Comment [on "The Tobacco Deal" by Jeremy Bulow & Paul Klemperer]. in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 395 (1998).

Comment

Comment by Ian Ayres: Bulow and Klemperer have written an empirically rich and insightful economic analysis of the various state and federal tobacco deals. In this comment, I analyze whether the settlements between four individual states (Florida, Minnesota, Mississippi, and Texas) and the four major cigarette manufacturers are illegal. This question is important, because if the settlements are legal, they represent an important innovation in the ability of states to "race to the bottom" as cartel ringleaders.

It has been understood that anticompetitive settlements can be produced when competitors sue each other in intellectual property or merger contexts.[1] And it has been understood that captured state agencies may cartelize in-state producers of a particular product.[2] But the individual state tobacco settlements suggest that a state may profitably cartelize out-of-state producers. Bulow and Klemperer show how the state settlements represent a deal that allows cigarette manufacturers to coordinate charging higher prices and to transfer the ensuing profits to the states in exchange for reduced legal liability. The key, of course, is that the damages paid to each state are tied to prospective out-of-state sales. If the basic structure of these settlements is legal, states that have virtually no nexus with a set of industry producers—and in fact have not been injured by the industry—may nonetheless sue the industry and set up a mutually beneficial cartel.

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1. Brodley (1995); Simms (1982).
2. *Parker* v. *Brown*, 317 U.S. 341 (1943).

Imagine, for example, that the state of Alaska sues Archer-Daniels-Midland and other producers of lysine on the cockamamie theory that lysine production creates a particular type of acid rain that has harmed the citizens of Alaska. Imagine that before the suit lysine is selling at a competitive price of $100 a ton, and that at the monopoly price of $120 a ton, 100 million tons could be sold. Immediately following the suit, the parties enter into a settlement whereby Alaska will be paid damages of $20 a ton on all lysine in excess of 50 million tons produced nationally by the industry in any future year. This hypothetical lysine settlement would likely raise the price of lysine to the monopoly level and split the monopoly profits between the lysine producers and the settling state. If 100 million tons are demanded at a price of $120 a ton, then Alaska would earn "damages" of $1 billion (50 million x $20) and the lysine producers would earn $1 billion on the 50 million ton offset, or inframarginal, units. Before agreeing to settle Alaska's fallacious suit, the lysine producers may wait to see if some other state would be willing to cartelize their industry for a smaller fee. In short, a race to the bottom may develop.

As Bulow and Klemperer emphasize, the November 1998 multistate agreement incorporated the essential aspects of this hypothetical agreement. Damages of 35 cents a pack were based on prospective national sales, but for small companies a certain percentage of sales was exempt. Of course, for any state settlement to be effective, it must be true that new entrants do not compete down the "settled" price, but it is possible for the state to sue the most likely potential entrants to reduce this problem. Moreover, the November 1998 multistate agreement shows that states can provide powerful carrots and sticks to discourage entry. If such shenanigans do not violate federal law, we're in a lot of trouble. Individual states may be tempted to cartelize private industries under the guise of settling sham litigation. Unfortunately, the extremely tentative thesis of this comment is that the state cigarette settlements in particular, and the sham litigation in general, are not clearly illegal.

Before diving into the legal analysis, however, let me mention in passing two issues concerning Bulow and Klemperer's analysis of the federal initiatives (the tobacco resolution and ensuing proposed federal legislation). First, with regard to youth smoking, Bulow and Kemperer argue:

> Restrictions on where tobacco can be sold and increases in the minimum legal age would make more sense than look-backs as youth smoking measures.

> Given the bill's hand-tying marketing restrictions on the companies, the incentives for reducing underage smoking should be directed at state governments, who would be responsible for the efficacy of antismoking programs and would have the police power to enforce rules against the illegal sale and consumption of cigarettes.

This analysis forgets that there is very little that the state can do that the cigarette manufacturers cannot do themselves. The marketing restrictions do not prevent manufacturers from disseminating efficacious antismoking programs, restricting where tobacco can be sold, or increasing the minimum age to whom their retailers can contractually sell. The authors are right to point to the police power of the state as a potential difference in the relative arsenal of manufacturers and states. But manufacturers can contract for substantial financial penalties and might even contract with individual states to help criminally enforce certain restrictions. Bulow and Klemperer show that the proposed look-back penalties are likely to be counterproductive. But properly structured penalties might do a better job of inducing manufacturers to curtail youth smoking.

Second, the authors' analysis takes the manufacturers' participation constraint largely as a given. Their last paragraph declares that the "companies can be bargained into accepting higher taxes and marketing bans and paying some money. They cannot be bargained into bankruptcy." It seems to me, however, that federal and state lawmakers can take actions to change both the manufacturers' best alternative to a negotiated settlement and their ability to hold out for a higher return. As an extreme example, manufacturers' bargaining power might be reduced if directors were held personally liable for dissipating company assets through time-consuming litigation if it is later found that debt claims substantially exceed equity. Bulow and Klemperer's overarching thesis seems to be directed at opponents of tobacco and in a sense advises these forces not to ask for an unreasonably large amount. But one might as easily tell manufacturers not to offer too little. The authors may have ignored an additional "political" constraint that the tobacco companies must be portrayed as having paid a substantial penalty for their malfeasance. Bulow and Klemperer argue that tax increases dominate lump-sum penalties, but the lump-sum payments may be necessary to fulfill this additional retributive constraint. It is difficult to model retribution and to trade it off against the other legislative interests (such as reducing smoking). It is understandable that the authors treat the retributive im-

pulse as relatively plastic. Taking retribution into account, however, makes me less sanguine about the possibility for a prospective deal.[3]

The remainder of this comment assesses three different reasons why the state settlements—and more generally the ploy of basing settlement payments on the prospective quantities of cigarettes sold nationally—might be unenforceable. For convenience I will refer to these rationales, respectively, as the nonlegislated taxation, extraterritorial taxation, and cartelization theories.

Nonlegislated Taxation

In their conference draft, Bulow and Klemperer argued: "First and foremost, taxes are a matter for a legislature to decide, not a matter to be settled between the executive branch and industry." This is not the "foremost" reason why the legality of the settlements should be questioned. For one thing, the power of taxation is a matter of state constitutional law, and a state could repeal a constitutional restriction (if it currently has one) requiring the legislature to impose all taxes, or the legislature (or the legislature's delegate) might be willing to enter into the same type of settlement to transfer money from other states' citizens to its own fisc.

There is also the important question of whether this settlement constitutes a tax or a fee. Even though there is some basis at the federal level for thinking that taxes are a matter solely for the legislature, courts have narrowly defined what constitutes a "tax." It is simply not the case that all payments to government are taxes (which must grow out of legislative action). For example, in upholding the Federal Communication Commission's collection of cable fees, the Supreme Court in 1974 had this to say about the difference between taxes and fees:

> Taxation is a legislative function, and Congress, which is the sole organ for levying taxes, may act arbitrarily and disregard benefits bestowed by the Government on a taxpayer and go solely on ability to pay, based on property or income. A fee, however, is incident to a voluntary act, e. g., a request that a public agency permit an applicant to practice law or medicine or construct a house or run a broadcast station. The public agency performing those services normally may exact a fee for a grant which, presumably, bestows a benefit on the applicant, not shared by other members of society.[4]

3. Other implicit constraints in their analysis that might thwart effective dealmaking concern the equitable sourcing and use of the government funds, such as the authors' concern that lawyers and Liggett should not unduly profit from any settlement.

The legislative action requirement is probably an attempt to ensure a broad-based political check against unwanted taxes, but a voluntary payment in exchange for a benefit is not a tax because the consent of the payer substitutes for the political check. Similarly, the fact that the tobacco companies consented to the state settlements may be considered by the courts as a substitute for the legislative-political check.[5]

Extraterritorial Taxation

The U.S. Supreme Court defined the extraterritoriality principle succinctly and unanimously in *Bonaparte v. Tax Court* (1881): "No State can legislate except with reference to its own jurisdictions."[6] The more majestic language of Chief Justice John Marshall in *McCulloch v. Maryland* (1819) is also apposite:

> It is admitted that the power of taxing the people and their property is essential to the very existence of government, and may be legitimately exercised on the objects to which it is applicable, to the utmost extent to which the government may chuse to carry it. The only security against the abuse of this power, is found in the structure of the government itself. In imposing a tax the legislature acts upon its constituents. This is in general a sufficient security against erroneous and oppressive taxation. . . . Would the people of any one State trust those of another with a power to control the most insignificant operations of their State government? We know they would not.[7]

The specific prohibition against states taxing activities that occur outside their jurisdiction is now normally said to be an implicit requirement of the Fourteenth Amendment's due process clause.[8]

4. *National Cable Television Association v. United States,* 415 U.S. 336, 341 (1974). The Supreme Court has also upheld judicially imposed taxes to fund school desegregation remedies; see *Missouri v. Jenkins,* 495 U.S. 33 (1990).

5. Of course, if the incidence of the settlement will largely fall on consumers, the question arises whether the companies' consent is sufficient.

6. 104 U.S. 592 (1881). In that case, the Supreme Court rejected the claim that a state issuing bonds could—because of the full faith and credit clause—exempt those bonds from the taxation of other states where the bondholders lived.

7. 17 U.S. 316, 368 (1819).

8. This prohibition on extraterritorial taxation actually predates the passage of the Fourteenth Amendment; see *Hays v. Pacific Mail Steamship Co.,* 58 U.S. (17 How.) 596, 599–600

In 1940, the Supreme Court articulated the basic standard for determining whether a tax was "extraterritorial," that is, whether it violated the due process clause:

> [The] test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.[9]

As one scholar has noted:

> This rather amorphous standard has been found to have two components. First, "no tax may be imposed unless there is some minimal connection between [the activities generating the income] and the taxing State." Second, "the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State.'"[10]

Under these standards, the settling states would argue that they have given something in return to the cigarette manufacturers—to wit, limitations on tort liability. Opponents of the settlement would argue, however, that the cigarette revenue attributed to the state for tax purposes was not rationally related to values connected with the taxing state. Florida has an interest in its in-state cigarette sales, but basing the settlement amount on cigarettes manufactured and sold outside the state is arguably not rationally related to Florida's interest. This argument becomes all the stronger in my lysine hypothetical, where the state is suing not to redress any actual harm but instead to organize an industrial cartel.

Although it is clearly true that an explicit attempt of the Florida legislature to impose a two cent per pack national excise tax would be unconstitutional, it is equally true that not every corporate settlement payment to a state that may have the effect of raising the ultimate price of the corporation's products is unconstitutional. One can easily imagine, for example, a scenario where Exxon's payments to the state of Alaska for the *Valdez* oil spill could have caused Exxon to increase its gasoline prices.[11] As an initial matter, the question of extraterritorial taxation only arises if one characterizes the settlement payments as a tax. While these payments have many of the economic features of taxes, Bulow and Klemperer's own analysis highlights some crucial differences in legal consequences. For example, the settlement liability may not survive bankruptcy of the current manufacturers in the same way that tax liabilities would (both in the sense of special priorities for tax liabilities and in the sense that subsequent purchasers of their assets might not be subject to the same liability). Moreover, the settlements only bind those manufacturers who consent.[12] As earlier mentioned, this is not the consent of those who have to bear the primary incidence of the "tax." But even without the consent of out-of-state consumers, the consent limitation means that Liggett and future entrants would not be liable to pay the prospective per-pack damages. Competition from nonconsenting manufacturers at least might mitigate the externality. Traditional excise taxes do not allow this competitive reaction from uncovered firms. Of course, the November 1998 multistate agreement also shows how states can try to dampen just such competitive reaction by rewarding entrants that join in the agreement and punishing those entrants that do not join.

If the issue ever reached a competent court, the most compelling reason why the settlement might be struck down concerns its explicit attempt to regulate extraterritorial behavior. Exxon's *Valdez* settlement may have indirect effects on out-of-state transaction prices, but the settlement did not explicitly change the marginal out-of-state cost of transacting in the same way the state cigarette settlements do. The Supreme Court, in *Brown-Forman Distillers Corp. v. New York State Liquor Authority,* showed an

(1854). The extraterritoriality principle also at times raises dormant commerce clause and full faith and credit clause issues; see Regan (1987a, b). The state cigarette settlements do not raise dormant commerce clause issues because they do not "favor local businesses over out-of-state businesses"; see *Pike v. Bruce Church, Inc.,* 397 U.S. 137 (1970).

9. *Wisconsin v. J. C. Penney Co.,* 311 U.S. 435, 444 (1940).

10. Goldstein (1991).

11. Although lump-sum payments are often sunk and do not affect the marginal prospective cost, one can imagine circumstances where lump-sum payments would increase a corporation's marginal cost of capital and possibly its product price. Indeed, Cramton, Everel, and Williams (1998) have shown that rivals for FCC wireless communication licenses tried to raise each other's sunk costs possibly to affect their ability to compete in the downstream consumer market.

12. The Supreme Court has considered whether a corporation's consent by choosing to do business in a state is sufficient to constitute what otherwise would be an unconstitutional extraterritorial tax. In *Western Union Telegraph Co. v. Kansas ex rel. Coleman,* 216 U.S. 1, 34–38 (1910), the Court held that a state had no power to condition the right to do local business on the payment of an extraterritorial tax. Justice Holmes dissented, arguing that the company had made a voluntary agreement.

antipathy to at least one type of explicit extraterritorial regulation.[13] *Brown-Forman* concerned the constitutionality of New York's "affirmation law," which required distillers that sold to wholesalers in New York to file monthly price schedules for their products and to affirm that they would not sell liquor at a lower price to any wholesaler anywhere else in the country during this period. Distillers who violated this affirmation could have their license to sell liquor in New York revoked. The Supreme Court struck down this explicit attempt to regulate out-of-state prices—even though the regulation did not discriminate against out-of-state trade and was not easily characterized as a tax—because of the direct and explicit nature of the attempt to affect extraterritorial transactions.

Although this extraterritorial due process challenge is the strongest grounds for attacking the state settlements, grave procedural barriers may preclude competent litigants from bringing suit before a competent tribunal. Who has standing to complain about the violation? It is far from clear that a cigarette smoker would be allowed to intervene to raise the claim. And because state courts are often thought to join the other branches of state government in competitive federalism races, one should not put great faith in state tribunals being able to make a disinterested determination of either this standing question or the underlying substantive issue.[14] Yet it is hard to conceive how such issues would make their way to a federal court with a less self-interested incentive to review the claim. It should not be surprising that (to my knowledge) no court has to date been presented with this substantive issue.

Cartelization

An alternative to the previous "tax" characterization is to attack the state settlements as attempts by the state to help cartelize the cigarette industry. Under this interpretation, the state settlements would be seen as agreements among the cigarette manufacturers and the individual states whereby the manufacturers would agree to raise prices and give the increased profits to the state in return for reduced tort liability. Or under the more extreme lysine hypothetical, the state would be helping industries raise prices, and

13. 476 U.S. 573 (1986).
14. Ayres (1992).

the increased profits would then be split between the manufacturers and the state (by means of the offset amount).

The problem with this theory is that "state action" is broadly immunized from Sherman Act antitrust scrutiny. Congress could prohibit anticompetitive state regulations, but the Supreme Court has held that Congress did not intend the Sherman Act to "preempt" even anticompetitive state action. Bulow and Klemperer recognized that a "state action" doctrine would allow a state to enter into a settlement that raised the in-state price of cigarettes just as it "allows cities and taxi owners to fix fares without running foul of the federal antitrust laws," but they do not seem to recognize that this doctrine also allows states to orchestrate higher prices that predominantly fall on out-of-state consumers. For example, in the mother of all state action cases, *Parker v. Brown,* the Supreme Court refused to strike down a California statute that created a commission to set prices and restrict output among California raisin growers.[15] Just like the Mississippi tobacco settlement, the California raisin regulations tend to raise the price on in-state and out-of-state consumers. The fact that the vast majority of consumers affected by the statute would be out-of-state does not affect the legality of the state's action.

Indeed, the prevailing standard for determining whether otherwise anticompetitive conduct is immune under the state action doctrine is the two-prong *Midcal* test, which requires that the challenged restraint must be "clearly articulated and affirmatively expressed as state policy" and "actively supervised" by the state.[16] These requirements, however, would do little to thwart either the cigarette settlements or the more pernicious lysine race-to-the-bottom. The settlements do more than merely give the cigarette manufacturers an opportunity to collude; they "clearly articulate" a mandated payment per pack.[17] And the states would actively supervise the collusion by, for example, auditing the yearly collection of the settlement

15. 317 U.S. 341 (1943).
16. *California Retail Dealers Assn. v. Midcal Aluminum,* 445 U.S. 97 (1980). See also *Southern Motor Carriers Rate Conference v. United States,* 471 U.S. 48 (1985).
17. This supervision requirement prevents the state from frustrating "'the national policy in favor of competition . . . by casting a gauzy cloak of state involvement over what is essentially a private price-fixing agreement.'" *324 Liquor Corp. v. Duffy,* 479 U.S. 335, 345 (1987).

amount.[18] The Supreme Court has emphasized that the active supervision requirement does not imply that the regulation must take the public interest into account:

> Our decisions make clear that the purpose of the active supervision inquiry is not to determine whether the State has some normative standard, such as efficiency, in its regulatory practices. Its purpose is to determine whether the State has exercised sufficient independent judgement and control so that the details of the rates or prices have been established as a product of deliberate state intervention, not simply by agreement among private parties.[19]

Courts will not inspect the purpose or effect of the regulation, only whether it is the true product of state action.

The single relevant exception to this broad doctrinal immunity concerns circumstances when the state itself is a "commercial participant" who colludes with other industry members. But the Supreme Court has recently emphasized that the "commercial participant" exception does not cover every potential state "conspiracy":

> There is no . . . conspiracy exception. The rationale of *Parker* was that, in light of our national commitment to federalism, the general language of the Sherman Act should not be interpreted to prohibit anticompetitive actions by the States in their governmental capacities as sovereign regulators. [T]his immunity[, however,] does not necessarily obtain where the State acts not in a regulatory capacity but as a commercial participant in a given market. That is evident from . . . *Union Pacific R. Co. v. United States,* 313 U.S. 450 (1941), which held unlawful . . . certain rebates and concessions made by Kansas City, Kansas, in its capacity as the owner and operator of a wholesale produce market that was integrated with railroad facilities. These sentences should not be read to suggest the general proposition that even governmental regulatory action may be deemed private—and therefore subject to antitrust liability—when it is taken pursuant to a conspiracy with private parties. The impracticality of such a principle is evident if, for purposes of the exception, "conspiracy" means nothing more than an agreement to impose the regulation in question. Since it is both inevitable and desirable that public officials often agree to do what one or another group of private citizens urges upon them, such an exception would virtually swallow up the *Parker* rule: All anticompetitive regulation would be vulnerable to a "conspiracy" charge.[20]

18. There is some question whether the state policy has to be articulated by a legislature; see *Hallie v. City of Eau Clair,* 471 U.S. 34, 63 (1985) and Wiley (1986). This raises an antitrust analog to the earlier issue of nonlegislative taxation. It may be that nonlegislative cartelization falls outside of the state action doctrine; however, state legislatures should have ample incentives to enter into the hypothetical lysine deal.

19. *FTC v. Ticor Title Insurance Co.,* 504 U.S. 621, 634–35 (1992). See also *New England Motor Rate Bureau, Inc. v. FTC,* 908 F.2d 1064, 1074 (1st Cir. 1990).

The only realistic hope of voiding the state settlements on antitrust grounds would lie in squeezing into the "commercial participant" exception. Clearly being an active conspirator is not enough. Although the state is not a participant in the manufacture of cigarettes, a court might be willing to find that the state participated in the market by claiming its share of the oligopoly profits. But, as with the extraterritorial taxation, substantial standing and jurisdictional barriers would need to be crossed before the substantive claim could be heard by a competent tribunal.

Conclusion

Bulow and Klemperer have done an admirable job in analyzing the pathologies of the various state and national tobacco deals. The individual state deals in particular represent a striking regulatory innovation that threatens to externalize beyond the consenting parties the majority of the costs of the deals. If such shenanigans are legal, they provide a blueprint for future mischief—a classic race to the bottom. Unfortunately, I have not uncovered a silver bullet that would be certain to kill the beast. The extraterritorial taxation effect *might* violate the due process clause, and a state's financial participation in cartel profits *might* run afoul of the Sherman Act, but it may be difficult for out-of-state consumers to pursue these claims in federal court (not subject to race-to-the-bottom pressure facing state tribunals).

Just because the state deals do not clearly violate current federal law, however, does not mean that they could not be made to. Congress should seriously think about prohibiting state settlements that condition payments on out-of-state behavior—or at least require stronger showings of out-of-state effects before allowing extraterritorial regulation.[21]

20. *City of Columbia v. Omni Outdoor Advertising, Inc.,* 499 U.S. 365, 374–75 (1991). See also Sullivan and Harrison (1998).

21. Unfortunately, the hypothetical lysine example was at least formally supported by Alaska's claim of an environmental externality (acid rain). Alaska under such a hypothetical federal statute would argue that payments conditioned on future lysine production were rationally related to the amount of prospective damage that would rain down.

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