is a particularly creative pending lawsuit by several states, led by New York, against several owner-operators of coal-fired power plants.[69] The gist of the complaint is that the companies' CO_2 emissions contribute to global warming, a "public nuisance" from which the plaintiff-states claim to suffer (along with the rest of the planet). Virtually all of the offending plants are located in non-suing states, whose citizens would be compelled to bear most of the costs of the suing states' desired abatement remedies.

In an ideal world, the affected states would respond to the CO_2 lawsuit by countersuing a New York company that inflicts a public nuisance. Barring that unlikely response, the states should be encouraged to intervene in the pending case. The suing states will attribute any setback in their imaginative lawsuit to global corporations and their GOP henchmen. It would be most useful if the opposition were carried by forces that are beyond such suspicions—New York's sister states.

It is harder to envision a *systemic* remedy for the logic of mutual exploitation that drives AG activism. Perhaps, though, AGs of states that consistently find themselves at the receiving end of initiatives launched by more enterprising AGs could agree among each other that none of them shall initiate a multistate proceeding, or join a request to join such, unless a supermajority of dissident states (say, two-thirds) approve that step. (The Republican Attorneys General Association might provide a forum and platform for such an agreement.) Such a supermajoritarian requirement would create a potent holdout against multistate settlements and, at a minimum, enhance the dissenters' bargaining power vis-à-vis the lead states in distributing the proceeds.[70] More optimistically, credible opposition by a significant number of states may prompt a more balanced discussion of the costs and benefits of hastily and incestuously crafted regulatory "solutions."

Admittedly, it is not easy to see why AGs should bind themselves in this fashion. The obvious difficulties that attend to the proposal, though, merely suggest the urgency of identifying effective means of counteracting the pernicious logic of AG "cooperation."

VI. Conclusion

> *Among the most formidable of the obstacles which the new constitution will have to encounter, may readily be distinguished the obvious interest of a certain class of men in every state to resist all the changes which may hazard a diminution of the power, emolument and consequence of the offices they hold under the state establishments … and the perverted ambition of another class of men, who will either hope to aggrandize themselves by the confusions of their country, or will flatter themselves with fairer prospects of elevation from the subdivision of the empire into several partial confederacies, than from its union under one government.*
>
> —Alexander Hamilton, *Federalist Papers* No. 1.

The great Hamilton did not know Eliot Spitzer, but he knew the type. Listen to the AGs' hysterical protests against the most modest attempts to preempt extraterritorial exercises of state authority: does not Hamilton's prediction that state officials will "resist" the Constitution sound quaintly understated? Consider the befuddled response—by Congress, by the courts, by corporate interests, by legal scholars—to the AGs' states' rights cant: can one doubt that the AGs have already "aggrandized themselves by the confusions of their country"? And what are the various multistate settlements and investigations, from the MSA to General Spitzer's ad-hoc global warming coalition, but so many single-purpose "partial confederacies."

For the foreseeable future, state AGs will continue to serve as the favored access point for regulatory enthusiasms. Their doors are always open for business of this sort, and they confront no serious institutional obstacles. A return to the constitutional order, if it is to occur at all, will require the patient work of a generation, not merely a few well-funded lawsuits or lobbying campaigns. It will require a hard-nosed recognition that the AGs, like the state demagogues of Hamilton's days, cannot be appeased; they have to be confronted. That confrontation ought to proceed from a candid, clear-eyed appreciation of what AG activism is and what it is not.

AG activism is *not* a legitimate response to the perceived failure of the federal regulatory system. The claimed power to determine when the federal system has failed is the power to run the system. Nobody gave the AGs that power; they have arrogated it.

AG activism is *not* a sensible response to the perceived failure of federal regulation. A good case can be made that federal regulatory policies, from energy to telecommunications to financial services, are indeed in need of much repair. But the needed reforms would provide a healthy dose of political and economic competition. AG activism systematically works toward the opposite result.

AG activism is *not* "devolution" or decentralization. It is rather a formally decentralized process that systematically yields uniform, centralizing policies, of a kind that the central

political institutions themselves have declined to adopt. To state that empirical observation is to recognize the system's absurdity.

Above all, AG activism is *not* federalism either in spirit or in execution. To quote Hamilton once more, it is a "symptom of the spirit which must either be killed, or it will kill the Constitution of the United States."[71]

[1] General Eliot Spitzer, Remarks given as part of Planned Parenthood of New York City's "Toward a More Civilized Society" lecture series (April 3, 2003), *at* http://www.ppnyc.org/facts/facts/spitzer.html.

[2] For a recent, particularly demagogic example see REDEFINING FEDERALISM: LISTENING TO THE STATES IN SHAPING "OUR" FEDERALISM (Douglas T. Kendall, ed., 2004). For the AGs' own federalism proclamations, see the excerpted quotes throughout this paper and, *e.g.*, Joshua Chaffin & Gary Silverman, *A Truce on Wall Street: Settlement at Last on Conflicts of Interest*, FINANCIAL TIMES, Dec. 11, 2002, at 21.

[3] Walter E. Dellinger III, Testimony before the United States Senate Committee on the Judiciary (Jul. 31, 2002), *at* http://www.judiciary.senate.gov/testimony.cfm?id=338&wit_id=793.

[4] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., diss.) (emph. added).

[5] Far from denying this observation, state AGs boast about their national ambitions. *See, e.g.*, New York Attorney General Spitzer's press releases, *at* http://www.oag.state.ny.us/press/agpress05.html.

[6] *See, e.g.*, Andrew Guzman, *Public Choice and International Regulatory Competition*, 90 GEO. L.J. 883 (2002).

[7] Quoted in Alan Greenblatt, *The Avengers General*, GOVERNING, May 2003, at 52.

[8] The unquestioned champion of AG activism, New York Attorney General Eliot Spitzer, has acknowledged that more energetic federal action would merely re-direct, rather than curb, entrepreneurial state AGs. If the Securities and Exchange Commission (SEC) acted in conformity with his (Spitzer's) notion of sound regulation, Spitzer acknowledged in commenting on his campaigns against financial institutions, he would "find something else to do. It's a big country." Andy Serwer, *Wall Street Story*, FORTUNE, July 8, 2002, at 28.

[9] See the Conclusion below.

[10] United States v. Cruikshank, 92 U.S. 542, 550 (1875).

[11] The usual citation is to *Cooley v. Board of Wardens*, 53 U.S. 299 (1851).

[12] *See, e.g.*, Hammer v. Dagenhart, 247 U.S. 251 (1918) and A. L. A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

[13] *See, e.g.*, Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the Race to the Bottom Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992).

[14] NLRB v. Jones & Laughlin Steel Corp, 301 U.S. 1 (1937); United States v. Darby, 312 U.S. 100 (1941); and Wickard v. Filburn, 317 U.S. 111 (1942).

[15] The best account of this grossly underestimated shift is Stephen Gardbaum, *New Deal Constitutionalism and the Unshackling of the States*, 64 U. CHI. L. REV. 483 (1997).

[16] *See* Camps Newfound v. Harrison, 520 U.S. 564 (1997) and, most recently, Granholm v. Heald, 544 U.S. ___ (2005). In addition, the dormant Commerce Clause continues to prohibit the direct state regulation of conduct in other states (*see* Healy v. Beer Institute, 491 U.S. 324 (1989)) and state taxes and regulations that impose an excessive burden on interstate commerce (*see* Pike v. Bruce Church, 397 U.S. 137 (1970) and Quill Corp. v. North Dakota, 504 U.S. 298 (1992)). (These latter restrictions, however, are extremely weak.)

[17] 317 U.S. 341 (1943).

[18] Q*uoted in* Steven Andersen, *The Rise of State Attorneys General*, CORP. LEGAL TIMES, Aug. 2003, at 1.

[19] The powers of state attorneys general vary somewhat from state to state, depending on state constitutions and statutes. In many states, attorneys general also draft and promote legislative proposals, assist district attorneys in the investigation and prosecution of serious crimes, administer certain types of state expenditures (such as contracting and state bonding), and disseminate information on legal issues confronting the state. For an overview *see* National Association of Attorneys General, *Duties of Your Attorney General*, *at* http://www.naag.org/ag/duties.php.

[20] For a fine account of the changes see Cornell W. Clayton, *Law Politics and the New Federalism: State Attorneys General as National Policy Makers*, 56 REV. POL. 525, 528 (1994).

[21] Morales v. Trans World Airlines, Inc., 504 U.S. 374 (1992).

[22] *See* Patricia A. Conners, *Current Trends and Issues in State Antitrust Enforcement*, 16 LOY. CONSUMER L. REV 37 (2003).

[23] For a description and analysis of the states' litigation and *amicus* positions see Stephen Calkins, *Perspectives on State and Federal Antitrust Enforcement*, 53 DUKE L.J. 673 (2003); and Michael DeBow, *State Antitrust Enforcement: Empirical Evidence and a Modest Reform Proposal*, *in* COMPETITION LAWS IN CONFLICT (Richard A. Epstein & Michael S. Greve, eds., 2004).

[24] Richard A. Posner, *Federalism and the Enforcement of Antitrust Laws by State Attorneys General*, *in* COMPETITION LAWS IN CONFLICT 252 (Richard A. Epstein & Michael S. Greve, eds., 2004); Posner, *Antitrust in the New Economy*, 68 ANTITRUST L.J. 925 (2001).

[25] Memorandum of 24 States as *Amici Curiae* in Support of the Commonwealth of Massachusetts et al, *New York v. Microsoft*, 224 F. Supp. 2d 76 (D.D.C. 2002) (No. 98-1233) (alleging state authority to proceed under *parens patriae* even after the federal government has agreed to settle); Memorandum *Amicus Curiae* of the United States (finding "no definitive case law" requiring dismissal of the state claims). For a possible explanation of the federal government's peculiar acquiescence see Michael S. Greve, *Cartel Federalism? Antitrust Enforcement by State Attorneys General*, 72 U. CHI. L. REV. 99 (2004).

[26] Freedom Holdings v. Spitzer, 357 F.3d 205, 226 (2nd Cir. 2004).

[27] The best of many accounts of the MSA's genesis is MARTHA DERTHICK, UP IN SMOKE (2002) . For a thorough analysis of the MSA's economic structure and effects see W. KIP VISCUSI, SMOKE-FILLED ROOMS: A POSTMORTEM ON THE TOBACCO DEAL 33–59 (2002).

[28] In addition to VISCUSI, see Jeremy Bulow & Paul Klemperer, *The Tobacco Deal*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 323, 324 (1998); Hanoch Dagan & James J. White, *Governments, Citizens, and Injurious Industries*, 75 N.Y.U. L. REV. 354, 425 (2000); and Christopher Schroeder, *The Multistate Settlement Agreement and the Problem of Social Regulation Beyond the Power of State Government*, 31 SETON HALL L. REV. 612, 613–14 (2001).

[29] VISCUSI, *supra* note 27, at 4.

[30] Janet Elliot, *Morales Ordered to Prison; Former Attorney General Gets 4 Years for Scheme*, HOUS. CHRON., Nov. 1, 2003, at A29.

[31] Ralph Thomas & Andrew Garber, *Out-of-State Donors Feed Gregoire Fund*, SEATTLE TIMES, Oct. 28, 2004, *at* http://seattletimes.nwsource.com/html/localnews/2002074950_gregoire28m.html.

[32] John Chase & Bruce Japsen, *Illinois Targets 48 Drug Firms*, CHI. TRIB., Feb. 8, 2005, at C1.

[33] *Quoted in* Serwer, *supra* note 8, at 28–29.

[34] Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings; Final Rule, 69 Fed. Reg. 22,299–22,317 (April 23, 2004) (to be codified at 17 C.F.R. pt. 239 and 17 C.F.R. pt. 274).

[35] Leonard Orland, *A New CEO—Or Else*, NAT'L L. J., Nov. 8, 2004, at 27. Following that announcement, General Spitzer, who had earlier proclaimed his intention to prosecute the case to the hilt, indicated his willingness to bargain. The case settled in January 2005 for a payment of $850 million, an abject apology, and certain commitments with respect to compensation policies and their disclosure. Terence Neilan, *Marsh to Pay $850 Million to Settle Charges by Spitzer*, N.Y. TIMES, Jan. 31, 2005, at C1.

[36] John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER Apr. 7, 2003, at 62.

[37] Matt Kelly, *Wall St. Settlement: Sifting for Evidence among e-mails*, NAT'L L. JOURNAL, May 5, 2003, at A11.

[38] David S. Samford, *Cutting Deals in Smoke-Free Rooms: A Case Study in Public Choice Analysis*, 87 KY. L.J. 845 (1999).

[39] Quoted in Greenblatt, *supra* note 7, at 52 .

[40] William Pryor [then-Attorney General, Alabama], *Actions and Multigovernment Lawsuits*, 74 TUL. L. REV. 1885, 1911 (2000) (explaining that he had no choice but to sign the MSA because Alabama consumers would in any event fund a portion of the settlement). *See also infra* p. 24.

[41] *See* Peter J. Wallison, *Shooting from the Hip: The SEC Has Stopped Doing Its Homework*, FINANCIAL SERVICES OUTLOOK (October 2004).

[42] SEC Open Meeting, June 23, 2004, C.R.I., Tr. 4, at 57–58, audio available at http://www.sec.gov/news/openmeetings.shtml.

[43] Ian Ayres, *Using Tort Settlements to Cartelize*, 34 VAL. U. L. REV. 595 (2000).

[44] Moreover, the cartel impulse may not prevail across the board. Declining industries—such as tobacco production for the U.S. market—are prone to capturing scarcity rents and to overcharging their customers one last time (before they walk out the door). Hopefully, other beleaguered industries—such as pharmaceuticals—do not put themselves in the same league.

[45] Serwer, *supra* note 8, at 29.

[46] More dramatically, the state tobacco lawsuits gained momentum only when and because the states had figured out a way to couch the claims in such a way as to preclude restitution for harmed smokers. DERTHICK, *supra* note 27, at 75.

[47] For example, a portion of the proceeds against an international vitamin cartel wound up in the pockets of organizations that fight malnutrition, bad nutrition, and obesity. *Groups Get Money from Vitamin Suit*, THE DAILY STAR, Mar. 21, 2002, *at* http://www.thedailystar.com/news/stories/2002/03/21/vita.html (expenditure of settlement funds on "meals for poor people, pre-natal care programs, nutritional cooking workshops and research on mastitis in dairy cows"); *Foodbank Awarded $525,000 in Vitamin Settlement*, IDAHO FOODBYTES, June 2003, *at* http://www.idahofoodbank.org/Monthly%20Newsletter/news-june03.htm.

[48] Greenblatt, *supra* note 7, at 52 (quoting Iowa Attorney General Tom Miller).

[49] Armand Jean du Plessis, better known as Cardinal Richilieu (1585–1642), was the mastermind of French absolutism. He rendered that regime practicable by figuring out a way to raise revenue for the crown without having to rely on the legislature. When Richilieu's system hit its limits (such as peasant revolts) and the E*tats-Generaux* had to be convened, this eventually prompted the French Revolution.

[50] The classic exposition is James Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975).

[51] THE FEDERALIST NO. 48, at 258 (James Madison) (Liberty Fund, 2001).

[52] Aspirants to the AG's office have long learned the lesson. Largely regardless of party affiliation, they campaign on a platform of "tough consumer protection." Louis Jacobson, *Out There (Part 2)*, ROLL CALL, Nov. 22, 2004, at 13.

[53] *See, e.g., Gregoire for Governor in Democratic Primary*, SEATTLE TIMES Sept. 5, 2004, at D2.

[54] DERTHICK, *supra* note 27, at 72. For an application to the antitrust context see Greve, *Cartel Federalism*.

[55] THE FEDERALIST NO. 73, at 382 (Alexander Hamilton) (Liberty Fund, 2001).

[56] See the terrific discussion by Larry D. Kramer, *Madison's Audience*, 112 HARV. L. REV. 611 (1999).

[57] Letter from James Madison to Thomas Jefferson (Oct. 24, 1787), *in* JAMES MADISON: WRITINGS, at 146 (Jack N. Rakove, ed., Library of America 1999).

[58] *See* DERTHICK, *supra* note 27, at 163–181.

[59] Star Scientific v. Beales, 278 F.3d 339 (4th Cir. 2002), *cert. denied*, 537 U.S. 818 (2002); based on U.S. Steel Corp. v. Multistate Tax Commission, 434 U.S. 452 (1978).

[60] Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359 (1998); ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002).

[61] *See, e.g.*, Transcript for *Interview with Eliot Spitzer Pt. 1*, NEIL CAVUTO, Fox News Network, no. 021501cb.140, Feb. 15, 2005.

[62] *See, e.g.,* Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U. J. L. & POL'Y 1 (2003) (then-Chief Justice of the Supreme Court of Delaware expressing grave concerns over excessive federal preemption of state corporate law under the Sarbanes-Oxley Act).

[63] By some accounts, the MSA monster is bleeding at all ends. *See* Roger Parloff, *Is the $200 Billion Tobacco Deal Going Up in Smoke?* FORTUNE, MAR. 7, 2005, at 11.

[64] Freedom Holdings v. Spitzer, 357 F.3d 205, 226 (2nd Cir. 2004) (quoted *supra* p.14).

[65] Id. at 235.

[66] As noted above, a confused (and erroneous) 1978 Supreme Court opinion appears to impede a successful Compact Clause challenge. But that case is easily distinguishable. For a thorough discussion see Michael S. Greve, *Compacts, Cartels, and Congressional Consent*, 68 MO. L. REV. 285 (2003).

[67] Ample precedent exists for such conditional *ex ante* approval. *See, e.g.*, Securities Exchange Act of June 6, 1934, codified at 4 U.S.C. § 112(a) (2000) (congressional *ex ante* consent to state "agreements or compacts for cooperative effort and mutual assistance in the prevention of crime"). *See also* Northeast Bancorp, Inc. v. Bd. Of Governors of Fed. Reserve Sys., 472 U.S. 159, 175–76 (1985).

[68] Richard Posner, *Enforcement by State Attorneys General, in* COMPETITION LAWS IN CONFLICT 252, 261 (Richard A. Epstein & Michael S. Greve, eds., 2004).

[69] State of Connecticut, et al., v. American Electric Power Co., et al., No. 04-05669 (S.D.N.Y., filed July 21, 2004).

[70] Economic theory predicts that collective action should often founder on disagreements over the distribution of the proceeds. Robert Cooter, *The Cost of Coase*, 11 J. LEG. STUD. 1 (1982). It is unclear why multistate settlements rarely encounter, let alone founder on, such disagreements. The most plausible explanation is that small states, acting individually, must take whatever the large lead states will grant them—or else, nothing.

[71] Hamilton is believed to have made the remark to John Jay, apropos the Virginia legislature's 1790 "Protest and Remonstrance" against the federal assumption of the war debts. Quoted in JOHN C. MILLER, THE FEDERALIST ERA, 1789-1801, at 52 (1960).

About the Author

Michael S. Greve is the John G. Searle Scholar at the American Enterprise Institute**,** where he directs AEI's Federalism Project and AEI's Liability Project. Mr. Greve has written extensively on the issues covered in this White Paper. His publications are available at http://federalismproject.org/publications/. Prior to his employment with AEI, Mr. Greve was the co-founder and director of the Center for Individual Rights, a public interest law firm. He is the chairman of the Competitive Enterprise Institute.